

News Analysis: France's New Antiabuse Rule on the Deductibility Of Financing Expenses

by Nicolas Jacquot

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In addition to rules on thin capitalization and arm's-length interest rates, France has just introduced a new rule that disallows the deduction of interest and other financing expenses incurred for acquisitions if the decisions relating to the shareholdings are not made in France or the control or influence over the acquired company is not exercised in France.

This new rule affects the tax treatment of French and non-French acquisitions by French companies held by international corporate groups or private equity funds that do not have an autonomous decision-making center in France.

Description of the New Rule

Under the new rule, interest and other financing costs incurred by a French company upon the acquisition of a participation shareholding¹ will not be deductible for French tax purposes if the French acquiring company is not able to demonstrate, by whatever means, that:

- the decisions relating to the acquired shareholding are effectively made in France by itself directly or by its French resident controlling or sister company; and
- the "control or an influence" over the acquired company is also effectively exercised in France by the French acquiring company directly or by its French-resident controlling or sister company.

The rule concerns participation shareholdings. Those shareholdings are eligible for the French participation exemption regime, which provides for a 90 per-

¹Generally, a shareholding in a French or non-French company, representing at least 5 percent of the company's shares and voting rights, that is held for at least two years.

cent² exemption of capital gains realized on the sale of shares. The rule doesn't apply to shareholdings in companies with assets that consist primarily of real estate assets or shares in real estate companies.

It requires the French acquiring company to demonstrate (by any means) to the French tax authorities that the decision, control, and influence conditions are satisfied for:

- shareholdings acquired on or after January 1, 2012, for the fiscal year or the fiscal years covered by the 12-month period following the relevant acquisition date; and
- shareholdings acquired before January 1, 2012, for the first fiscal year beginning after January 1, 2012.

If compliance with those conditions cannot be demonstrated, a portion of the interest and other financing costs incurred by the French acquiring company will be added back to its taxable income for the fiscal year during which proof of compliance was required and for subsequent fiscal years until the expiration of an eight-year period following the relevant acquisition year (even if the requirements are met during the subsequent years). In other words, the rule covers acquisitions that took place after January 1, 2004.

The portion of the interest that is added back into the taxable income is equal to the sum of the interest and the ratio between the acquisition price of the shareholding and the average amount of the acquiring company's aggregate debt during the relevant fiscal year. Specific rules apply to mergers, spinoffs, or any similar transactions.

However, the rule contains some safe harbor provisions. It does not apply if:

- the aggregate value of the shareholding at stake is less than €1 million;
- the acquisition is not financed with debt incurred by the acquiring company or by a related company (for example, any French or non-French

²The rate decreased from 95 percent to 90 percent in accordance with a clause adopted on September 19, 2011.

company that directly or indirectly controls the acquiring company or a sister company)³; or

- the debt-to-equity ratio of the French acquiring company is not higher than that of its group of related companies.

Actual Impact of the New Rule

The rule raises several questions, as the text of the law is not always clear. For example:

- What are the “decisions relating to the shareholding”?
- Do they include the decision to acquire the shares?
- What is the meaning of the wording “control or an influence exercised over the acquired company”?
- What is the nature of the evidence that must be produced or that may be accepted by French tax authorities to demonstrate that the decisions, control, and influence are exercised in France?

Unfortunately, the preparatory work for the new rule is light, but it seems to indicate that the acquiring company will have to provide evidence that it constitutes an autonomous decision-making center in relation

³For French tax purposes, companies are deemed to be related if one company owns, directly or indirectly, more than 50 percent of either the share capital or the voting rights of the other company, or if both companies are under the control of a single third-party company.

to the relevant shareholding, as if it were to be regarded as a permanent establishment for French tax purposes.

It also indicates that the French acquiring company will be expected, for example, to provide legal and functional charts of the group to which it belongs and the minutes of the meetings of the shareholders or boards of directors.

Final Remarks

Although the way it is written indicates the contrary, this new rule is clearly and solely an antiabuse provision. Therefore, in theory, it should only target structures with an artificial location of a holding in France; otherwise its compatibility with EU law would be questioned. Its actual impact, however, will depend on the attitude of the French tax authorities. It is not clear whether they will require the French acquiring company to have a high degree of substance.

As it is not in the tradition of French tax authorities to give clear-cut criteria for the application of antiabuse provisions, the new rule probably will require the auditing of past and future acquisitions by French companies to ensure the deductibility of interest and other financing expenses. It is also advisable to prepare documentation to prove that the French acquiring company (or its French resident controlling or sister company) held by an international corporate group or investment fund plays a key role in the management of the acquired companies.

Still, it is too soon to qualify this badly conceived new antiabuse provision as a sledgehammer to crack nuts. ◆

◆ *Nicolas Jacquot, partner, Taxand France, Paris*