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France Tax Alert

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Tax authorities issue draft comments on antihybrid rule

On 15 April 2014, the French tax authorities (FTA) issued long-awaited draft comments on the new anti-hybrid rule that limits the deductibility of interest paid to related entities. Although the comments do not resolve all issues relating to the anti-hybrid rule, they provide some welcome clarifications. Interested parties have until 30 April 2014 to submit their own comments.

Under the anti-hybrid rule, interest paid by a French entity on a loan granted by an affiliated French or nonresident company is nondeductible for French corporate income tax purposes if the borrower is unable to show that the interest is subject to tax at the level of the recipient company at a rate equal to at least 25% of the tax that would have been due under the normal French rules. If the lender is not "domiciled or established" in France, the taxation of interest it receives must be equal to at least 25% of the corporate tax liability that would have been due in France had the company been domiciled or established in France.

Although initially drafted to target "hybrid instruments," i.e. instruments that qualify as debt in France but that are regarded as equity in the country in which the lender is resident, it now appears that the scope of the provision is broader and applies to interest expense where the corresponding interest income is not taxed or is taxed at a low rate, regardless the form of the debt instrument. The rule is applicable retroactively to interest incurred during the fiscal year ended since 25 September 2013, irrespective of the date the loan was granted.

The anti-hybrid rule represents France's first concrete step to give effect to the OECD base erosion and profit shifting (BEPS) project (action No. 2).

FTA comments

The main clarifications made by the FTA are as follows:

Minimum taxation rate: As noted above, if the lender company is not established in France, the taxation of interest it receives from a French borrower must be at least 25% of the corporate tax that would have been due in France had the lender been established in France.

The FTA has clarified that the comparison of the tax rates is to be made by reference to the French standard corporate income tax rate (i.e. 33.1/3%), increased by additional contributions (i.e. between 34.43% and 38%, depending on the size of the lender). As a result, interest received by the foreign entity must be subject to a minimum taxation of at least 9.5% (i.e. 38% x 25%) for the interest to be deductible by the French borrower.

The FTA points out in its comments that it is not necessary that the interest received give rise to effective taxation in the hands of the lender, but only that such income be included in its taxable base. It also confirms that the minimum taxation test relates only to taxation of the gross interest income, before deduction of any expenses, even finance charges. According to the FTA, expenses and charges, regardless of their nature, that are taken into account in determining the taxable result of the lender are not taken into account for purposes of the anti-hybrid rule. For example if the lender borrows funds from a third party in order to grant a loan to its French related entity, the interest it pays to the third party, which is deductible from the lender's own taxable results, is disregarded in determining the taxation applicable to the interest paid by the French borrower company. Only the interest flows into the lender are relevant and must pass the minimum taxation test, not the overall tax burden of the lender (e.g. it is irrelevant whether the taxable results of the lender are nil or show a loss).

In addition, even though not specifically confirmed by the FTA, the fact that the lender benefits from a tax consolidation regime should not be taken into account; clarity on this issue in the final guidelines would be welcome.

Burden of proof: The burden of the proof of minimum taxation is on the French borrower. If so requested by the FTA, the French taxpayer must show that the interest it intends to claim as a tax deductible expense is subject to minimum taxation at the level of the lender and that the lender has booked the corresponding profit in its own results. The French borrower must present this evidence for the fiscal year in which the interest is deducted from its taxable results. If the borrower and the lender have different year ends, the evidence must be presented for the year in which the lender receives the interest.

If the tax year in which the borrower intends to treat the interest as deductible is different from the year in which the lender will be taxed on the interest (because of differences between accounting or tax rules in France and the other country), the interest will not be taken into account in arriving at the taxable results of the French borrower, but it will become deductible in the year in which the interest will be taxable in the hands of the foreign lender. In such a case, the borrower will have to submit documentation with its tax return proving that the minimum taxation test is met for the relevant year.

Coordination with French CFC rules: Article 209 B sets out the French controlled foreign company (CFC) rules, under which the profits of entities controlled by French companies and located in jurisdictions where the CFC benefits from a tax-privileged regime are subject to corporate income tax in France even if such profits are not distributed to the French controlling company. The FTA has clarified that, where finance charges that fall within the scope of the anti-hybrid rule are deemed to be profits taxable in France in the hands of the borrower under the CFC rules, the borrower is not required to treat the interest as a disallowed expense under anti-hybrid rule.

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