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COUNTRY DIGEST

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News Analysis: New Criteria Relevant To French Thin Cap Rules

The French Senate and National Assembly have given their preliminary approval for another amendment[1] of the thin capitalization rules in the amended finance bill for 2011 to make the rules more restrictive. The final vote approving the measures is expected soon.

Decisions Made in France

Under the proposed reform, as of January 1, 2012, the right to deduct interest due on purchases of shares in target companies would be denied unless the French acquiring company demonstrates — by any means:

- that the decisions concerning the shares are effectively made by it or by a related party established in France; and
- that if a controlling interest is held in the target companies, that control is exercised by the French company or a related party established in France.

For the purposes of this new rule, a related party can be a controlling company or an entity controlled by the acquiring company, as established in section L. 233-3 of the French Commercial Code.

The rule targets the purchase of shareholdings that are eligible for France's long-term participation exemption (mainly shares in non-real-estate property companies that represent at least 5 percent of the financial and voting rights of the company).

If the owner of the shareholdings cannot demonstrate that ''the decisions relating to such shares have been made in France,'' the nondeductible portion of the interest borne by the owning company would be calculated as follows (for each financial year until the ninth year of acquisition):

$$\text{Amount of interest due by the French acquiring company} \times \frac{\text{Purchase price of the shares}}{\text{Average indebtedness of the company}}$$

Average indebtedness of the company

This new rule would apply to financial years open as of the acquisition date of new shareholdings, or, for shareholdings acquired before January 1, 2012, it would apply to financial years open as of January 1, 2012. In practice, shareholdings acquired before 2004 would fall outside the scope of the new regulation.

By way of exception, the new rule wouldn't apply to shares held in subsidiaries whose value is less than €1 million. The new rule also wouldn't apply if the company can demonstrate that the shares have not been financed with a new loan or if its group indebtedness ratio exceeds its own indebtedness ratio.

Substance in France

The initial purpose of this reform was to limit the debt push-down strategy of international groups selling the shares of their existing non-French subsidiaries to their French profit-making companies, or in the context of a multijurisdictional acquisition, making their French profit-making subsidiaries acquire non-French target companies.

As a result of those acquisitions, the French companies' profits are reduced by the amount of interest regarding the financing of the acquisitions, while dividends received from the non-French subsidiaries by the French holding companies usually are tax exempt for up to 95 percent of their amount, and long-term capital gains realized on the resale of those subsidiaries are tax exempt for up to 90 percent.[2]

However, the Parliament's decision to very loosely define the concept of ''decisions effectively taken by

[1]The French thin capitalization rules were previously amended at the end of 2010 to allow third-party loans to be recharacterized as related-party debt if the loans are secured by guarantees given by related parties (with a few exceptions).

[2]If they are not real estate property companies.

the French holding company (or a related party)'' will likely affect many more situations.

Indeed, contrary to the initial intent of the Parliament, the reform would also apply to the purchase of French companies, meaning that it would apply to ''plain vanilla'' French investment structures in which a foreign investor acquires a French target through a newly formed French holding company that bears the financing, and forms a French tax group with the French target.

In other words, any time a French company buys another company (or takes a shareholding in the company of 5 percent or more), it will have to demonstrate that any decisions relating to that investment are, in fact, made in France by the owner of the shares (or a related party), regardless of whether the target company is French.

Moreover, and even more importantly, the Parliament's concept of ''decisions effectively made in France'' is vague and could lead to opposing interpretations among the French tax authorities, the taxpayer, and the courts.

If one analyzes this concept through the perspective of the French tax authorities, the ''decisions effectively made in France'' should include, for example, the decision to purchase the shares and how to finance the purchase, the dividend policy and the financing policy of the target (in case of controlling interest), and the decision to sell the shares. In the context of a controlling interest, these decisions should also include the major decisions taken by the target company itself.

Further, one must consider the possibility that the word ''decision'' would not be construed literally and would not be limited to the legal decision made by the legal representative of the company (for example, to buy or sell the shares). Indeed, the French tax authorities are likely to argue that most of the preliminary steps necessary to make those decisions (such as preparatory studies and the negotiation of the legal documentation relating to the transactions) and more generally, all the main steps pertaining to the overall decision process, should take place in France. Indeed, the preamble explaining the purpose of the reform confirms that the company would have to establish the ''reality of its decision process'' and demonstrate that it constitutes an autonomous decision center for the purpose of managing its shareholdings.

In practice, a decision center should be deemed to exist in France if the holding's level of substance fulfills the general criteria used to identify a permanent establishment (that is, the presence of the premises, equipment, and human resources — such as directors and employees — in France) and if the activities of the decision center are not limited to ancillary activities, which is unlikely in the case of a mere passive holding company.

The requirements could be complex and difficult to fulfill for investments made in France by investors with no presence in France, such as non-French private equity investment funds.

In light of the proposed reform, international industrial groups with an operating subsidiary in France that is held through a French passive holding will likely have to reexamine their French decision processes.

Freedom of Establishment

Just weeks after the European Court of Justice confirmed the importance of the freedom of establishment in *National Grid Indus BV v. Netherlands* (C-371/10) (see *Doc 2011-24891* or *2011 WTD 230-22*; see also p. 7 of this issue for related discussion), one may wonder if the de facto requirement of making a decision in France is compatible with that freedom, insofar as the rule requires that any nonresident who wants to make a French investment must have sufficient substance in France. By way of comparison, a French company held by French investors should de facto meet those substance requirements. It could be argued that the difference could potentially raise a discrimination issue.

In that respect, both the French Supreme Court (in *Coréal Gestion,* No. 249047, Dec. 30, 2003) and the ECJ (*Lankhorst-Hohorst* (C-324/00), *Doc 2002-27361*, *2002 WTD 241-23*) have already held that a difference in the treatment of thin capitalization rules by resident subsidiary companies based on the seat of their parent company constitutes an obstacle to the freedom of establishment, which is prohibited by article 43 EC.

However, under this reform, it is not so much the nationality criteria that is at stake (which would have been precluded by EU law), but a new criteria: the ''place of decision.''

In fact, it seems as if the Parliament is trying to apply the ''genuine economic activities'' criteria used by the ECJ in *Cadbury Schweppes* (C-196/04) (see *Doc 2006-19082* or *2006 WTD 177-8*) in a reverse manner to deny non-French investors the right to benefit from favorable thin capitalization rules for those who are investing in France through a company that is not deemed to carry on genuine economic activities there.

This situation raises the more general question of whether a host member state, despite the freedom of establishment, can systematically impose substance on foreign investors in that state in order to enable the investors' local holding company to benefit from the favorable thin cap regime (or any other more favorable national tax regime).

As is often the case when it comes to freedom of establishment, the response to this question will likely depend on the analysis of the proportionality of the requirement imposed on non-French investors.

In that respect, the mere fact that the burden of proving that those decisions were made in France rests

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with the investors — as opposed to the French tax authorities — seems to presume that French holdings controlled by non-French investors are necessarily interposed to reduce French taxes. Those presumptions are usually not viewed as a factor of proportionality by the ECJ, but the debate remains open. ◆

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