

European Tax Newsalert

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France introduces new limitation on interest expense deductibility

On December 21, the French Parliament adopted the fourth Amended 2011 Finance Act. This Amended Finance Act introduces a new limitation on interest expense deductibility for participation or shareholding ("*titres de participations*") acquisitions that could impact French and multinational companies ("MNCs"). This new limitation is referred to as "Carrez Amendment".

Interest deductibility and qualifying holding control test ("Carrez Amendment")

1. Background

Under current law, interest expense ("*charges financières*") incurred by a French company for financing participation or shareholding acquisitions is generally deductible for corporate income tax purposes. However, various provisions of the French tax code ("FTC") already limit this deductibility, including:

- (i) article 39-1-3; when the interest rate on related party financing exceeds the interest rate periodically published by the French tax authorities or an arm's length rate;
- (ii) article 212; contains thin capitalization rules applicable to related party financing or third party financing guaranteed by related parties;

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- (iii) article 223B; restricting interest deductibility for debt-financed share acquisitions from related parties in a fiscal unity ("Charasse Amendment");
 - (iv) the abnormal act of management theory; when the purchase of the shares or a loan's terms and conditions are not in line with the business interest of the French company;
 - (v) article 64 of the Code of Fiscal Procedures; in case of a fictitious or purely tax-motivated arrangement.

The new measure limits the interest expense deductibility for qualifying participation acquisitions where the French acquiring company is not in a position to demonstrate that it actually i) makes decisions relating to the acquired participations and ii) exercises an actual control or influence over these participations.

The purpose of the French legislator is to prevent the interest deduction for the participation acquisition by a French entity when the acquired participation is effectively managed outside of France.

2. Scope of the new limitation

The "Carrez Amendment" disallows interest expense for participation acquisitions if the French acquiring company is not able to demonstrate, by any means, that:

- The decisions relating to these participations are effectively made by i) the acquiring company itself or by ii) a company established in France that "directly or indirectly" controls the acquiring company under the meaning of Article L.233-3 of the French Commercial Code, or by iii) a company established in France that is "directly" controlled by the same company as the one controlling the French acquiring company under the meaning of Article L.233-3 of the French Commercial Code (i.e., a "sister" of the acquiring company) and,
- Where "control or influence" is exercised over the acquired company, this control or influence is effectively exercised by the acquiring company, or by a company established in France that "directly or indirectly" controls the acquiring company, or by a company established in France that is "directly" controlled by the same company as the one controlling the French acquiring company.

Participations or qualifying shareholdings that fall within the scope of this measure are controlling interests in French or foreign entities which, from an accounting standpoint (under French GAAP), are recorded as "*titres de participation*" and participations which are eligible for the French dividend participation exemption regime.

Expenses covered by this limitation are not only interest *strict sensu* but also fees and penalties directly connected to acquisition financing such as prepayment or credit facility fee.

This limitation applies to any financing provided by related parties or third parties.

Further guidance is expected, notably on the definition of the concepts of "control" and "influence" which currently raise a lot of debate.

3. Computation of the new limitation

If the French acquiring company cannot provide the required evidence, for a given Fiscal Year, the amount of disallowed interest expense will be computed as follows:

$$\text{Interest expense of the fiscal year} \times \frac{\text{Acquisition price of the qualifying shareholdings}}{\text{Average amount of debt of the acquiring company for the fiscal year}}$$

When applicable, the interest deduction disallowance will apply beginning with the fiscal year in which the evidence was not provided until the end of the eighth year following the year of the participation acquisitions.

In the case of a merger, demerger, spin-off or any assimilated restructuring performed within the eight-year period mentioned above, the disallowance will continue to apply at the level of the new entity holding the participations for the remaining period. In this case, the amount of the interest deduction disallowance will be computed based on the formula above (i.e., by using the original acquisition price of the absorbed or demerged entity and the average Fiscal Year's indebtedness of the new holding entity).

4. Safe harbors

This new limitation will not apply where:

- the total fair market value of the participations owned by the French acquiring company does not exceed EUR 1M;
- the participation acquisition has not been financed by debt either at the level of the French acquiring company or at the level of a company (French or foreign) of the same group under the meaning of article 212 of the French tax code and article L.223-16 of the French Commercial Code;
- the debt-to-equity ratio of the group as defined by article 212 of the French tax code is equal to or higher than the debt-to-equity ratio of the acquiring company.

5. Implementation of the new limitation

The new limitation will apply to fiscal years opened on or after January 1, 2012.

There will be no grandfathering clause: this new measure targets all acquisitions, whether such acquisitions were made before or after January 1, 2012.

For acquisitions made after January 1, 2012, the demonstration that decisions are made and control or influence are exercised by a French company will have to be made for the 12-month period following the acquisition of the qualifying participation.

For acquisitions completed before January 1, 2012, such evidence will be required for the first fiscal year beginning on or after January 1, 2012.

6. Conclusion

This new measure triggers a shift of the burden of proof to the taxpayer. Therefore, French companies should review the conditions of their participation acquisitions made before January 1, 2012. After that date, French companies should be able to demonstrate to the French Tax Authorities that the decisions relating to their participations are effectively made in France and, when applicable, that control or influence is also exercised from France.

Going forward, companies should review and monitor their decision-making processes in France to ensure that they continue to satisfy to this new qualifying shareholding control test.

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