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Private Equity – EME

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Private Equity Sound Bite

Tax Relief on Acquisition Debt

Tax relief on acquisition debt is clearly of particular importance for the PE sector. Perry Yam chairs a discussion between three of his European tax colleagues, comparing the approaches taken in France, Germany and the UK on this issue.

Perry: *It seems fair that tax relief on acquisition debt interest is restricted to the level of interest that a third party lender would have charged, but have your countries imposed more restrictions than this 'arm's length' test?*

Stéphane Letranchant: This is very topical in France, because new rules have restricted the tax relief to 85% of annual net interest costs of more than €3m (reducing to 75% for financial years beginning on or after 1.1.2014). This is on top of the previous restrictions, which include a thin capitalisation regime (including for some secured third party loans), a specific provision for a French purchaser acquiring a French target company from a controlling entity to form a tax group (Charasse Amendment) and a specific provision for a French company acquiring a target company controlled by a foreign investor after the acquisition (Carrez Amendement).

Thomas Gierath: Germany also has a cap on tax relief for interest, at 30% of the borrowing company's EBITDA where the annual net interest costs are €3m or more. This cap applies to all interest, so even if the company is borrowing on market terms from a third party bank.

Caspar Fox: The UK has extended the 'arm's length' test to cover bank debt supported by a parent guarantee. It also introduced the worldwide debt cap rules a few years ago, to deny tax relief for interest where the amount of UK debt exceeds the external debt of the consolidated worldwide group.

Perry: *Are these restrictions aimed at PE companies in particular?*

Caspar: No, the worldwide debt cap rules were a general reaction to overseas groups loading their UK subsidiaries with a disproportionately high share of their group debt. The general 'arm's length' test is the most relevant restriction for the PE sector.

Thomas: The same in Germany: the 30% cap was introduced to stop multinational groups shifting profits of their German subsidiaries into low-tax countries. Relief should be available in PE transactions where the debt ratio of the acquisition vehicle is in line with the debt ratio of the entire target group. The aim is therefore to structure the transaction so that the PE fund and its other portfolio entities are not part of the consolidated target group.

Stéphane: In France, the different restrictions apply to all companies without distinction.

Perry: *Can companies get certainty from the tax authority on the level of tax relief available?*


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Thomas: In Germany, tax rulings are rarely used for interest tax relief in PE deals. Binding rulings are available for the tax authorities, but they must be given before the deal goes ahead and are not binding if the facts change during the term of the debt. PE buyers generally therefore rely on the considerable guidance published by the tax authorities on the interpretation of the law.

Caspar: Companies can seek clearance from the UK tax authorities once they have entered into the loan, so they know how much tax relief to claim in their tax return. But some PE companies prefer not to seek the clearance. The benefit of certainty (particularly when it comes to an exit) has to be weighed against the risk of bringing it to the tax authority's attention.

Stéphane: Broadly speaking, companies can always ask the French tax authority for a ruling in respect of their tax situation. However, they would not use this procedure for their acquisitions.

Perry: *Have the benefits of tax relief on acquisition debt interest been reduced in other ways?*

Caspar: Tax relief used to be received as the interest accrued, but now it is generally when the interest is paid. This was a significant change when introduced a few years ago, given that the interest on shareholder debt is often rolled up until an exit. PE companies can usually achieve the same tax position as before, however, by issuing 'payment in kind' notes in discharge of the interest (with those notes only being repaid on an exit).

Stéphane: In certain circumstances, interest costs which are not tax deductible because of the thin capitalisation rules can be carried forward to later years. However, the tax relief on all other non-deductible interest costs is lost forever.

Thomas: In Germany, any interest that cannot be used in one year due to the cap can in principle be carried forward to later years, provided that there is no change of control in the borrower (such as a trade sale of the target company). Also, in principle 25% of the interest is not deductible when calculating the borrower's German trade tax position.

Perry: *Are you expecting any further developments in this area?*

Stéphane: The measures introduced over the past 2 years on restricting the tax relief on interest and taxing capital gains of holding companies has affected France's reputation as an attractive jurisdiction for PE acquisitions I cannot exclude the possibility of further restrictions in the future.

Thomas: I currently do not see any new developments locally. It will be interesting to see if the interest limitation rules will be part of the EU initiative to harmonise the corporate taxation system in Europe. This would certainly be in the interest of investors and targets in the PE sector.

Caspar: I do not expect the current UK government to change its position. It is aware that the UK treatment of tax relief on interest is more favourable than in many other countries, and it regards this as a competitive advantage for attracting foreign investment in the UK.

Perry: *Many thanks, everyone.*

Event Highlight – Poker Evening

On Wednesday 24th April, the European Private Equity Team hosted a Private Equity Poker Event at The Broadgate Tower in London.

The event was themed as a poker evening with a master class and subsequent tournament!

Mike Barnes from **Wyvern Partners**: "I had fabulous fun with an assortment of charming hosts and met some interesting guests many of whom I shall keep in touch with, including people from Blue Gem, Patron Capital, LGV, and fellow advisors from Cavendish. You may be great lawyers, but equally memorable is your ability to put on a genuinely valuable networking event that is also entertaining and competitive without being taken too seriously. Thank you all again, for what I hope will be an annual fixture."

Sophie Bower from **Vitruvian**: "It was a really excellent evening. Great idea to do it as poker, and had much fun at our table. It was a good opportunity to trade war stories!"

David Keech from **Oakley Capital**: "Although my poker skills were sadly not quite up to scratch, it was great fun and also good to meet other people working in the PE space."

Leonard Murdock from **Cavendish**: "It was a most enjoyable evening and I made some useful connections, despite my severe lack of aptitude for Poker!"