France releases draft guidelines on new hybrid mismatch rules

April 18, 2014

In brief

The French tax authorities on April 15, 2014, released draft guidelines regarding the legislation enacted on December 30, 2013, targeting hybrid mismatch arrangements.

Public consultation and comments on the draft guidelines may be submitted until April 30, 2014.

The draft guidelines are binding on the French tax authorities until revised guidelines are published.

US multinationals with French subsidiaries or branches should review their financing structures in light of these guidelines to ensure that the interest borne by their French affiliates is tax deductible.

In detail

The Finance Act for 2014 added a new test to the existing rules governing interest deductions for financing from a lender that is directly or indirectly related to a French borrower.

The draft guidelines released by the French tax authorities on April 15, 2014, provide important clarifications of this new hybrid mismatch or anti-hybrid-financing rule.

Under the new rule, interest deductions are allowed only if the French borrower demonstrates that the lender is, for the current tax year, subject to corporate tax on the interest income that equals 25% or more of the corporate tax that would be due under French tax rules.

When the lender is domiciled or established outside France, the corporate tax determined under French law equals the tax liability that the lender would have owed on the interest had it been resident or domiciled in France.

Companies covered by the new rules

Entities or bodies subject to French corporate tax (per se or upon election) are subject to the new rule.

The new rule also applies to the computation of the portion of the taxable profit of transparent entities allocated to partners that are subject to French corporate tax.

Tax reference rate applicable to the interest income

The draft guidelines confirm that the borrower must demonstrate that the gross interest income is subject to a statutory rate of at least 25% of the standard French tax rate applicable to the lender.

The standard French tax rate applicable for the 25% test is the standard tax rate plus additional surtaxes when applicable. Therefore, the minimum local tax rate for purposes of this test would range from 8.33% to 9.5% depending whether the lender is subject to additional surtaxes.

The draft guidelines indicate that the interest income need not trigger an effective payment of tax. A lender that is in a loss position could meet the test if it demonstrates that the gross interest income is effectively included in its tax base.

Similarly, the draft guidelines provide that the test addresses only taxation of the gross interest income regardless of any expenses that would reduce the lender's taxable income. The guidelines provide an example of a back-to-back financing to illustrate that, to determine the tax rate applicable to the lender's interest income, interest expenses do not have to be taken into account.

The legal characterization of the interest income to the lender is irrelevant. The test focuses only on the tax treatment of the amount owed by the French borrower to the lender.

The draft guidelines also attempt to clarify the impact and interaction of the new hybrid mismatch rule with French controlled foreign companies rules.

Foreign lenders

When the lender is not domiciled or established in France, the corporate tax that would be due under French standard tax rules is deemed to be the corporate tax — plus additional surtaxes, if applicable — the lender would have been subject to had it been a French tax resident.

Thus, the tax rate effectively applicable to the gross interest income of the foreign lender — including specific rebates, deductions, and exemptions applicable to the interest income — is compared with the French rate that would have been applicable had the lender been a French tax resident. The test thus focuses on specific local rules that may reduce or limit the amount of taxable interest.

The draft guidelines confirm that the test applies only to gross interest and not to the global effective taxation of the lender.

Burden of proof and documentation

Taxpayers must provide documentation to support their corporate tax calculation if requested by the French tax authorities.

The draft guidelines indicate that the borrower can provide any kind of support documentation to demonstrate that the lender is effectively subject to the minimum required corporate tax on the gross interest income received.

Timing

The analysis of the lender's tax rate must be available for each tax year in which the borrower claims an interest deduction under French rules.

The draft guidelines discuss the situations in which the borrower and lender have different tax years and confirm that the rules apply to the tax year in which the lender receives an interest payment.

For example, say a borrower with a tax year ending on December 31 pays interest on February 15, May 15, October 15, and December 15, 2014, to a related-party lender with a tax year ending on May 31. The borrower would have to provide proof that the lender is effectively subject to the minimum required tax rate on the gross interest received with respect to:

- The tax year ending on May 31, 2014, for the interest received on February 15 and May 15, 2014, and,
- The tax year ending on May 31, 2015, for the interest received on October 15 and December 15, 2014.

In case of a discrepancy between the tax year during which the borrower claims a deduction and the tax year during which the income is included in the lender's taxable income —for example, when there is a difference in accounting or tax rules between countries — the interest expense will not be deductible.

However, the borrower may take an interest deduction in the later tax year during which the interest income effectively is included in the lender's taxable income.

Flow-through lending entities

When the lender is a flow-through entity or a qualifying collective investment vehicle constituted under French law, the law of an EU member state, or the law of a country that has concluded a mutual administrative assistance agreement with France and that is not blacklisted by France, the hybrid mismatch rule applies if a related-party relationship exists between (1) the borrower and the flow-through entity or qualifying collective investment vehicle, and (2) the flow-through entity or qualifying collective investment vehicle and one or several of its partners or unit holders.

Once these conditions are satisfied, the minimum taxation rate test is applied by reference only to the related-party partners or unit holders in the flow-through or collective investment vehicle. If a condition is not met, the anti-hybrid rules do not apply.

For example, say related-party partner D has a 75% interest in flow-through entity B (the remaining partners are non-related parties under French rules) and B owns 100% of company A. B is also a lender to company A and partner D is not taxed on the gross interest received through B. In this case, the draft guidelines indicate that the interest will not be deductible by the borrower (company A) because D is a related party to B and does not satisfy the minimum taxation rate condition explained above.

Note: The fact that only non-related partners or unit holders in the entity or collective investment vehicle may not be subject to a minimum taxation rate has no impact on the deductibility of the interest by the borrower.

In addition, according to the draft guidelines, when a partner in a flow-through entity or collective investment vehicle would itself be a flow-through entity or collective investment vehicle, the interest would not be deductible by the borrower because the flow-through partner would not satisfy the minimum taxation rate test.

Deemed distribution

The draft guidelines do not address whether interest that would be disallowed as a result of the new hybrid mismatch rule should be treated as a deemed distribution and possibly subject to French dividend withholding tax and 3% distribution tax.

Retroactive application

The new rule applies retroactively to interest booked during tax years ending on or after September 25, 2013.

The takeaway

US and international groups should review their financing structures involving French entities as well as the documentation required to demonstrate that the gross interest income is subject to a statutory rate of at least 25% of the standard French tax rate.

Let's talk

For a deeper discussion of how this might affect your business, please contact:

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