Hybrid Mismatches and Financial Instruments
About the difficulty of enacting anti-avoidance rules

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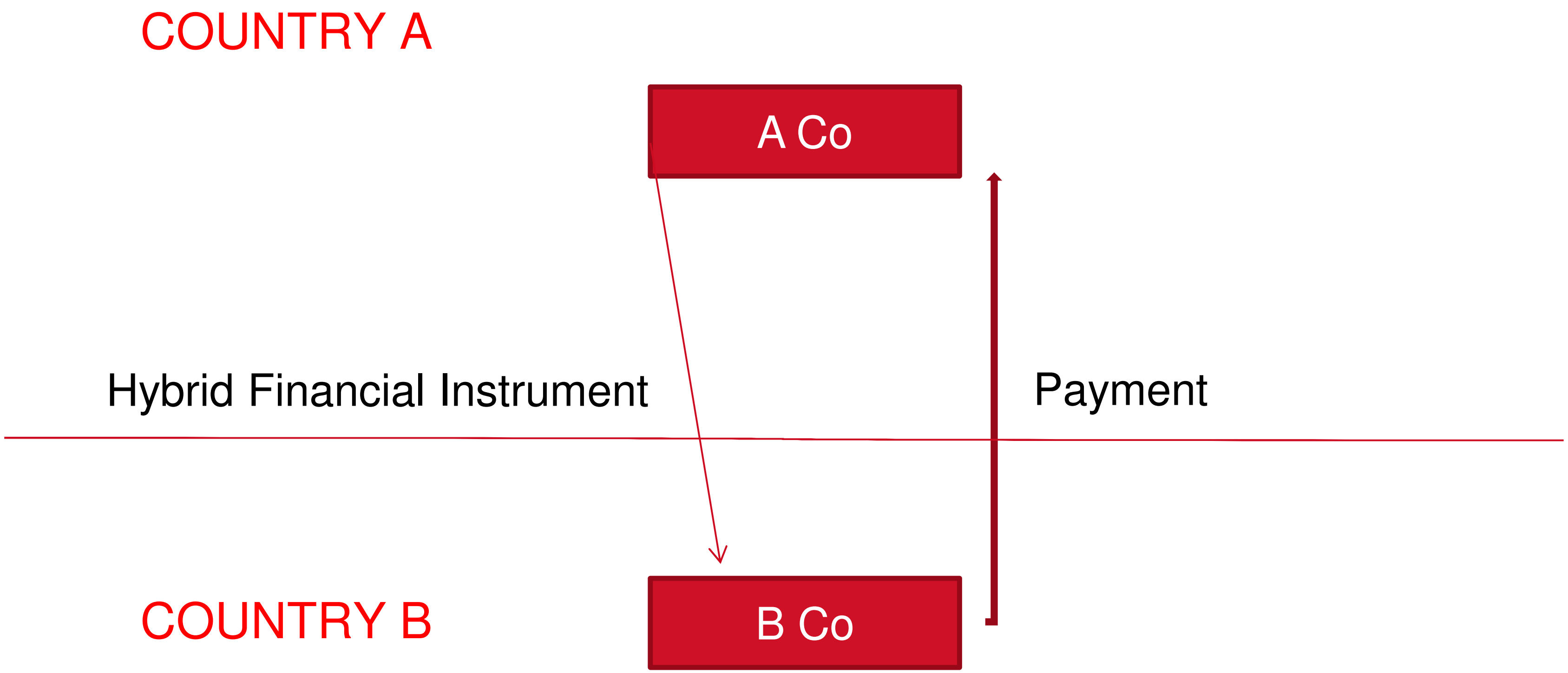
- 1- Context and OECD doctrine
- 2- French reforms
- 3- Technical issues related to coordination of tax systems

Basic case of deduction/non-inclusion



Strong international pressure

- **OECD action plan on BEPS**
- Action 2 : develop model treaty provisions and recommendations regarding the design of domestic rules to neutralise the effect (e.g. double non-taxation, double deduction, long-term deferral) of hybrid instruments and entities.

- **European Union : reform of the parent subsidiary directive (exemption of dividends)**
- The State where the parent company is established must refrain from taxing such profits to the extent that such profits are not deductible by the subsidiary and tax such profits to the extent that such profits are deductible by the subsidiary

Coordination rather than harmonisation

- **In 2012 OECD identified several policy options (see the first report on hybrid mismatch arrangements) ; options refined in 2014**
  - Harmonisation of domestic laws
  - General anti-avoidance rules
  - Specific anti-avoidance rules
  - Rules specifically addressing hybrid mismatch arrangements ➔ linking rules

- **Observations**
  - Harmonisation is hardly conceivable
  - GAARs harm the need for legal safety
  - SAARs generally miss their target + do not prevent GAAR from applying
  - Coordination between tax systems is probably the best policy option ; however question whether primacy of tax analysis over legal analysis is always desirable

French reforms

- **Introduction of a linking rule regarding interest deduction**
  - Interest deductibility depends upon tax treatment in the State of the payee

- **Introduction of a linking rule regarding dividend exemption**
  - Dividend exemption depends upon tax treatment in the State of the payer

The rule regarding interest deduction

› **Brief description of Art. 212 FTC (after Budget Law for 2014):**

- Goal of the rule : deny double dip structures where interest is deductible in France without being taxed in the recipient's State, mostly because of different characterization (dividend),
- **Interest paid to a related entity is deductible to the extent that it is subject to sufficient taxation at the level of the recipient,**
- **Sufficient taxation means 25% of French CIT** which would have been paid under ordinary French rules: 25% x 33,1/3% = 8,33%
- Specific rules apply to transparent structures and to collective investment vehicles:
  - No taxation at their level ➔ not in the scope as such;
  - However, partners in the scope if dual test is met : debtor is related to the fund + fund is related to partners
- **General comment : this rule does not explicitly target financial instruments / entities ; it establishes a subject to tax condition of deduction**

Practical issues

- **Interpretative issues**
  - **Sufficient taxation of interest at the level of the payee**:
    - Gross interest vs net interest
      - Ex. : no tax paid in the country of the lender because the lender also deducts interest
      - Tax base does not matter... What about beneficial ownership?
    - Notional interest deduction : in the scope?
    - Check-the-box : in the scope? Interesting issue of disregarded payment made by a hybrid entity to a related party. French law vs OECD Approach?
  - **Burden of proof:**
    - Debtor must prove sufficient taxation at the level of the lender
    - Problem of timing of taxation. See OECD on this.
  - **Risk of recharacterization of interest?**
    - Constructive dividend subject to withholding tax? No

French reform regarding interest deduction, BEPS and EU Law

› **Compatibility of the French new rules with higher standards:**

- **EU Law**:
  - The text applies regardless of State where the recipient is established (i.e. also if the recipient is subject to French CIT) : enough with respect to EU Law standards?
  - No safe harbor clause
- **Treaty Law**:
  - Non-discrimination clause applicable?

The rule regarding dividend exemption

- Art. 145 FTC now states that dividends paid by subsidiaries enjoy exemption only to the extent that they have not been deducted at the subsidiaries' level

- Fewer problems of interpretation so far

- Brazilian juros?

How to prevent circularity?

› **Circularity** :

- Deduction in the payer jurisdiction? Yes if taxation in the payee jurisdiction

- ➔ Taxation in the payee jurisdiction? Yes if deduction in the payer jurisdiction…

How to prevent circularity?

- **OECD Report, 2012 deals with circularity for the first time**

- Finally, it is worth mentioning that in principle operating rules that link the
- tax treatment in one country to the tax treatment in another country may also require
- introducing a **"tie-breaker" test** to solve issues that may arise when both countries' tax
- laws look at the treatment in the respective other country

- Country rules linking the domestic tax treatment to the foreign
- tax treatment do not generally contain a tie-breaker test for cases where the other
- country involved has similar rules. **Although the matter may become more relevant as more countries introduce similar rules, it appears that to date this has not caused major issues. This is likely due to the fact that only sophisticated taxpayers engage in such arrangements and they generally avoid using arrangements where they see a risk of double taxation.**

How to prevent circularity?

- **OECD Deliverable, 2014, gives priority to the source State**

- Response : deny the deduction
  - The payer jurisdiction will deny a deduction for such payment to the extent it gives rise to a D/NI income

- Defensive rule : require the payment to be included in ordinary income
  - If the payer jurisdiction does not neutralize the mismatch, then the payee jurisdiction will require such payment to be included in ordinary income to the extent the payment gives rise to a D/NI income

- Conclusion : it seems that the linking rule in the payer jurisdiction
  - must be applied first
  - and must disregard any reverse linking rule in the payee jurisdiction

Example

- A Dutch company lends money to a French related entity ; this loan is treated as an equity instrument in the Netherlands

- Applicable rules :
  - Netherlands :
    - Domestic treatment as a dividend ➔ exemption
    - But parent-subsidiary directive is now applicable in cross-border situations
  - France :
    - Rule denies deduction if the interest is not subject to tax in the Netherland

Example (cont.)

- Circularity?
  - No if OECD approach is followed
  - But : the French rule is not clear in this respect + the denial of dividend exemption in the Netherlands is due to the directive, not to domestic law
  - ➔ it is difficult to be sure whether the directive does not actually deprive the French rule on interest deduction from any effect at all, which would be very different from the OECD approach

Thank you for your attention