Tax Management International Forum

Comparative Tax Law for the International Practitioner

Hybrid Transactions in the Form of Loans

In this issue of the International Forum, leading experts from 19 countries and the European Union address the ways that Forum countries deal with hybrid transactions in the form of loans. Hybrid mismatch arrangements that can produce multiple deductions for a single expense or a deduction in one jurisdiction with no corresponding taxation in the other jurisdiction have been a driving concern for the Organisation for Economic Cooperation and Development. In its final report under Action 2 of its action plan on base erosion and profit shifting (BEPS), the OECD called on tax authorities to adopt domestic rules that would prevent taxpayers from exploiting differences in the tax treatment of a financial instrument to create unintended tax benefits.

Volume 38, Issue 2

JUNE 2017

www.bna.com

Bloomberg BNA

THE TAX MANAGEMENT INTERNATIONAL FORUM is designed to present a comparative study of typical international tax law problems by FORUM members who are distinguished practitioners in major industrial countries. Their scholarly discussions focus on the operational questions posed by a fact pattern under the statutory and decisional laws of their respective FORUM country, with practical recommendations whenever appropriate.

THE TAX MANAGEMENT INTERNATIONAL FORUM is published quarterly by Bloomberg BNA, 38 Threadneedle Street, London, EC2R 8AY, England. Telephone: (+44) (0)20 7847 5801; Fax (+44) (0)20 7847 5858; Email: marketing@bna.com

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THE FORUM

FRANCE

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1. General Comments on the Characterization of Hybrids

Whether the transfer of funds to a French entity subject to corporate income tax (CIT) represents debt or equity for French tax purposes has obvious and significant consequences for the tax treatment of the income and expense flows related to the financing instrument by each party.

The main aspect on which this paper will focus is that, while a French borrower is allowed to deduct the interest payable under a debt instrument, even though the deduction may be subject to various limitations, no deduction is allowed with respect to a dividend payment. One area in which debt/equity issues are particularly relevant is in the treatment of hybrid instruments, i.e. instruments that are treated as debt under the tax rules of one country but as equity under those of another country. As a result of this difference in treatment, the use of a hybrid instrument may, intentionally or unintentionally, achieve a position in which a deduction for an interest payment is obtained in one country without a corresponding income inclusion in the other country.

There are other important aspects particular to each method of financing (i.e. debt or equity), notably the treatment of the related income flows with respect to withholding taxes — no withholding tax normally applies to interest paid by a French borrower, while a 30% withholding tax potentially applies to dividends, subject to the effect of France's tax treaties and the exemption granted under France's domestic law implementation of the EU Parent-Subsidiary Directive (Article 119 *ter* of the French Tax Code (CGI) provides a total exemption from withholding tax for dividends paid to an EU resident company holding more than 10% of the French distributing company).

In the reverse situation, where the financing is granted by a French entity to a foreign entity, classification of the relevant instrument as equity rather than debt may allow the related income flows to benefit from the participation exemption under France's holding regime. This latter situation is, however, not covered in this paper, which focuses instead on the treatment of a French entity (FrenchCo) subject to CIT in France and financed by a foreign entity (FCo).

As a general principle and as provided by Article 38 *quater* of Appendix III to the CGI, the legal classification and accounting treatment of a transaction under French GAAP (*Plan Comptable Général* or PCG) determines its tax treatment,[1] except where the tax law provides for a different treatment. In the absence of a specific definition of debt or equity in French tax law, the legal classification and accounting treatment will prevail for purposes of determining the relevant tax treatment.

From a French statutory accounting standpoint, the issuance of bonds convertible into equity is treated in a similar way to the issuance of conventional bonds, i.e. they are booked as debts and interest paid by the issuer is considered a financial expense. The same treatment applies to bonds issued with a warrant (OBSA) and subordinated debt. The accounting treatment of bonds redeemable in shares (ORAs) is more ambiguous since, in some circumstances, such instruments are recorded under French GAAP as "other equity funds." ORAs have consequently historically been the subject of more debate than other such instruments (see below), but normally remain subject to treatment as debt.

Although the French tax authorities must normally rely on the legal and accounting classification of a transaction, they may challenge such classification by reference to the legal and economic characteristics of the transaction if they have sufficient elements to establish that the contractual or accounting treatment is erroneous, based on either the misclassification of the transaction with respect to its legal analysis, or because the transaction is abusive or fraudulent.

Except in situations where the accounting and legal classification of an instrument as debt would be obviously incorrect, the recharacterization of debt as equity would be subject to the abuse of law (or *fraus legis*) procedure rules contained in Article L 64 of the French Tax Procedure Code (LPF), which is quite demanding for the tax authorities to implement.[2] In all cases, the burden of proof would, in principle, lie with the tax authorities but the French entity would be required to provide clear information on the features and purposes other than tax of the transaction concerned (in that sense, the burden of proof is in fact shared between the taxpayer and the tax authorities).

The purpose of the discussion that follows is not to deliver a precise analytical grid (which anyway does

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not exist), but to comment on how this issue has been approached by the tax authorities and to provide illustrations by reference to the few existing cases that address the matter. In any event, the question of how an instrument is to be classified has lost much of its relevance and materiality from a tax perspective as a result of recent changes to the law, which automatically limit the effect of hybrid instruments (see II., below).

2. Comments of the French Tax Authorities

As indicated above, the French tax authorities have not provided any precise analytical grid for classifying an instrument as either debt or equity and have stated that a case-by-case analysis should be conducted, based on the characteristics of the particular instrument concerned. No single element is decisive in determining how an instrument is to be classified and only a comprehensive analysis of a transaction can lead to its potential reclassification. It is, however, worth referring to some of the past comments of the tax authorities on this subject, though only by way of illustration and not as representing a rule.

The French tax authorities' guidance (in the form of a statement of practice) on the thin capitalization rules,[3] for example, acknowledges the existence of hybrid instruments that share features of both debt and equity. The tax authorities indicate that equity features would, in particular, be the absence of a predefined reimbursement date and the ability of the issuer to suspend the remuneration in the case of insufficient profit, and that debt features would be the existence of predefined fixed or variable remuneration, the absence of voting rights and the right to liquidation surplus. The authorities conclude their statement of practice by noting that once the analysis of an instrument is made that results in its classification as debt, then the interest paid on the instrument is subject to the thin capitalization rules commented on in the guidance.

The French tax authorities also had to comment on these questions in their guidance[4] on the tax treatment of Islamic Finance and Sharia-compliant instruments (Shariah law forbids the payment of any form of interest). The tax authorities indicated that such instruments should be treated in a manner similar to debts, to the extent certain requirements are met. In particular, the tax authorities indicated that "Sukuk" Sharia transactions should be equated with debt instruments, provided:

- The Sukuk holders have priority over shareholders whatever the nature of the equity stakes of the latter.
- The Sukuk holders do not have rights that are specific to shareholders, namely voting rights and rights to share liquidation surplus (unless the Sukuks have been converted into shares).
- Remuneration on the Sukuks is based on the performance of the collateralized assets, but must include an expected rate of return that must be capped at an accepted market rate (EURIBOR, LIBOR) increased by a margin consistent with market practice in relation to debt instruments. The remuneration could be zero in the case of an issuer in a loss-making position. The Sukuks can be reimbursed at below par value (because of the index-linking mentioned in the Sukuk agreement).

It is worth noting that the author has provided comparable analysis with respect to the tax treatment of convertible contingent bonds (CoCos) issued by banks to enhance their Tier 1 equity funds,[5] since hybrid instruments are of great interest to banks from a regulatory perspective, quite apart from any tax advantage that they may confer.

3. Case Law

There is so far little case law on the recharacterization of debt into equity, or the reverse (equity into debt, where a hybrid instrument is used to finance a foreign investment and the French investor claims the benefit of the participation exemption).

The Abuse of Law Committee (which is an administrative committee, not a Court, and does not create "case law" *per se* since the advice of the Committee is not binding on the Courts, even if a positive answer of the Committee shifts the burden of proof to the taxpayer[6]) had to comment on the treatment of exceptional distributions made by a French entity by way of the issuance of ORAs and confirmed the authorities' view that the transactions concerned could be regarded as constituting *fraus legis* under the general anti avoidance rules contained in Article L 64 of the LPF (which is also referred to as being designed to combat "abuse of law" or "fraud to the law").[7] In a decision handed down on the same day, the same Committee concluded that the implementation of a participating loan, concomitant with a reduction of capital through a share repurchase, was not abusive.[8]

In the opposite situation (where the issue was the equity financing of a foreign corporation held by a French holding entity and the benefit of the exemption for dividends received by the French entity), the Committee concluded [9] that a transaction involving the use of preferred shares and a number of other specific elements, was a sham that allowed a bank to benefit improperly from the participation exemption.

As regards actual court cases, the most significant decision on the subject under discussion is the recent decision of the High Court in *SAS Ingram Micro*,[10] even though this concerned the payment of an exceptional dividend distribution by the way of the allocation of ORAs, rather than a pure hybrid situation. The High Court confirmed that the overall transaction, which, in practice, allowed equity reserves to be replaced by debt, without any cash movement, was a fraud. The fact that the reimbursement took the form of ORAs played a part in the analysis (because the refinancing was considered circular since it did not involve any cash movement and used an instrument designed to revert to equity on redemption), but certainly does not allow the conclusion to be reached that ORAs are not debt instruments.

The case created some doubt as to whether the High Court intended to challenge the old principle according to which taxpayers are totally free to decide how they finance themselves, whether by debt or equity (which is a different issue from the treatment of hybrids). Some comments on the case seem to indicate that the intention of the High Court was not to challenge this principle and that the case should remain an isolated instance — one can but hope that the tax authorities will share a similar conviction.

Another interesting case in this respect was heard by a local court of appeal,[11] which held that the creation of debt resulting from a share buy-back financed by debt did not run counter to the interests of a French entity, which remained free to decide how it should be financed, irrespective of the existence of an advantage for the foreign investor concerned. The Court noted that the fact that a transaction affords advantages to a shareholder in a French entity is not of itself sufficient for the transaction to be regarded as abnormal if the transaction also affords advantages to the entity.

Hence, a challenge to the effect that debt has been artificially created can be made on the grounds of *fraus legis* and Article L 64 of the LPF (but only in limited situations if decades of case law confirming free choice as to financing are to be believed) and other specific debt creation rules provided for by French law (see II.C., below), not on abnormal management or transfer pricing grounds. But again, this concerns debt creation more than it does the use of hybrids as such.

4. Tentative Conclusion

Situations in which a financial instrument that is classified as debt for French commercial law and accounting purposes is recharacterized by the tax authorities as equity for tax purposes remain rare and it is impossible to draw a clear line between the two types of financing. A multi-criteria approach is required, with no particular criterion predominating.

The terms of remuneration, participation in profits and losses and the modalities of redemption are, of course, important factors in the analysis of a financial instrument, but it is not easy for a loan to be recharacterized as equity: convertible bonds and ORAs are, in principle, treated for tax purposes as debt, at least until they are converted into or redeemed with shares. As discussed above, the use of ORAs to replace equity reserves by debt was held by the High Court in *SAS Ingram Micro* to constitute an artificial arrangement and treated as an instance of *fraus legis*, but this decision was essentially driven by the specific fact pattern at issue.

Nor does the fact that a security does not have a predetermined duration disqualify it from being a bond. For example, subordinated bonds (*titres subordonnés à durée indeterminée* or TSDIs) do not have a stated maturity and are reimbursable on the judicial liquidation of the issuer, but this does not allow them to be reclassified as equity (the same is true of perpetual bonds — CoCos). From an accounting standpoint,[12] TSDIs are classified as debt instruments and the French tax authorities also equate TDSIs with debt for tax purposes.[13]

Nor is the fact that the remuneration for a loan is contingent on, and partly or wholly determined with respect to, the profits of the issuer a decisive factor pointing to the conclusion that the loan should be classified as equity. Participating loans, for example, are, in principle, treated as debt, as are indexed bonds and Sukuks.

Where an instrument ranks on the liquidation of the borrower is an important factor in determining its character as either debt or equity (see the discussion of Sukuk at I.A.2., above, in this regard). For example, in the case of a company that has been granted a participating subordinated loan, the lender is reimbursed before the company's shareholders. However, like the other criteria weighed in making the debt/equity distinction, such ranking cannot be taken into account in isolation: for example, on liquidation a preferred share can be refunded before the rest of the equity, but this does not make it a debt.

As suggested above, these complex discussions have lost some of their significance now that France has enacted the measures recommended in the OECD's guidelines allowing a deduction to be denied to the payor where the payment concerned is not recognized as income by the recipient. The relevant rules are discussed in II.A., below.

In light of the above remarks, it can be seen that the assumption in the case under discussion that the financing transaction between FCo and FrenchCo is not supported by any legal documentation would not be fatal to the argument that the financing should be regarded as debt.

Even in the event that FrenchCo and FCo failed to draw up legal documentation (which would be both unwise and, in practice, highly unlikely), the accounting treatment (which would normally be based on a legal analysis under French GAAP) would be a crucial element in the analysis of the arrangement, since the accounting treatment is binding on the taxpayer and is deemed to reflect its management decisions, even if those decisions can be challenged by the tax authorities. This can be illustrated by the conclusion reached by the High Court in a recent case[14] in which a branch recorded a transfer of funds to its head office as a receivable rather than as repatriation of equity: the High Court held that interest should have been charged to the head office on the recorded receivable.

As regards the consequences of FCo's treating the instrument as debt (as assumed for purposes of this section), the approach of the French courts in determining the character of a cross-border transaction is always to rely exclusively on French criteria. The classification of the transaction under foreign rules is ignored. For example, the High Court has held[15] that the character of a foreign partnership (in the case concerned, a U.S. general partnership) should be determined by comparing it with similar French entities with comparable legal features, not by reference to its classification or tax treatment in the foreign country concerned. The same reasoning was used in a case concerning a U.S. LLC.[16] More recently, the High Court[17] held that a debt waiver granted by a French company to its U.K. subsidiary should not necessarily be treated as a (non-deductible) capital contribution, even though it was so treated for U.K. accounting purposes: The High Court reversed the decision of the Court of Appeal, because the lower court should have classified the debt waiver by reference to French legal and accounting standards, irrespective of its foreign law treatment.

The fact that the issuer treats an instrument as debt does not, of itself, prevent the tax authorities reclassifying the instrument as equity if this is the correct analysis under French corporate law and accounting rules.

However, even though the characterization of the instrument as debt by FCo is irrelevant for the legal analysis, it is an element that would be considered in the overall factual analysis. The foreign treatment and whether or not the parties are related in practice (even if not in theory) will clearly have an impact on the conclusion reached by both the tax authorities and the Courts, since establishing *fraus legis* requires an analysis of the intention of the parties to the transaction concerned. In the author's opinion, it is unlikely that the abuse of law procedure could apply or even be invoked by the tax authorities where the hybridity between unrelated parties is merely the result of a difference in treatment of one single instrument and not the result of a contorted attempt to achieve different treatment in each of the countries concerned (for example, the use of listed CoCos by banks to enhance their Tier 1 ratios).

The fact that interest on a debt is taxed in the hands of the recipient will, however, have direct consequences in the context of new limitations on the deduction of interest (see II.A., below).

B. FCo Does Not Treat the Transaction as a Loan for FC Accounting and Income Tax Purposes

The fact that FCo and FrenchCo are related does not of itself point towards either debt or equity treatment, but it does invite an analysis of how the instrument is treated by the financing entity in the foreign country (FC).

As noted above, the treatment of the instrument by FCo, i.e., its classification as equity, is, in theory, not taken into account for purposes of determining its treatment under French tax law in the hands of FrenchCo. However, even though the position under this second scenario should consequently be the same as under the first scenario (see I.A., above) the treatment of the instrument as equity by FCo and the consequent exemption of the payments made to it by French Co are, in practice, likely to affect the analysis for French tax purposes.

In *SAS Ingram Micro*, the High Court regarded the absence of taxation of the foreign company concerned in its country of residence as a relevant factor. The wording of the decision indicates that this was not a crucial element in the Court's analysis (the Court refers to it incidentally — "*au demeurant*"), but it seems likely that the existence of a hybrid mismatch (deduction/non-inclusion) was regarded as important in this particular case. *Fraus legis* requires the identification of an element of intention to avoid tax and it seems unlikely that the recharacterization would have succeeded had the judges felt that the hybrid mismatch was merely the result of differences in tax treatment between the two countries.

Finally, as already noted, the absence of documentation suggested in the case study would not necessarily be fatal to the analysis of an instrument as debt. In the hypothetical absence of documentation, the accounting treatment by FrenchCo would be a clear indication of how the instrument should be characterized (see above), but the tax authorities would be able to mount a challenge using the approach described above. The absence of any documentation would be a poor platform for a French borrower wishing to argue for the existence of a debt for French tax purposes if the instrument concerned were treated as equity in the lender's country of residence.

C. Difference if a Loan Agreement of Some Sort Exists

Where a loan agreement exists, the loan agreement is, in principle, treated as such, but the tax authorities can recharacterize it, based on the approach discussed above. In any event, new rules would apply to limit the deduction of interest if the counterparty was not taxed or was only taxed at a low rate (see II.A., below).

II. General Rules Regarding the Deduction of Interest Paid to a Nonresident Lender (Assuming the Transaction Is Accepted as a Loan)

A. Effect on General Rules if It Is Known That the Lender Does Not Include the Interest Income in Taxable Income

Assuming the instrument is treated as debt, interest paid by a French taxable entity is, in principle, deductible on an accrual basis (including capitalized interest). Unlike in a number of countries, interest is deductible in France even if the debt on which it is payable is related to the acquisition of shares in a controlled entity (whether in France or abroad), which is an important element in the computation of the French taxable base. Even though, as is widely known, France has a high nominal corporate tax rate (though this may change under a new presidency), this interest deduction can significantly reduce the effective rate of taxation (at least it *could* when corporate rates were higher than they are currently).

Interest payable by FrenchCo may, however, be subject to various rules limiting its deduction. Most — but not all — of the limitations concerned apply to interest paid to related parties. The residence of the lender is in principle irrelevant for purposes of determining whether a deduction is available — any rule to the contrary could be denounced as discriminatory (see V., below).

The new rules on hybrids and payments to low-tax countries are summarized in this section. Other rules on debt-to-equity ratios and thin capitalization will be described in II.B., below, and other limits on interest rates and the debt creation rules will be described in II.C., below.

Hybrid instruments are a major focus of attention in the current initiatives of the OECD and EU authorities — not only in the context of efforts to combat tax avoidance and prevent the OECD member countries/EU Member States suffering tax leakage, but also because hybrid mismatches are regarded as generating unjustified competitive advantages for the multinational groups that can implement them. Neither the OECD nor the EU proposals will be addressed here since they are not purely a question of French domestic law and have anyway been extensively discussed elsewhere.

France has implemented most of the recommendations made by the OECD as well as EU recommendations and Directives (see further at VI., below). Whether interest is to be included in the lender's taxable income and how it is to be taxed have become relevant issues since the introduction by the 2014 Finance Bill of what is now Article 212, I-b of the CGI, which establishes a new condition for the deduction of interest by reference to a minimum level of taxation in the hands of the beneficiary, where the beneficiary is a related party of the payor. The law applies for financial years closed after September 25, 2013.

In summary, to obtain relief for interest it pays, a French borrowing entity must now be able to establish, when requested to do so by the tax authorities, that the lender (where the lender is a French or foreign related party) is subject to income tax on the interest received from the French borrower at a rate of at least 25% of the standard French CIT rate (i.e., 33.33% x 25% = 8.33%) or, according to the tax authorities, at a slightly higher rate of 9.5% in situations where additional contributions assessed on CIT would be due. The purpose of this new rule is, therefore, not only to combat hybrid instrument mismatches and situations of double non-taxation, but also to target payments of interest to low-tax countries.

The rule applies only to interest paid to related parties, not to interest paid to other lenders. If the lender is a transparent entity: (1) the rule only applies if the French borrower and the members of the transparent entity are related parties; and (2) whether the minimum taxation threshold is met is tested at the level of the entity's members (subject to certain conditions).

If the lender is a foreign tax resident, the characterization of the instrument in the lender' country of residence is irrelevant — the only relevant question concerns the level of foreign tax applicable to the income received by the lender. The comparison between the minimum 25% threshold and the rate of foreign tax is made with respect to the gross interest income, computed in accordance with French tax rules (for example, the interest is computed on an accrual basis and no account is taken of any basis rebate or deduction for expenses that may apply for foreign tax purposes). The foreign tax rate is computed based on the theoretical foreign tax payable at the nominal rate, not on the effective tax paid. Thus for example, the fact that the lender is in a loss position or does not pay tax because of local tax consolidation or group relief rules is not taken into account. Nor, in principle, is the fact that the lender may itself pay interest to another party.

Because of its general objective of combatting tax optimization (a broader concept than tax avoidance), this rule works mechanically to determine the taxable basis, quite independently of any tax avoidance considerations. There is no safe harbor allowing the taxpayer to avoid the application of the rule by establishing that there is no tax avoidance motive (unlike under other anti-avoidance measures, such as the controlled foreign company (CFC) rules).

Nonetheless, the tax authorities explained in comments issued in December 2015 concerning schemes that can be regarded as fraudulent, that *fraus legis* can be invoked in the following situation: A corporation in State A creates a subsidiary in State B financed by equity; the subsidiary in turn establishes a branch in State C (a low-tax country) that on-lends to a French borrower and the interest is not "effectively" taxed in B and C (although the computation should in principle only take into account the theoretical tax paid in State B). Taxpayers in this position are invited by the guidance to disclose themselves to the tax authorities — and, one might say, *frauslegis* gets back in through the back door.

Should the income received by the foreign lender be taxed in France under the French CFC regime,[18] the interest would be regarded as being sufficiently taxed (so that there would be no cumulative application of the two sets of measures).

B. Specific Limits on Interest Deductions Based on the Ratio of Debt to Equity

The relevant rules will not be discussed in any great depth here, but may be summarized as follows:

- Thin capitalization rules (related party loans): Article 212 of the CGI provides that a borrowing entity is deemed to be thinly capitalized if the total amount of interest incurred on related party loans that is deductible under the interest rate test fails all three tests below (i.e., the tests are cumulative tests):
  (1) Debt-to-equity ratio test: the average of amounts made available to the borrowing company in the form of debt by related entities (including non-interest bearing loans and loans obtained from third parties but guaranteed by a related entity) may not exceed 1.5 times the amount of the borrowing company's net equity or share capital. For each financial year, the taxpayer is free to use either the total equity at the beginning of the year or the total equity at the close of the year. If it is higher than its net equity, the borrower can use the share capital at the end of the financial year. The interest on the excess portion of debt may be non-deductible, depending on whether two other conditions are fulfilled.
  (2) Interest coverage ratio test: interest payable may not exceed 25% of the borrowing entity's operating profit before tax, increased by: (a) interest payable to related parties; (b) depreciation allowances taken into account in determining the entity's pre-tax operating profit; and (c) the portion of finance lease payments taken into account in determining the sale price of leased assets at the end of the lease.
  (3) Interest received test: the above limitations only apply if interest paid to related parties exceeds interest received by the borrowing entity on loans it has itself made to related parties. The existence of this test can increase the level of deduction allowed compared to what would be allowed if only the first two tests applied, especially in the case of a pool leader located in France.
- The deductibility of the excess portion of the interest paid (the excess portion being computed by applying that of the three tests above that produces the most taxpayer-favorable result) is deferred, if it exceeds 150,000 euros (the deferred deduction may be taken in a subsequent year to the extent allowed after applying the above limitations in that subse-

quent year). However, the application of these rules can be avoided if the company can establish that its debt-to-equity ratio is lower than the overall debt-to-equity ratio of the group of which it is a member.

- General limitation on interest relief (this applies to all debt, i.e., it is not restricted to related-party debt): in addition to the above rules limiting deductions for interest paid to related parties, a 75% general limitation applies to the deduction of net financial expenses, i.e., the net difference between all financial income and all financial expenses, when this difference exceeds 3 million euros. Once this threshold is reached, the 75% limit applies to the whole amount of the net expense, from the first euro (and not only to the amount of net expense in excess of 3 million euros). In the case of a tax consolidated group, this threshold is not increased in proportion to the number of companies in the group. The limitation applies to all interest and financial expenses, even those incurred in transactions with unrelated parties.

C. Limits on Interest Deductions Based on Other Factors

The following limitations on interest deductions may also apply:

- Limitation on the maximum interest rate (related party loans): this limitation, which applies only to loans granted by related parties when the borrowing entity is subject to CIT, is computed by reference to floating-rate loans with terms of over two years granted by French banks (2.15% in 2015, 2.03% in 2016). It is however possible to avoid the limitation by establishing that the rate that could have been obtained in a similar situation from an independent credit institution would have been higher.
- Rules preventing artificial debt push-downs and earnings stripping:
  - Under Article 223 B of the CGI (the "Charasse" amendment), a specific limitation applies to interest on debt related, or deemed related, to the acquisition from a related party of shares in a company that becomes part of the tax consolidated group.
  - Under Article 209 IX of the CGI, a similar limitation (the "Carrez" amendment) applies to interest on debt (including third party debt) related to the acquisition of shares in a French or foreign company, when the acquiring entity cannot demonstrate a sufficient level of involvement in the target company's management.
- Interest paid to beneficiaries located in non-cooperative countries and tax havens: under Article 238 A of the CGI, interest paid to beneficiaries in such countries is deemed non-deductible, unless the borrower can demonstrate that the expense corresponds to a genuine loan (interest paid to beneficiaries located in listed "non-cooperative" countries[19] may be subject to a high rate of withholding tax — up to 75%).

D. Possibility of a Transaction Being Bifurcated Into a Portion That Permits Deductible Interest and a Portion That Does Not

Recharacterization of debt as equity (and *vice versa*) is not made in accordance with the provisions of a particular law but with the broad concept of *fraus legis*, which relies entirely on a case-by-case analysis. No bifurcation in characterization would seem to be possible, assuming the instrument concerned is a single instrument. Other rules limiting interest deductions may give rise to bifurcated treatment, especially those that apply only with respect to loans from shareholders or related parties.

E. Effect of an Income Tax Treaty Between France and FC

France's tax treaties generally do not include provisions that would directly allow the recharacterization of debt as equity (or *vice versa*).

III. Difference if FCo Were an Entity That Is Treated as Transparent for FC Tax Purposes

Compared to those of most countries, France's rules on the treatment of partnerships are quite specific.[20] In principle, unlike in most countries, which apply a pure look-through approach for tax purposes, in France a partnership is regarded as an entity/person distinct from its partners and tax liability is computed at the level of the partnership. Despite the fact that a partnership is recognized as a separate entity for tax (and legal) purposes, in principle, the persons liable for the tax on (their shares of) the partnership income are the partners, even though the income will not necessarily have been distributed to them.

Whether it would make any difference to the position set out in II., above if FCo were an entity that is treated as transparent for FC tax purposes would depend on the status of the foreign partnership further to the analysis described immediately above. In essence, the position would probably not be much affected.

IV. Withholding Tax Issues

As noted in I.A., above, the characterization of an instrument has a direct impact on the treatment of the income flows attached to it for withholding tax purposes, since payments of interest are, in principle, not subject to withholding tax (except where the payments are made to beneficiaries in non-cooperative States), while dividends may be subject to withholding tax. The rate of withholding tax on dividends will depend on whether there is a tax treaty between France and the country of residence of the beneficiary and, if there is an applicable treaty, what rate(s) is/are provided for in that treaty.

V. Difference if FCo Has a Permanent Establishment in France

Both French constitutional rules (the principle of equality enshrined in Article 13 of the 1789 Declaration of Human and Citizens Rights) and EU rules (the principles of freedom) proscribe the discriminatory treatment of investments made by foreign investors, not only in an EU context but also in a non-EU context (although this aspect will not be elaborated on in this paper). The non-discrimination rules contained in most of France's tax treaties also have the same implications.

For this reason, most rules enacted in French law are now (in principle) designed in such a way as to ensure that a foreign investor is not treated less advantageously than a French investor. The new anti-hybrid rules therefore apply in a purely domestic context (i.e., where a French borrower and the French branch of a foreign financing entity are involved) as well as in a cross-border context. That being said, this is largely an academic matter because situations in which there is a mismatch in the French tax treatment of two French taxpayers (including where one is a branch) are unlikely to occur.

VI. Legislative Changes

To say that the French Administration has been very active in promoting the OECD and EU initiatives referred to above is perhaps to put it mildly — most of the relevant measures had been incorporated into positive law even before the final OECD BEPS reports were published or the EU Directives issued.

Further to Directive n° 2014/86/EU of July 8, 2014, a "linking rule" was introduced by the amending Bill for 2014. As of January 1, 2015, dividends that can be deducted from the taxable income of the distributing company are excluded from the benefit of the participation exemption.[21]

In addition, further to Directive n° 2015/121/EU of January 25, 2015, the Amending Bill for 2015 introduced new restrictions on the exemptions deriving from the EU Parent-Subsidiary Directive (i.e., exemption from CIT for dividends paid by EU subsidiaries in the hands of their French parent companies and exemption from French withholding tax for dividends paid by French parent companies to their EU subsidiaries).[22] The restrictions apply to schemes designed to obtain artificially the benefit of these exemptions. These restrictions will not be discussed any further here because they do not directly concern the situation discussed in this paper.

Turning to the subject matter of this paper, no specific rules have yet been implemented regarding the treatment of hybrid entities, even though the Draft Bill for 2014 required the Administration to prepare a report on such hybrid structures. Article 9 of the Anti-Tax Avoidance Directive (ATAD),[23] however, does provide further rules on hybrids. Article 9 provides as follows:

1. To the extent that a hybrid mismatch results in a double deduction, the deduction shall be given only in the Member State where such payment has its source.
2. To the extent that a hybrid mismatch results in a deduction without inclusion, the Member State of the payer shall deny the deduction of such payment.

These rules must be implemented by the EU Member States by December 31, 2018, at the latest.

This proliferation of measures seems certain to give rise to a host of questions as to how the measures will apply in practice — not only from a purely French point of view (what is the scope of the measures? what is the order of priority among the various rules?), but also from the point of view of the interaction between the rules of the various countries concerned (potential differences in scope, timing and the order of priority among the various rules in each country) since, under the ATAD, implementation of the measures is mandatory (high-tax countries will be concerned that the failure of some countries to implement these rules in a sufficiently rigorous manner may create new "unfair" competitive advantages).

The profusion of rules will also doubtless generate a deal of uncertainty and multiply the number of instances of double taxation that it will require arbitration to resolve. One of the objectives of the BEPS initiative was to create economic efficiency by eliminating the artificial tax advantages enjoyed by some multinationals. Unfortunately, it seems that the initiative is going to give rise to considerable complexity and economic inefficiency affecting a large number of stakeholders.

The French tax authorities have for many years had adequate tools to challenge transactions that could be regarded as purely tax-driven (in France, the abuse of law procedure has been part of statutory law since 1925 with respect to registration duties and since 1941 with respect to direct taxes) and all the talk surrounding BEPS has put taxpayers on such notice that few would deliberately (or lightly) engage in these kinds of transaction, with the attendant risk of facing double taxation rather than achieving double deduction.

The effect of the BEPS rules is to enlarge significantly the scope of transactions that are potentially within the ambit of anti-avoidance provisions. This is the result of a shift away from the subjective approach of general anti-avoidance rules (such as the French abuse of law rules), in which the intentions of the taxpayer are scrutinized, to specific measures that apply mechanically and catch not only tax-avoidance but also mere tax optimization arrangements, in which no fraud can be detected, and even situations in which there are mismatches of a purely mechanical nature. In this respect, these rules represent not only a means of combatting tax evasion and optimization, but a way for high-tax countries to reduce the attraction of lower-tax countries. The absence of safe harbor rules in most of these new measures will no doubt increase the number of instances of double taxation. In this new environment, tax optimization is not so much a matter of identifying opportunities to achieve double deductions as a matter of steering clear of the risk of double taxation, just as it is in the transfer pricing arena.

NOTES

[1] French Tax Code (*Code Général des Impôts* or CGI), Art. 38 *quater* of Appendix III.

[2] *See* Thierry Pons, *The Economic Substance Doctrine*, France response, Tax Mgmt. Int'l. Forum (June 2010).

[3] Tax instruction 4 H-8-07, December 31, 2007.

[4] Tax instruction 4 FE/S2/10, July 23, BOI-DJC-FIN-20.

[5] *See* Thierry Pons, *Tax Implications Of Contingent Convertible Securities*, France response, Tax Mgmt. Int'l. Forum (June 2012).

[6] For further explanation, *see* Thierry Pons, *The Economic Substance Doctrine*, France response, Tax Mgmt. Int'l. Forum (June 2010).

[7] Committee of December 7, 2010 *Affaire n° 2010-12 concernant la société X France Holding*.

[8] Committee of December 7, 2010 *Affaire n° 2010-13 concernant la SAS Z France Holdings*.

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[9] Committee of December 5, 2014 *Affaire n° 2014-30 "SA X."*

[10] CE 13-1-2017 no 391196.

[11] CAA Versailles n° 10VE03601 January 24, 2012.

[12] *Mémento comptable* 2012 n° 2130-4.

[13] *See in this context*: Tax instruction 4 C-3-95 n° 3, April 25, 1995, and administrative doctrine 4 C-2342 n° 3, October 30, 1997, BOI-BIC-CHG-50-30-20-10 n° 60, September 12, 2012. For relevant case law, *see* CAA Versailles July 5, 2016 no 14VE02647, *SA Carrefour*.

[14] CE November 9, 2015 no 370974, *Sté Sodirep Textiles SA-NV*.

[15] CE 24-11-2014 no 363556 *Sté Artemis*.

[16] CE 27-6-2016 no 386842 *Sté Emerald Shores LLC*.

[17] CE 31-3-2017 no 383129 *SAS Senoble Holding*.

[18] CGI, Art. 209 B. *See* Thierry Pons, *CFC rules*, France response, Tax Mgmt. Int'l. Forum (March 2011).

[19] "Non-cooperative" countries are specified in a list published every year by the tax administration. A non-cooperative country is a non-EU Member State that :

- Has been subject to OECD review;
- Has not concluded a tax treaty with France allowing for the full exchange of information for purposes of applying the Contracting States' tax legislation; and
- Has not concluded such treaties with at least 12 other countries.

The last list published by the Administration includes Botswana, Brunei, Guatemala, the Marshall Islands, Nauru, Niue and Panama.

[20] *See* Thierry Pons, *Taxation of Inbound Investment by a Foreign Partnership*, France response, Tax Mgmt. Int'l. Forum (March 2016).

[21] CGI, Art. 145, 6, b.

[22] CGI, Arts. 145, 6, k and 119 *ter*, 3.

[23] EU Directive 2016/1164 of July 12, 2016, laying down rules against tax avoidance practices that directly affect the functioning of the internal market.