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IFA Conference.

Hybrid Instruments

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OECD BEPS Report - Action 2 Neutralising the Effects of Hybrid Mismatch Arrangements.

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General principles and the consequences of a political momentum.

1. **Double tax treaties**
   - ✓ Recognised by leading authors and courts as an important complimentary source of interpretation of bilateral treaties (based on the OECD model)
   - ✓ Dynamic approach, i.e., interpretation in light of commentary "in force" at date of judges' decision (CA, 17 Jan 2006, n°20316C), <u>BUT</u> only to the extent underlying provisions remain unchanged (CA 2 May 2013, n°32185C and 17 May 2013, n°32221C)

2. **Transfer pricing**
   - ✓ Interpretation of arm's length principle introduced into Luxembourg tax law (art. 56, ITL and TP Circular) on the basis of OECD guidelines
   - ✓ Position of the Luxembourg government in the FIAT Finance and Trade case

3. **BEPS**
   - ✓ General intention to comply with BEPS initiatives, including addressing hybrid mismatch arrangements, <u>BUT</u>
   - ✓ Not a "first mover"
   - ✓ Luxembourg will probably await EU measures and implement *a minima*

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EU Parent Subsidiary Directive – Anti-Hybrid Rule.

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Implementation *a minima*.

Text of the new anti-hybrid rule

"*[The Luxembourg participation exemption regime] shall not apply to any income within the meaning of Council Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States of 30 November 2011 distributed by a company resident in another member state of the European Union as defined in article 2 of directive 2011/96/EU, to the extent that it is deductible in such Member State […].*" - Article 166 of the Luxembourg Income Tax Law

Scope of the Luxembourg anti-hybrid rule

- ✓ Only applicable to dividends
- ✓ Not applicable in a purely domestic context
- ✓ Not applicable where the subsidiary is resident in a third country outside the EU (*contra*, e.g., the Netherlands)

Legal arguments supporting such position

- ✓ Literal interpretation: the anti-hybrid rule refers to dividends paid to a company resident in "another" "member state"
- ✓ Context: European directives aim at regulating a (European but) cross-border situation
- ✓ Reference to the scope of the initial Parent-Subsidiary Directive limits the scope of Council Directive 2014/86/EU
- ✓ Luxembourg traditionally follows the principle of an implementation *a minima* ("*la directive, rien que la directive*")

For future reference – Doc. parl. 6847 and A31445805

EU Anti Tax Avoidance Directive and other expected changes.

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What’s in the pipeline - ATAD.

Wording of proposed ATAD following Final Presidency Compromise dated 17 May 2016*

Art. 2(8) - Definition of «hybrid mismatch» currently aligned with OECD definition i.e., targeting situations between associated enterprises and structured arrangements, but only between Member States

Art. 10 - “*[...] 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*”

Typical situations	Practical impact in Luxembourg (post ATAD implementation possibly as from 1 January 2018)
Luxembourg payer under hybrid instrument (e.g., PEC), whereby recipient most of the time located in third country (e.g., U.S., Canada)	In scope, but impact limited, unless extended to third countries (as suggested during discussions leading to Presidency Compromise). Commission to propose a complement to the text on hybrid mismatches (to apply the provision also with third countries) by October 2016.
Conversion of convertible debt instrument into shares of EU issuer and subsequent sale of such shares by Luxembourg parent	Luxembourg grants rollover upon conversion of debt into equity. Is deferral of taxation sufficient to constitute non inclusion? Potentially, but in the present case presumably no deduction; liability to creditor simply replaced by «liability» to shareholder. If parent opts out of rollover regime, no non-inclusion, parent fully taxable on gains. A subsequent sale of shares should benefit from exemption.
Redemption by Luxembourg issuer of convertible debt instrument at FMV	Deduction at Luxembourg issuer level, but presumably inclusion at EU parent level. If not, this rule would require Luxembourg payer to deny deduction.
Luxembourg recipient of dividend from EU subsidiary	In scope. In the event the Luxembourg recipient holds a debt instrument stapled with an equity instrument, Luxembourg has under its rules considered interest paid under the debt instrument (deductible at EU subsidiary level) as a dividend, exempt under the participation exemption regime (e.g., ELPD). The current anti-hybrid provision (even implemented *a minima*) requires a Luxembourg parent to include any income which is deductible in the subsidiary country into the taxable basis of the parent; the dividend would hence not benefit form the Luxembourg participation exemption regime.

**Note: No agreement between Member States could be reached on 25 May, the proposal is expected to be rediscussed at the ECOFIN meeting on 17 June*

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Expected changes to standard structures.

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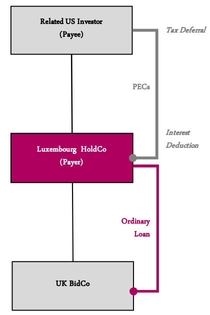
Are PECs issued to a US investor bound to disappear?

Example

- ✓ Payer jurisdiction treats preferred equity certificates ("**PECs**") as debt and accruals/payments as deductible interest
- ✓ Payee jurisdiction (i.e., the US) treats PECs as equity, whereby payee is fully taxable at regular rates on returns earned, but only upon receipt, which is deferred
- ✓ Luxembourg payer uses funds received under the PECs to grant an ordinary loan to UK BidCo (the "**Ordinary Loan**")

OECD Recommendations

- ✓ Primary Rule: No (immediate) deduction in payer jurisdiction – No provision of Luxembourg law currently allowing this principle to be applied; ATAD will (at least initially) only apply to EU Member States
- ✓ Defensive rule: Ordinary income inclusion in payee jurisdiction – As a rule Luxembourg payer, not payee



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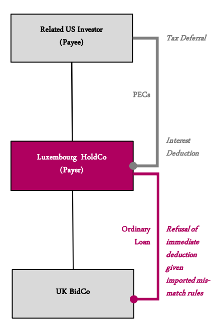
Are PECs issued to a US investor bound to disappear? Cont'ed.

Interpretation of difference in timing of recognition in line with OECD Action 2

- ✓ Safe harbour – No mismatch if payment required to be included in ordinary income by payee "in an accounting period that commences within 12 months of the end of the payer's accounting period"
- ✓ Interest payments on PECs financing tax exempt shares are subject to Luxembourg domestic recapture rule (i.e., no deduction to the extent of tax exempt income received). Is this sufficient to render anti-hybrid rule not applicable (partially)?
- ✓ A difference in timing of recognition of payments will not give rise to D/NI outcome if payer "can establish, to the satisfaction of the tax administration, that payee can be expected to include the payment in ordinary income within a reasonable period of time" (OECD Final Report on Item 2, Rec. 1.1, §56)
- ✓ Special situations:
  - Lender has right to waive interest at any time prior to payment? (OECD Final Report on Item 2, (OECD Final Report on Item 2, Ex. 1.21)
  - "Dividend blocker" (e.g., majority shareholder receives no dividend if minority shareholder does not receive actual payment of interest under PEC (OECD Final Report on Item 2, Ex. 1.22)
- ✓ Imported mismatch rule requires disallowance in payer jurisdiction (UK) of deductions under an instrument (Ordinary Loan) ultimately sheltered by a hybrid instrument (absent effective mismatch rules); implementation in the UK may create issues with common structures involving UK corporate tax payer



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MRPS and non tax hybrids.

Mandatorily redeemable preferred shares ("MRPS")

- ✓ In Luxembourg, MRPS generally equity from corporate law perspective (formal approach) and debt for tax purposes (domestic hybrid)
- ✓ MRPS may qualify as equity abroad (e.g., in Canada), hence MRPS in scope
- ✓ Recent LTA position: accounting opinion that MRPS qualify as debt under Lux GAAP required to benefit from debt qualification for tax purposes
- ✓ Anti-hybrid rule will eliminate deduction; however probably no change in character of payment, hence arguably no dividend withholding tax (domestic legislation)

Additional Tier 1 Capital

- ✓ Eligibility criteria: Subordination even to subordinated creditors, no or very long maturity, full discretion of the issuer to postpone/cancel distributions, coupons payable solely out of distributable income
- ✓ Luxembourg tax follows (i) Lux GAAP rather than IFRS and (ii) substance over form principle (§11 StAnpG)
- ✓ Generally, instruments such as additional tier one capital qualify as debt instruments for Luxembourg tax purposes (notwithstanding equity features); entitlement to deduct coupons, no withholding tax at Luxembourg issuer level and inclusion at holder level
- ✓ Hybrid features do not aim at achieving hybrid treatment for tax purposes, but only for IFRS / Basel III Guidelines, i.e., they often qualify as debt in both payer and payee jurisdiction; additional tier 1 capital should not be caught by Action 2