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New Tax Rules Applying to Interest Paid into Non-Cooperative Jurisdictions: A French Revolution

The Third Amended Finance Act 2009 has radically changed the French approach to interest withholding tax. This new legislation provides for tax restrictions applying to transactions involving so-called "non-cooperative" jurisdictions, and will affect French issuers of debt and equity instruments, as well as French borrowers.

1. Introduction

In the context of the hunt launched by a large number of governments against some "tainted" jurisdictions, the Third Amended Finance Act 2009, finally approved by the French parliament a few hours before Christmas Eve 2009, published in the Official Journal on 31 December 2009 and commented on by the French tax authorities in February 2010, has radically changed the French approach to interest withholding tax. Mainly inspired by the German anti-tax-haven legislation enacted a few months previously, this new legislation, which abolishes a 45-year-old tax system and provides for tax restrictions applying to transactions involving so-called "non-cooperative" jurisdictions, will affect French issuers of debt and equity instruments, as well as French borrowers. Market practices prevailing within the old world, when negotiating the tax clauses of debt instrument documentation, are being adapted to these new rules but (despite some clarifications provided by the French tax authorities in a recently published ruling) some uncertainties remain with regard to the new legislation.

2. Previous Legislation

Before the Third Amended Finance Act 2009 of 30 December 2009 (the Law) was enacted, French-source interest paid outside of France was, in principle, subject to an 18% withholding tax.[1] However, various provisions of the CGI led, in practice, to a practical exemption from withholding tax on interest payments (subject to certain conditions). In particular, Art. 131 *quater* of the CGI provided for an exemption from interest withholding tax where the loan qualified as a "loan contracted outside France", i.e. where (according to the interpretation of the French tax authorities) (1) the interest arose under a debt instrument that qualified as a loan (i.e. basically, an agreement providing for a stated principal amount, a repayment date and interest computation rules) and (2) the funds were made available to the borrower after the loan agreement was executed.

3. New Legislation

The new legislation substantially modifies the withholding tax regime on interest payments.

From 1 March 2010, interest payments may be made free of any withholding tax. However, a 50% withholding tax applies on interest payments made into a "non-cooperative state or territory".[2] This withholding tax is triggered irrespective of the tax residency of the beneficiary of the payments (i.e. interest payments made by a French taxpayer for the benefit of a creditor that is tax resident in a cooperative jurisdiction but to a bank account opened by the latter in a branch of the bank located in a non-cooperative state or territory, would trigger the 50% withholding tax, subject to relief under an applicable treaty).

In addition, the tax deductibility of French-source interest paid into or derived by persons established or domiciled in a non-cooperative state or territory may be restricted.

3.1. Definition of non-cooperative states and territories

Under Art. 238-0 A of the CGI, a jurisdiction is classified as a non-cooperative state or territory if:
- it is not a member of the European Union;
- it has been under scrutiny by the OECD Global Forum on Transparency and Exchange of Information; and
- it has not entered into with France, or with 12 other jurisdictions, a treaty providing for exchange of information with regard to tax matters.

On 12 February 2010, the French government published a list of non-cooperative states and territories applicable for the 2010 calendar year. This list includes the following jurisdictions:
- "traditional" tax havens (under the criteria defined in 1998 by the OECD): Anguilla, Belize, Cook Islands, Dominica, Grenada, Liberia, Marshall Islands, Montserrat, Nauru, Niue, Panama, St Kitts and Nevis, St Lucia and St Vincent and the Grenadines; and
- other financial centres: Brunei, Costa Rica, Guatemala and the Philippines.

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1. Art. 125 A-III French Tax Code (*Code Général des Impôts*, CGI).
2. Restated Art. 125 A-III CGI.

The government will update the list every year, in order to include jurisdictions which would qualify as non-cooperative states or territories pursuant to the criteria referred to above or which would, in practice, not be sufficiently cooperative with the French tax authorities. In any case, if a state or territory is added to the list in year N, the new rules will only have effect on payments to this state or territory as from 1 January of year N+1. Jurisdictions which agree to exchange information with regard to tax matters with France, or which are removed from the above-mentioned OECD list of jurisdictions under scrutiny, would be removed from the list of non-cooperative states and territories with immediate effect.

During the debates before the French parliament prior to the enactment of the Law, the Ministry of Finance did not exclude that an EU Member State[3] might be added to the list of non-cooperative states and territories in a future update, if such a jurisdiction does not effectively cooperate with France when applying the tax information exchange agreements concluded between them. However, it is highly unlikely that the tax restrictions applied to payments made into EU Member States would comply with some of the fundamental EU freedoms (free movement of capital and, in certain situations, freedom of establishment) and the EU anti-discrimination rules (and such potential incompatibility was pointed out by the Ministry of Budget and some members of the French parliament during these debates). Accordingly, the risk that an EU Member State would be classified as a non-cooperative state or territory by the French government should be remote.

3.2. Non-deduction

French-source interest paid into, or derived by persons established or domiciled in, a non-cooperative state or territory, is not deductible by the payer for French tax purposes.[4] These provisions refer not only to the destination of the interest payment (i.e. in most cases, the location of the branch where the bank account into which the payment is made, is held), but also to the tax domicile of the creditor (i.e. interest paid into a cooperative jurisdiction to a creditor tax resident in a non-cooperative state or territory would not suffer interest withholding tax, but would not be tax deductible by the French taxpayer). This restriction will apply with regard to fiscal years beginning on or after 1 January 2011.

Under certain conditions, such non-deductible interest may be recharacterized as constructive dividends under Art. 109 of the CGI, in which case they could be subject to the dividend withholding tax set out under Art. 119 bis of the CGI, at a rate of 25% or, where the interest is paid into a non-cooperative state or territory, 50% (unless an applicable treaty provides for a reduced rate).

Accordingly, in certain circumstances, French-source interest paid into a non-cooperative state or territory to a creditor tax resident in a cooperative jurisdiction having concluded an income tax treaty with France could be (1) exempt from the 50% interest withholding tax (based on treaty relief) but (2) subject to French dividend withholding tax, if the relevant tax treaty provides for a broad definition of the term "dividends", including constructive dividends. However, one should bear in mind that the French dividend withholding tax rate is generally capped at 15% under the provisions of French income tax treaties.

3.3. Entry in force; grandfathering

Interest payments on debt instruments (including corporate loans and bonds, and units or bonds issued by French securitization vehicles – *fonds communs de créances* or *fonds communs de titrisation*) issued or entered into prior to 1 March 2010 will (1) continue to benefit from the exemption (where available) provided by Art. 131 *quater* of the CGI[5] and (2) be deductible under standard conditions. In addition, interest paid on debt instruments issued as from 1 March 2010 but that are assimilated to issuances made before that date will also benefit from the grandfathering clause.

3.4. Mitigating factors

The new rules are subject to various mitigating factors.

First, as noted above, (1) debt instruments issued prior to 1 March 2010 (or assimilated to instruments issued before that date) will not be affected by the new interest deductibility restriction rules and (2) provided that such debt instruments (issued prior to 1 March 2010) fulfil the conditions provided under Art. 131 *quater* of the CGI, they will not be affected by the new interest withholding tax rules.

Second, payments made (1) into a non-cooperative state or territory (with regard to the 50% withholding tax and to the restriction on deductibility) or (2) to a beneficiary established or domiciled in a non-cooperative state or territory (with regard to the restriction on deductibility), may be made without adverse tax consequences if the debtor establishes that the "main purpose and effect" of the transactions from which the payments originate is not to "locate" income in a non-cooperative state or territory (the safe harbour provision).

Third, it must be emphasized that if payments are made into a non-cooperative state or territory to a beneficiary which is tax resident in a jurisdiction having entered into a tax treaty with France providing for a reduced or zero rate of withholding tax, the 50% withholding tax would accordingly be reduced or eliminated in application of these treaty provisions, but as noted above, French dividend withholding tax may be due in such cases if such interest is recharacterized as a constructive dividend under French domestic law by reason of its non-deductibility at the level of the French debtor.

3. The Ministry of Finance made reference to Luxembourg and Austria.
4. Art. 238 A CGI.
5. See 2.

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3.5. Comments by the French tax authorities

A ruling (*rescrit*) 2010/11 (FP and FE) of the French tax authorities dated 22 February 2010 (the Ruling) provides answers to some of the questions that are raised by the new rules. The ruling clarifies some points regarding what would constitute a payment into a non-cooperative state or territory, triggering the 50% withholding tax:

- in the case of a chain of payments in France before any payment is made outside France, only the first payment outside France by a French paying agent (within the meaning of Art. 75, Annexe II of the CGI) must be taken into consideration. If this first payment out of France is not made directly to a non-cooperative state or territory. For example in the context of an international syndicated loan, interest paid by a French debtor to a facility agent (acting on behalf and for the account of the syndicated lenders) established outside France in a cooperative jurisdiction, would not be subject to the 50% withholding tax;
- if the payment is made by wire transfer, the authorities will take into account the place of residence or the place of the registered office of the administrator of the account in order to determine whether the payment is made to a non-cooperative state or territory, and not the place of residence of the beneficiary; and
- if the payment is made in cash or by check, the authorities will take into account the place of residence or the place of the registered office of the person to whom the cash is remitted or to whom the check is written.

Accordingly, the provisions of the Ruling greatly limit the risk of international syndicated loans being caught by the 50% withholding tax.

The Ruling also provides that listed debt instruments and debt instruments cleared through clearing systems will, under certain conditions, be deemed not to have as their "main purpose and effect" to "locate" income in a non-cooperative state or territory (with regard to both the 50% withholding tax and the restriction on interest deductibility for corporate income tax purposes). In this respect, the Ruling provides that instruments:

- offered by means of a public offer within the meaning of Art. L.411-1 of the *Code Monétaire et Financier* or pursuant to an equivalent offer other than in a non-cooperative state or territory (for this purpose, "equivalent offer" means any offer requiring the registration or submission of an offer document by or with a foreign securities market authority);
- admitted to trading on a French or foreign regulated market or on a multilateral securities trading system, provided that such market or system is not located in a non-cooperative state or territory, and the operation of such market is carried out by a market operator or an investment services provider, or by such other similar foreign entity, provided further that such market operator, investment services provider or entity is not located in a non-cooperative state or territory; or
- admitted, at the time of their issue, to the clearing operations of a central depositary or of a securities clearing and delivery and payments systems operator within the meaning of Art. L.561-2 of the *Code Monétaire et Financier*, or of one or more similar foreign depositaries or operators, provided that such depositary or operator is not located in a non-cooperative state or territory,

will be considered as not having this purpose. This also greatly limits the risks in the case of a public placement or a private placement of debt instruments cleared, at the time of their issue, through a clearing system (e.g. Euroclear).

The Ruling, however, does not provide for any clarification on the type of evidence on "main purpose and effect" which will be required from a French debtor if a debt instrument is not issued on a financial market or cleared through a clearing system (e.g. a mere corporate or mortgaged syndicated loan). In addition, the Ruling does not define precisely what type of criteria should be used in order to determine whether, at inception, the main purpose of a debt transaction was to locate income in a non-cooperative state or territory and, assuming the transaction did not have any such main purpose, whether the fact that most of the interest arising from the transaction would eventually be paid to a non-cooperative state or territory (e.g. following an assignment of loan participations by some initial lenders to a new lender), would be sufficient to consider that the main effect of the transaction is to locate income in a non-cooperative state or territory (i.e. the interaction between the subjective test of the main purpose, and the objective assessment of the main effect, has not yet been clarified by the tax authorities).

4. Consequences for Debt Market Professionals

It is fair to say that the grandfathering provisions introduced in the enacted version of the Law, as well as the deferral of their entry into force (which were absent from the preliminary draft legislation, presented in November 2009, and have been introduced by lawmakers at the request of French debt capital market participants) contributed to avoid a retrospective chaos in the French debt market. In most cases, the new rules will not apply to transactions pre-dating 1 March 2010, so that the legal documentation related to such transactions (and, in particular, the gross-up and tax call provisions) will not have to be renegotiated. It cannot be excluded, however, that borrowers and issuers may want to slightly amend or complete the terms and conditions of their documentation (notably with regard to EMTN programmes launched before 1 March 2010, but with notes to be issued on or after 1 March 2010), for instance in order to exclude any potential gross-up obligations arising in the future for the sole reason of an interest payment being made into a non-cooperative state or territory.

Equally, the Ruling eliminates most of the uncertainties surrounding the future public placement of debt instruments (i.e. listed debt instruments or, more generally, debt securities cleared through clearing systems (e.g. Euroclear, Clearstream) issued as from 1 March 2010). In most cases, such debt instruments (such as bonds issued by French banks or corporates; units issued by French *fonds communs de titrisation*) will benefit from the safe harbour provision (as interpreted by the tax authorities) and, accordingly, interest arising under such debt instruments will not be exposed to interest withholding tax and non-deductibility (even if there is eventually an interest payment to a bondholder in a non-cooperative state or territory).

However, where newly issued debt instruments are not deemed under the Ruling to benefit from the safe harbour provision (e.g. publicly placed notes which, for technical reasons, would not fall under any of the three categories specified in the Ruling, such as certain notes issued under German law, or, more generally, international syndicated loans), the new legislation obliges French issuers, as well as lenders and dealers, to revisit their traditional view on the tax provisions concerning transaction documentation.

Indeed, under the new rules, interest withholding tax on foreign interest payments becomes the exception (contrary to the previous legislation), but if the tax is actually triggered, its potential amount will become almost unbearable for most French debtors. For a theoretical interest payment of 1,000, and assuming an interest withholding tax rate of 50%, a corporate income tax rate of 33.33% and loan documentation providing for a full gross-up obligation, the French debtor may have to pay a gross amount of 2,000, from which 1,000 will be effectively paid to the lender and 1,000 to the French Treasury as interest withholding tax. In addition, the French debtor will not be entitled to deduct such gross amount of 2,000 from its French taxable income. Hence, the after-tax cost of such payment for the French debtor would not be 666.7, as anticipated, but 2,000.

In addition, due to the yearly update of the list of non-cooperative states and territories, a creditor may suddenly become a black-listed creditor well after it entered into the loan transaction and even in the absence of an assignment or transfer of its rights under the facility documentation or in the absence of a transfer of its facility office (both events which, traditionally, trigger the application of provisions protecting the borrower under syndicated loans documentation, as they are under the full control of the lender). The future decision of the French government to add a jurisdiction to the list of non-cooperative states and territories cannot be easily anticipated by either the borrower or the lender at the time they enter into a particular funding transaction. However, during the period between the publication of the updated list of non-cooperative states and territories and its entry into force (as from 1 January of the following year), the lender may be in a position to amend its chain of payments so that future interest payments will be made by the borrower into a cooperative jurisdiction. In addition, if the tax domicile of the lender creates a tax deductibility issue for the French borrower (an issue which, indirectly, affects all the other lenders because it reduces the debtor's financial capacity), it may be agreed that the lender will transfer its participation to a related party domiciled in a cooperative jurisdiction.

In this context, a market practice is emerging among French practitioners, resulting in a combination of amendments to the standard tax provisions of syndicated loans documentation, including notably:

- the undertaking by both the borrower(s) and the facility agent (acting on behalf of the pool of creditors) to maintain the bank accounts through which the payments are made in a cooperative jurisdiction;
- if the facility agent is established in France, and due to the ambiguous definition of "payment outside France" under the Ruling, borrowers would generally insist that the distribution accounts opened by each of the lenders, to which the facility agent will transfer the interest received from the borrower, be maintained in a cooperative jurisdiction, as well. Conversely, if the facility agent is acting from outside France and payment is made by the borrower to the facility agent's bank account opened outside France in a cooperative jurisdiction, this payment will be regarded by the French tax authorities as the first payment of the chain outside France and any further payment through the chain, up to the lenders, will not trigger French interest withholding tax;
- if a "clean" lender were to become a black-listed lender by reason of a change to the list of non-cooperative states and territories, triggering a payment of French withholding tax and, most likely, the restriction of deductibility of interest owed to this lender for French tax purposes, a mitigation clause may be introduced in the loan documentation, providing that the relevant lender will make its best efforts to resolve this issue as soon as it becomes aware of it (e.g. by changing its chain of payments or, as the case may be, by transferring its participation in the loan to a related party domiciled in a cooperative jurisdiction). If the lender fails to mitigate or resolve this tax issue (i.e. interest withholding tax and/or absence of tax deductibility), the loan documentation will provide whether or not a tax gross-up obligation will be imposed on the French debtor, depending on the outcome of the negotiation among the parties. However, the absence of a gross-up obligation will not help the French borrower resolve its potential tax deductibility issue. Accordingly, in certain circumstances, the parties may agree to include an indemnity from the creditor with regard to any loss incurred in this regard by the French debtor; and
- if French withholding tax were to be due and/or interest deductibility were to be restricted for the reason that interest is paid into a non-cooperative state or territory, a tax call provision may typically be included in the loan documentation, for the benefit of the borrower. However, such tax call provisions

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are difficult to implement effectively, as they constitute a disruption in the necessary equality among all the creditors (one of them being reimbursed (1) before the others and (2) at face value, which may differ from the fair market value of the debt upon its reimbursement) and they may inadvertently provide an incentive for some of the other lenders to transfer their participations into non-cooperative states and territories in order for them to be potentially reimbursed in advance by the French borrower.

Aside from the various contractual techniques contemplated by practitioners in order to deal with the allocation between borrowers and lenders of the main tax risks and liabilities generated by the new legislation, it is worth recalling that the new rules have not – officially – been enacted in order for France to levy additional taxes or create further disruption in the debt markets, but to avoid tax evasion and discourage transactions voluntarily engaged by French taxpayers with counterparts established in non-cooperative states and territories or involving payments made into non-cooperative states or territories. The author hopes that the departments of the French tax authorities in charge of tax investigations will keep in mind this *ratione legis* in the course of future audits of French debtors having financial debts to foreign creditors on or after 1 March 2010.

Given the relatively short current list of non-cooperative states and territories, the real test for the French tax authorities will likely be the update of list of non-cooperative states and territories as from 1 January 2011, taking into account the effective standard of cooperation of some jurisdictions that have concluded tax information exchange agreements with France (or 12 other states) and have encountered technical issues in their implementation process (e.g. due to the lack of experienced tax authorities in such jurisdictions).

BOOK

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