ALLIANCE OF INDEPENDENT FIRMS

INTERNATIONAL COMPARISON

THIN CAPITALIZATION RULES

UPDATED INFORMATION
NOVEMBER 2011

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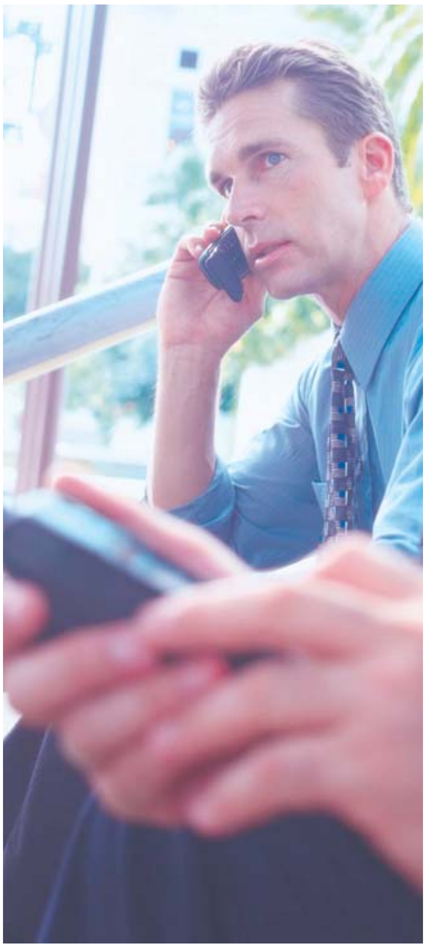
Austria

Conditions for them to apply	They apply on loans between related subjects, if debtor and/or creditor reside in Austria. There are no conditions written in law. All conditions result out of judicature. Following the court decissions these conditions have to be met: ✔ economically ediquate equity there is no condition determining the required percentage of equity ✔ comparable interest rate regarding loans between independent persons based on OECD Transfer Price Guidelines ✔ form of the loan agreement: written, common contract period, securities, special rights, etc. For example if the agreement does not include conditions regarding securties, the financial authorities won't accept the agreement even if the above mentioned conditions are met.
Consequences	The interest is not deductible in the income tax of the local debtor and, at the same time, is treated as dividends earned by the linked creditor. Depending on double tax treaties there will be withholding tax up to 25%
Liabilities reached	financial liabilities
Subjects excluded	none



Argentina

Conditions for them to apply	Apply on loans between related subjects, when the debtor resides in Argentina and the creditor in a foreign country. The creditor must reside in a foreign state, under an agreement to avoid double taxation signed with Argentina, the effective witholding rate income income tax on interest charged must be below 35% The amount of financial liability at the close of the fiscal year related to the foreign creditor must be above 200% of equity of the debtor company at the same date. The mentioned conditions should be given together.
Consequences	No income tax deductible in the local society debtor, the interest generated by the ratio of financial liabilities linked with foreign creditor in excess of the limit of 200% of equity.
Liabilities reached	**Example:** Interest expense linked with foreign creditors related in the accounting: U$S 15.000.- Financial liabilities linked to foreign creditors: U $ S 250,000 .- Equity local debtor Company: U $ S 90.000 .- Maximum limit of liability that generates interest deductible: U $ S 180,000 .- (2 X 90,000) Excess of financial liabilities: U $ S 70.000 .- (250000-180000) Share of surplus over the total financial liabilities (70.000/250.000) = 0.28 Financial interests are not deductible for income tax: 15,000 X 0.28 = U $ S 4200 These interest shall not are deductible for income tax debtor of the local society and at the same time are treated as dividends earned by the foreign creditor linked, is not subject to income tax withholding at the time to turn them outside. Only financial, are not achieved commercial liabilities, or for services.
Subjects excluded	This presumption does not apply to the following cases: ✔ Resident banks in Argentina authorized to operate by Law 21.526 ✔ Financial trusts under the Law 24.441. ✔ Companies whose main purpose is to leased assets, and secondarily perform financial activities.

Chile

Conditions for them to apply	a) When debtor resides in Chile, during commercial year, accrue interests from debt excess. b) when related debtor resides abroad. c) When excess of debt started with transactions which rates are lower than 35%; it means a rate of 4%, or they are exempt from additional tax in Chile. d) When debts from exempt or subjected transactions to special rate of 4%, not exceed 300% tax net equity. If it exceed it , will be subjected to special tax of 35% applied over interests as follows:
Consequences	No income tax deductible in the society debtor, the interest generated by the ratio of financial and commercial liabilities linked with creditor in excess of the limit of 300% of equity **Example:** Financial interest linked with foreign creditor in the accounting results US$ 15,000 Financial liabilities linked with foreign creditor US$ 350,000 Equity local debtor Company: US $ 90,000 Maximum limit of liability that generates interest deductible: US$ 270,000 (3 x 90,000) Surplus of financial liabilities US$ 80,000- (350,000 - 270,000) Ratio of surplus over financial liabilities total (80,000/350,000)= 0,228 Financial interests are not deductible from income tax: 15,000 x 0,228 = US$ 3,420 These interests shall not be deductible from income tax of local debtor Society and at the same time are affected 35% tax penalty by debt excess.
Liabilities reached	All financial and commercial liabilities are reached such as: a) Credits granted from abroad by banking entities or International finance company; b) Price balance by imported assets to Chile with differed coverage or collect systems and; c) Bonus or debentures issued in foreign currency by Chilean Companies.
Subjects excluded	a) Interests by credits generated by not-linked b) Or being linked, conditions are not given of debt excess, it means, debts are not higher than three times

Germany

Conditions for them to apply	They apply to all german tax payers and all type of debt financing regardless of weather the interest is paid to a related or unrelated party in Germany or abroad. The interest deduction is capped by 30 percent of the earnings before interest, tax, depreciation and amortization (EBITDA). Anything beyond that “barrier” is a subject of either a deduction according to the three exceptions in this regulation or could be carried forward indefinitely. Nevertheless, for every 1 EUR interest payments which should be carried forward there must be additional 3.33 EUR EBITDA. Notwithstanding these restrictions, the net interest expense is fully tax deductible if the company: 1. is not a member of a tax group; 2. incurs net interest expense of not more than €1 million per year; or 3. has an equity ratio that is equal to or higher than the worldwide equity ratio. The escape clause in 3. above states that if the equity ratio of the German group is greater than the worldwide equity ratio, the 30 percent interest limitation does not apply. This exception is applicable only if, at the level of each group entity, less than 10 percent of the net interest expense is paid to a more than 25 percent shareholder that is not part of the worldwide consolidated group (or to a third party with recourse to such shareholder).
Consequences	**Example:** Company A GmbH is part of a group of comapnies Substantial shareholder S (more than 25% shares) pledges his saving deposit at Bank C to the lending bank D. ("harmful" loan) A GmbH has neto interest expenses of a) 100.000EUR and an EBITDA of 350.000. b) 1.100.000EUR and an EBITDA of 350.000. Equity of the A GmbH is smaller than the equity of the consulidated balance sheet of the tax group Solution: a) These interest is (partly) deductible in the income tax of the local debtor society as the interest is smaller than € 1 million. b) These interest is not (partly) deductible in the income tax of the local debtor society and, at the same time, it is treated as dividents.
Liabilities reached	Only financial. Commercial or service liabilities are not included.
Subjects excluded	This presumption does not apply to the following cases: Partenership

Israel

Thin Capitalization Rules - Transfer prices in an international transaction,
Section 85a of the Income Tax Ordinance

Conditions for them to apply	Any international transaction, both in case of the granting of a loan and also in the case of receipt of a loan, where "special relations" exist between the parties to the transaction, in respect of which: ✓ A "special price" has been stipulated for the transaction Or ✓ Other "special conditions" have been determined for the transaction, in a manner that such lower profits would be derived from the transaction than if there had been no "special conditions", and the transaction had been determined in accordance with ordinary commercial market conditions, with no special relations existing between the parties.
Consequences	✓ The transaction will be reported according to market conditions. ✓ The transaction will be liable for tax accordingly. ✓ The tax liability in Israel: When a controlling company in Israel grants a loan to a controlled company overseas, at a cost of credit which is lower than the market price, the theoretical difference in interest will be liable for tax in Israel. ✓ When an overseas controlling company grants a loan to a controlled company in Israel, at a cost of credit which is higher than the market price, the difference in interest will not be recognized as an expense in Israel. ✓ Conclusion: In any transaction between parties consisting of an Israel resident and an overseas resident, where "special relations" exist, it is necessary to prove that the conditions of the transaction were "market conditions". ✓ It is possible to obtain prior confirmation, in a "pre-ruling" process, that the transaction is being carried out under market conditions.
Liabilities reached	The section will apply in all instances ✓ The law applies to all business activity in Israel, without exception, with all being required to act in accordance with market value and market conditions. ✓ Including any transaction with respect to an asset, right, service, credit etc. ✓ Exceptions: Specific exception need to be examined in accordance with the specific provision in the treaties for the prevention of double taxation, to which Israel is a signatory.
Subjects excluded	Conditions for non-applicability of the main rule to a "loan" which is regarded as an investment ✓ These provisions will not apply to a loan where all of the following conditions apply: ✓ The loan is from a controlling shareholder to a company controlled by him. ✓ The loan is not linked to any index and does not bear any interest or yield. ✓ Repayment of the loan is subordinate to other obligations and has priority only over the distribution of assets at liquidation. ✓ Recording in accounting records The loan is to be recorded in the controlling shareholder's books as an "investment" and not as a loan.
Definitions	✓ "Control" – Holding, directly or indirectly, of 50% or more of one of the means of control on at least one day in the tax year. ✓ "Means of control" – As defined in Section 88 of the Income Tax Ordinance. ✓ "Special relations" – Including relations between a person and one of his relatives, and also control by one party to a transaction over the other party, or the control by a person over the parties to a transaction, directly or indirectly, alone or together with another.

Mexico

Conditions for them to apply

They apply to interest accrued on loans between related parties, when the debtor resides in Mexico and the creditor in a foreign country.

If the creditor resides in a foreign state where, under an agreement signed with Mexico to avoid double taxation so the effective withholding rate of income tax on the interest it charges must be 15% if not 30%.

Only taxpayers with interest-bearing debt with related parties residing abroad, be limited the deductibility of these when your debts are greater than three times the equity.

To determine the amount of debts that exceed the limit, be subtracted from the average annual balance of all debts interest-bearing taxpayer office, the amount obtained by multiplying the quotient obtained from divide by two the sum of stockholders' equity at the beginning and end of exercise.

When the average annual balance of the debts of the taxpayer incurred to related parties abroad is less than the amount in excess of the debts referred to above, are not deductible in full the interest earned on these debts. When the average annual balance of the debts owed to related parties abroad is greater than the excess amount referred to above shall not be deductible interest on these debts to parts abroad related only by the amount obtained by multiplying those interests by the factor obtained dividing the amount in excess among this balance.

Consequences

Example:

Triple Equity for the year

Balance of equity at beginning of year	$ 100,000.00
Plus: Balance of equity at year final	200,000.00
Equals: Balance	300,000.00
Divided by two (2)	
Equals: Average equity for the year	150,000.00
Times Three (3)	
Total: Triple stockholders' equity	$ 450,000.00

Amount of debt that exceeds the Triple the Capital

Average total bearing debt interests with residents nationwide	$ 200,000.00
Plus: Average Total debt bearing interests independent living abroad	300,000.00
Plus: Average total debt foreign related parties	400,000.00
Total: Average Total Debt	900,000.00
Minus: Triple exercise of shareholders' equity of	$ 450,000.00
Total: Amount of debts that exceed three times the capital	$ 450,000.00

Amount of debts that exceed the the triple capital	$450.000,00
Against: Average total debt of related foreign parts	$ 900,000.00
Result: Factor 0.5000	

ACCRUED INTERESTS WITH RELATED PARTIES NON-DEDUCTIBLE

Accrued interests to related parties		$ 100,000.00
Times: Factor	0.5000	
Total: Accrued interests with related parties Non-deductibles		$ 50,000.00

Liabilities reached

There is no activities limited it is open to all Companies liabilities.

Subjects excluded

There is no subjects excluded.

Portugal

Conditions for them to apply	They are applicable to the debts between related parties, when the debtor is a resident in Portugal, and the creditor is not a resident entity in Portugal or in any other Member State of the European Union. The total amount of debts, at any time of the fiscal year, that exceeds 200% of the amount holding by the creditor in the equity of the local debtor company, is considered to be excessive. The equity includes the share capital and all other components of the equity, except those related to unrealised gains or losses.
Consequences	The interests generated on the excessive debt are not income tax deductible in the local debtor company. **Example:** Interest expense: EUR 15.000 Total debts: EUR 250.000 Equity of the local debtor company: EUR 90.000 Maximum limit of debts that generates deductible interest: EUR 180.000 (= 2 X EUR 90.000) Excessive debt: EUR 70.000 (= 250.000 - 180.000) Proportion of the excessive debt on the total debts: 0,28 (= 70.000 / 250.000) Interests that are not deductible for income tax: EUR 15.000 X 0,28 = EUR 4.200 If transfer pricing rules are not applicable, the deductible interest shall not exceed the 12 month Euribor rate in force at day the loan was granted, plus a 1,5% spread. Those interests are not deductible in the income tax of the local debtor society and, at the same time, they are subject to income tax withholding at source.
Liabilities reached	Loans, guarantees and trade-related credits more than six months overdue.
Subjects excluded	The thin capitalization rules are not applicable if: ✓ the creditor shareholder is not resident in a tax haven; and ✓ the taxpayer (local debtor company) proves the terms and conditions of the loan obtained is at arm's length.

Spain

Conditions for them to apply	Thin capitalization rules apply on loans between a company and associated persons or companies not resident in Spanish territory. When the direct or indirect net remunerated borrowing of a company with another or other associated entity exceeds the result of applying the ratio 3 to the fiscal capital, the interest accrued on such excess shall be deemed to be dividends. For the application of the foregoing provisions, both net remunerated borrowing and fiscal capital shall be reduced to their average amount during the fiscal period. Fiscal capital shall be deemed to be the amount of shareholders' equity, excluding the result of the financial year Taxpayers may submit a proposal to the Tax Administration for the application of a different ratio to the ratio. The proposal shall be based on the borrowing that the taxpayer would have obtained under normal market conditions with independent persons or companies. That provision shall not be applicable to transactions carried out with persons or companies resident in countries or territories statutorily classified as tax havens.
Consequences	The interest accrued on the excess of the ratio 3 between the borrowing and the fiscal capital shall be deemed to be dividends. They will not be deductible for the debtor entity and the creditor will be liable to Non Resident Taxation. **Example:** Loan: 4,000 euros Interest expense with foreign linked creditors: 400 euros (10%) Equity of the local debtor Company: 1,000 euros Maximum limit of liability that generates deductible interest: 3,000 = (3 X 1,000) Surplus of financial liabilities: 1,000 =(4,000-3,000) Financial interests that are deductible for income tax: 3,000 X 10% = 300 euros Financial interests that are considered dividends and not deductible for income tax: 1,000 X 10% =100 euros These interests are not deductible in the income tax of the debtor entity and, at the same time, they are treated as dividends earned by the foreign linked creditor.
Liabilities reached	A positive adjustment in Corporate Income Tax.
Subjects excluded	This presumption does not apply to the following cases: ✔ Financial entities ✔ When the associated company not resident in Spanish territory is resident in another member state of the European Union, unless it is resident in a territory which is statutorily classified as a tax haven. Nevertheless, a general anti-abuse rule may be liable even to European Union countries, in some cases that could be considered as purely artificial arrangements.

UK

Conditions for them to apply

There are no statutory conditions for the rules to apply. In general they will apply to an enterprise with more debt than it could and would have borrowed on its own resources, because it is borrowing either from or with the support of connected persons, but thin cap rules extend to other terms and conditions of lending and borrowing such as the interest rate, the duration of loan, repayment terms, etc.

Furthermore the thin cap rules can apply in respect of transctions bewteen UK enterprises and not just between UK and non-UK enterprises.

The UK does not have 'safe harbours' with regard to financial ratios that measure a company's capitalisation, like some other countries do. HM Revenue & Customs will look at each case on its own, based on the trading activities of the relevant company. In the past, HMRC usually looked at "debt:equity ratio" and "interest cover " i.e. the ratio of pre-interest profit to interest payable. They would expect that the loan would be matched by equity so would accept 1:1. However, they have now become more flexible and although 1:1 is their starting point, they recognise that particular circumstances and industries can merit a different outcome.

Consequences

Example:

Interest expense owed to the creditor company in the financial result: £100,000.
Arms length interest relief agreed with HM Revenue & Customs - £80,000

The excess interest of £20,000 over the arms length amount will be disallowable for corporation tax purposes, but it will still be treated as interest. This means that any witholding tax to be deducted from the interest will have to paid over to HMRC on the excess amount plus the arms length amount.

Liabilities reached

The UK thin cap rules are part of the UK transfer pricing rules, so the rules apply to most transctions.

Subjects excluded

Normally small and medium sized enterprises are exempt unless one of the enterprises to the transaction is resident in a country with which the UK does not have a double tax treaty with an appropriate non-discrimination clause. In the case of medium sized enterprises, HM Revenue & Customs may give notice that they will be required to apply the rules.

An entity qualifies as either a small or medium sized enterprise if it meets the staff headcount ceiling for that class and one (or both) of the financial limits as below:

	Maximum number of staff	And less than one of the following limits:	
		Annual Turonver	Balance Sheet Total
Small enterprise	50	€10 million	€10 million
Medium enterprise	250	€50 million	€43 million

ANDORRA
ANGOLA
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AUSTRIA
BELGIUM
BULGARIA
COLOMBIA
COSTA RICA
CYPRUS
CHILE
CHINA
ECUADOR
EL SALVADOR
FRANCE
GERMANY
GREECE
GUATEMALA
HONDURAS
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