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French Thin-Capitalization Rules

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Introduction

Article 113 of the French Finance Act for 2006 (law n° 2005-1719 dated 30 December 2005) has introduced French thin-capitalization rules, codified under Article 212 of the French Tax Code ("**FTC**"). These rules have given rise to comprehensive comments by the French tax authorities in a circular referenced 4 H-8-07 published in the Official Tax Bulletin n° 133 dated 31 December 2007 (the "**Circular**").

Article 12 of the Finance Act for 2011 (law n° 2010-1657 dated 29 December 2010) introduced new provisions extending the scope of the French thin-capitalization rules to certain loans granted by third-party lenders and guaranteed by a related undertaking.

The purpose of this Briefing is to highlight the key points about the French thin-capitalization rules. It is only a summary of these rules.

Scope of the thin-capitalization rules

1. The thin-capitalization rules apply to entities subject to corporate income tax (including French permanent establishments or foreign entities, as well as partnerships to the extent of the percentage of rights held by partners subject to corporate income tax).
2. The thin-capitalization rules apply to all loans granted to the borrowing company by any related undertaking (*"entreprise liée"*) (an "**Affiliate**") or secured directly or indirectly by an Affiliate.
3. All types of loans (whether resulting from an advance of funds or a receivable) must be taken into account. Are however excluded: (i) advances made by an Affiliate acting as supplier or client in the frame of normal commercial relationships, (ii) advances granted by financial institutions to an Affiliate if granted under conditions similar to that granted to third party clients and (iii) non-interest bearing advances granted to partnerships.

4. An Affiliate is defined by reference to Article 39-12 of the FTC pursuant to which affiliation links are deemed to exist between two undertakings (a) where one of the undertaking holds directly or through an interposed person the majority of the share capital of the other undertaking or exercises *de facto* therein the decision power, or (b) where the two undertakings are under the control of a third undertaking under the conditions defined in (a) above. As a result, loans granted by sister or grandparent companies to a French company may fall within the scope of the thin-capitalization rules, whatever the number of interposed companies.

5. Until the Finance Act for 2011, loans granted by third parties such as financial institutions were outside the scope of these tax limitations, even if such loans were guaranteed by the parent company of the borrowing entity or by any other affiliated company. For fiscal years ended as from 31 December 2010, interest incurred on loans granted by unrelated lenders must be taken into account for the purposes of the thin-capitalization limitations described in paragraphs 7 and 8 below when the reimbursement of such loans is guaranteed by a party who is an Affiliate of the borrower, or by another person, the commitment of which is itself guaranteed by an Affiliate of the borrower ("**Guaranteed Loans**"). The scope of the relevant guarantees is very broad and includes personal guarantees, first demand guarantees, comfort letters with a contractual obligation guaranteeing a result, pledges, mortgages, etc.. As far as real security interests are concerned (i.e. guarantees *in rem*), the loan is deemed guaranteed only up to the same proportion as the value of the asset as at the date the security interest has been created bears to the initial amount of the financing. By way of exception, Guaranteed Loans do not fall within the scope of the thin-capitalization limitations in the four following circumstances:

   a. bonds issued within the frame of a public offer within the meaning of Article L 411-1 of the Monetary and Financial code or under equivalent foreign regulations (this exclusion is therefore not applicable to private placements);

   b. loans guaranteed exclusively by a pledge over the shares of the borrowing company or over the borrowing company receivables or over the shares of a company owning directly or indirectly the borrowing company when the holder of such shares and the borrowing company are members of the same French tax consolidated group;

   c. loans contracted for the purposes of repaying an existing debt, which became compulsorily repayable due to a change of control of the borrower, up to the amount of capital reimbursed and interest falling due upon the repayment of the existing debt; and

   d. loans entered into before 1 January 2011 in connection with an acquisition of shares or with the refinancing of such an acquisition.

How do the limitations work in general?

6. **Interest rate limitation** - Article 212-I of the FTC provides that, in respect of a given fiscal year, interest incurred on loans granted by all Affiliates is tax deductible up to the rate referred to in Article 39-1-3°-1st paragraph of the FTC[1], or, if higher, up to the rate that the borrowing entity could have obtained from independent financial credit institutions in similar circumstances (i.e. a market rate) (the "**Allowable Interest**"). According to the Circular, the rate should be compared to the rate that would be granted by an independent financial credit institution in similar circumstances, having regard to the nature and amount of the financing, the availability period, the foreign exchange risk borne by the lender (if any) and the credit risk of the borrower. The interest paid to an Affiliate will be deemed to be at market rate if the borrower can provide a contemporaneous credit offer from an independent financial credit institution offering no better condition for a similar financing. Interest paid to an Affiliate which exceed interest at market rate is not deductible and is definitively lost.

[1] The rate mentioned in to Article 39-1-3°-1st § is the annual average of the average effective floating rates on bank loans to companies with an initial maturity exceeding two years.

7. **Thin-capitalization limitations** - Then Article 212-II of the FTC provides that when the amount of Allowable Interest (and for the purposes of the thin-capitalization limitations, including the interest incurred under Guaranteed Loans) simultaneously exceeds, with respect to the relevant fiscal year, the three following limits [2]:

   a. ***The debt/equity ratio***: the amount of Allowable Interest (including interest incurred under Guaranteed Loans) multiplied by the ratio between (i) 1.5 times the shareholders' equity (*capitaux propres*) of the borrower[3] (at the opening or the closing of the financial year[4]) and (ii) the average amount of indebtedness in respect of loans from Affiliates (including the amount of indebtedness under Guaranteed Loans) throughout the relevant financial year; according to the Circular, the taxpayer is allowed to substitute the amount of share capital to the amount of shareholders' equity if the amount of share capital is higher[5]; and

   b. ***The interest coverage ratio***: 25% of the operating profit (loss) before taxes increased by (i) the amount of Allowable Interest (including interest incurred under Guaranteed Loans), and (ii) the amount of depreciation allowances taken into account to determine the operating profit before taxes and by the portion of finance lease payments taken into account to determine the sale price of the asset at the end of the lease (hereinafter the "**Increased Operating & Financial Result**" or "**IOFR**"); and

   c. ***The interest received test***: the amount of interest earned by the borrowing entity itself from Affiliates;

   that part of the amount of Allowable Interest that exceeds the highest of the three limits, cannot be deducted with respect to the relevant fiscal year (the "**Non-Deductible Interest**" or "**NDI**") unless it does not exceed EUR 150,000.

Year 1 ("Y1")
Allowable Interest owed to Affiliates (including interest incurred under Guaranteed Loans) in Y1: EUR 1,000,000.
a) Limit based on debt/equity ratio: EUR 400,000.
b) Limit based on interest coverage ratio: EUR 700,000.
c) Interest received from Affiliates: EUR 20,000.
NDI = 1,000,000 – 700,000 = EUR 300,000 (this amount is greater than EUR 150,000)

8. The NDI with respect to a given fiscal year ("**Y1**") can be deducted in respect of the subsequent fiscal year ("**Y2**") in an amount equal to the positive difference between (i) 25% of the IOFR of Y2 and (ii) the amount of Allowable Interest (including interest incurred under Guaranteed Loans) in respect of Y2. In order to get a tax deduction of NDI of Y1 against the profits of Y2, the taxpayer must therefore (i) not fall within the rules described in paragraph 7 above and (ii) not incur Allowable Interest (including interest incurred under Guaranteed Loans) in excess of the interest coverage ratio described in paragraph 7(b) above. The balance of NDI, if any, can be deducted under the same conditions in subsequent fiscal years (Y3 and onwards), after a 5% write-off at the opening of each such subsequent fiscal years.

[2] If the amount of Allowable Interest remains within at least one of the three limits, then the amount of Allowable Interest if fully deductible in the relevant fiscal year.

[3] All shareholders funds (including retained earnings) are be taken into account; however the shareholders' equity that is taken into account is the shareholders' equity as it appears in the accounts: “hidden reserves” (i.e., latent gains on the assets) are not included.

[4] The taxpayer is entitled to choose the best option.

[5] This concession is subject to compliance with the commercial code rules providing for a specific recapitalization procedure in the event the shareholders' equity becomes lower than half the share capital.

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Year 2 ("Y2")

Allowable Interest owed to Affiliates (including interest incurred under Guaranteed Loans) in Y2: EUR 750,000.

a) Limit based on debt/equity ratio: EUR 300,000.

b) Limit based on interest coverage ratio: EUR 730,000.

c) Interest received from Affiliates: EUR 0.

The amount of Allowable Interest (including interest incurred under Guaranteed Loans) of Y2 (EUR 750,000) exceeds the highest of the three limits (EUR 730,000) by EUR 20,000 only, i.e., less than EUR 150,000: the amount of Allowable Interest (including interest incurred under Guaranteed Loans) of Y2 is fully deductible in Y2.

None of the NDI of Y1 can be deducted in Y2, because the difference between the limit based on the interest coverage ratio (EUR 730,000) and the Allowable Interest (including interest incurred under Guaranteed Loans) in Y2 (EUR 750,000) is negative.

Year 3 ("Y3")

Allowable Interest owed to Affiliates (including interest incurred under Guaranteed Loans) in Y3: EUR 600,000.

a) Limit based on debt/equity ratio: EUR 450,000.

b) Limit based on interest coverage ratio: EUR 800,000.

c) Interest received from Affiliates: EUR 0.

The full amount of Allowable Interest (including interest incurred under Guaranteed Loans) incurred in Y3 (EUR 600,000) is deductible in Y3 because it is lower than the limit based on the interest coverage ratio (EUR 800,000).

In addition, NDI of Y1 (EUR 300,000) minus a 5% write-off (EUR 15,000), i.e., EUR 285,000 can be deducted in Y3, in an amount equal to the difference between the limit based on interest coverage ratio of Y3 (EUR 800,000) and the amount of Allowable Interest (including interest incurred under Guaranteed Loans) of Y3 (EUR 600,000), i.e., EUR 200,000. The balance of NDI of Y1 (EUR 85,000) less a 5% write-off (EUR 4,250), i.e., EUR 80,750 can be carried forward for a possible use in Year 4.

9. In the event of a reorganization subject to the tax-neutral regime set out in Article 210 A of the FTC (mergers or de-mergers), the NDI carried forward in accordance with the rules described in paragraph 8 above by the absorbed entity, may be transferred to the absorbing entity, in the same way as the absorbed entity can transfer its tax losses carry forwards to the absorbing entity.

Exemptions

10. The rules described in paragraphs 7 and 8 above do not apply to interest incurred (i) for the purposes of financing transactions realized as part of a group cash pooling agreement (for the centralizing company), (ii) for the purposes of financing the acquisition of assets that are in turn subject to a finance lease transaction[6], and (iii) by regulated credit institutions. Such interest expenses are also not taken into account for the purposes of applying the rules described in paragraph 7 above.

[6] *This exemption would notably apply to tax lease transactions involving "GIE fiscaux" or similar structures.*

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Safe harbor provisions

11. Article 212 includes a safe harbor provision. The rules described in paragraphs 7 and 8 above do not apply if the borrowing entity brings evidence that the overall debt/equity ratio of the group to which it belongs is, with respect to the relevant fiscal year, higher than – or equal to – its own overall debt/equity ratio. For the purposes of these provisions, the word "group" means all the entities, whether French or foreign, which are under the exclusive control of the same entity within the meaning of Article L 233-16 II of the French Commercial Code[7]. For the purposes of determining the voting rights held by the controlling entity, the percentages of votes held by each group entity must be aggregated. The overall debt/equity ratio of the French borrowing entity is calculated at the close of the relevant fiscal year and is equal to the ratio between (i) its total indebtedness (not just indebtedness towards related undertakings) and (ii) the total amount of its shareholders' equity (*capitaux propres*) (as determined as described in paragraph 7(a) above, i.e., with the option to choose between shareholders' equity and share capital). The overall debt/equity ratio of the group is equal to the ratio between (i) the total indebtedness (excluding intra-group debts) shown on the balance sheet of the most recently closed accounting period of each group company and (ii) the aggregate amounts of equity (*capitaux propres*) shown on the balance sheet of the most recently closed accounting period of each group company, after deduction of the book value of the shareholdings in controlled companies and after adjustments to neutralize the impact on the equity of intra-group transactions. For simplification purposes and pursuant to the Circular, it is accepted that the overall debt/equity ratio of the group be calculated based on public data published in accordance with applicable regulations governing consolidated accounts. The Circular provides guidance as to how the overall debt/equity ratio must be calculated depending on whether the consolidated accounts are prepared under French GAAP or under IFRS or US GAAP.

NDI are not "deemed distributions"

12. The NDI, the deduction of which is deferred as described in paragraph 7 above, are not treated as "deemed distributions". As a result, if the lender is a foreign company, the NDI will not be subject to dividend withholding tax in France and will benefit from the interest withholding tax exemption.

How does the limitation work for tax-consolidated groups?

13. Specific rules apply to tax-consolidated groups. Each tax-consolidated entity (a "**Group Entity**") is required to compute NDI at its level in accordance with the aforementioned rules. The NDI incurred by a Group Entity cannot be carried forward against the subsequent results of that particular Group Entity. The aggregate amounts of NDI incurred by each Group Entity (the "**Group NDI**") can however give rise to an immediate tax deduction, in whole or in part, at tax group level, if and to the extent the Group NDI exceeds an amount equal to the difference between (i) the sum of (a) all interest paid by all Group Entities to Affiliates that are not part of the tax-consolidated group (including interest incurred under a Guaranteed Loan even if such Guaranteed Loan is guaranteed by a Group Entity) and (b) NDI incurred by Group Entities prior to joining the tax group and deducted in the relevant fiscal year, and (ii) 25% of the aggregate amount of all IOFR of each Group Entity (as determined pursuant to the rules described in paragraph 7(b) above and adjusted by the deduction of interest paid to Affiliates that belong to the group and by dividends received from another Group Entity).

    The balance of Group NDI that cannot be immediately deducted can be carried forward and subsequently deducted from the tax group's consolidated result pursuant to rules equivalent to that described in paragraph 8 above. The

[7] *According to article L 233-16 II of the French commercial code, "the exclusive control by a company results from:*

1° either the direct or indirect holding of the majority of the votes in another entity;

2° either the designation, over two consecutive fiscal years, of the majority of the members of the governing or supervising bodies in another entity; the [controlling] company is deemed to have made this designation where that company has held, over this period, directly or indirectly, more than 40% of the votes and where no other shareholder was holding, directly or indirectly, a greater percentage;

3° or the right to have a dominant influence on another entity pursuant to the provision of an agreement or by virtue of the bye-laws, and where the dominating company is a shareholder in this entity."

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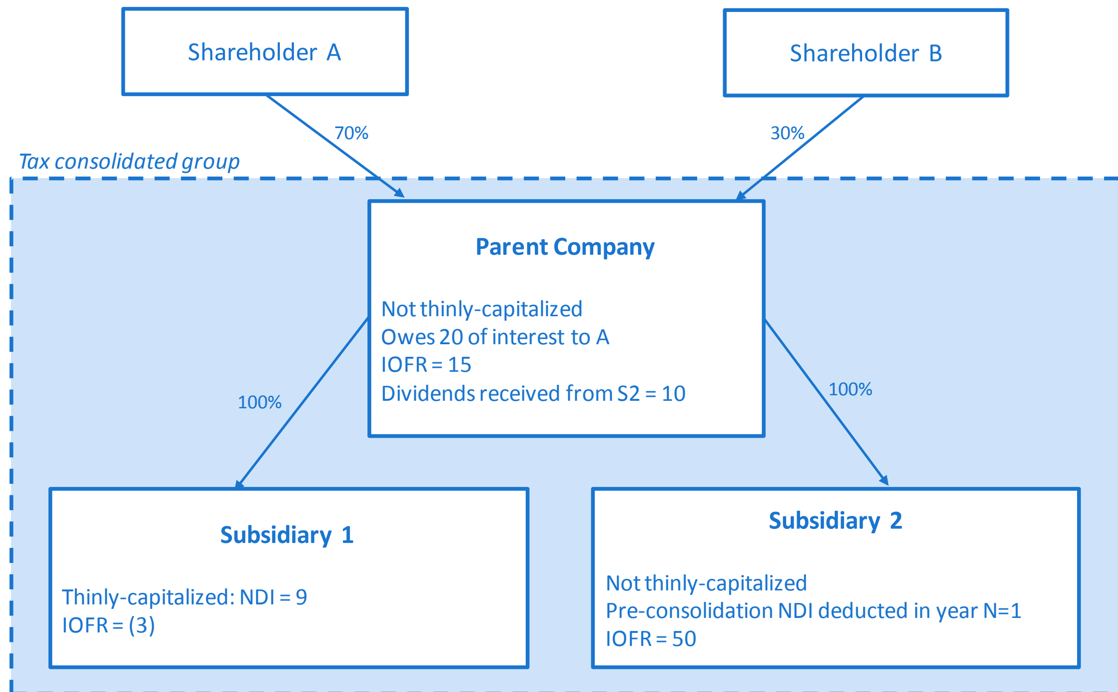
rules described in this paragraph are aimed at effectively eliminating the effect of the new thin-capitalization rules with respect to loans among Group Entities.

14. Example (facts with respect to fiscal year N):



15. Solution:

The aggregate amount of NDI determined at the level of each Group Entity and transferred at group level is equal to 9 (i.e., NDI calculated at the level of S1 which is the only thinly-capitalized entity in the tax group).

The maximum amount of non-deductible interest at group level is equal to the difference between:

(a) The amount of interest due to Affiliates that do not belong to the tax consolidated tax group (20) plus the amount of pre-consolidation NDI deducted by Group Entities (1): 20 +1 = **21**; and

(b) 25% of aggregate IOFR of Group Entities (15 - 3 + 50) plus interest due by Group Entities to Affiliates that do not belong to the tax group (20) less dividends received by Group Entities from other Group Entities (10): 25% * (15 - 3 + 50 + 20 - 10) = **18**

The maximum amount of non-deductible interest at group level is therefore equal to: 21 - 18 = **3**

With respect to the current fiscal year, the parent company of the group will therefore be allowed to deduct from the consolidated group result the difference between the aggregate amount of NDI determined at the level of each individual group member and transferred at group level (9) and the maximum amount of non-deductible interest at group level (3): 9 - 3 = **6**

The deduction of the balance of NDI transferred at group level (**3**) with respect to fiscal year N ("**NDI_N**") is deferred and may be deducted at group level in the following fiscal year: see below.

16. Example – continued (facts with respect to fiscal year N + 1):

S1 is still thinly-capitalized; NDI with respect to fiscal year N + 1 = 6

Interest paid by Group Entities to Affiliates that do not belong to the tax group amount to 19

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The aggregate amount of IOFR of Group Entities plus interest due by Group Entities to Affiliates that do not belong to the tax group less dividends received by Group Entities from other Group Entities is equal to 80

17. Solution – continued

The aggregate amount of NDI determined at the level of each Group Entity and transferred at group level is equal to 6 (i.e., NDI calculated at the level of S1 which is the only thinly-capitalized entity in the tax group).

This amount is fully deductible from the group result as the amount of Interest paid by Group Entities to Affiliates that do not belong to the tax group (19) is lower than 25% of the adjusted aggregate amount of IOFR of Group Entities (25% * 80 = 20)

The balance of NDI_N (3) are deductible at group level in fiscal year N + 1 up to amount equal to the difference between:

- 25% of the adjusted aggregate amount of IOFR of Group Entities: 25% * 80 = **20**; and
- The amount of interest due to Affiliates that do not belong to the tax-consolidated tax group (19) plus the amount of pre-consolidation NDI deducted by Group Entities (0): 19 + 0 = **19**

The balance of NDI_N (3) are deductible at group level in fiscal year N + 1 up to an amount equal to: 20 - 19 = **1**

The remaining balance of NDI_N (**2**) is deferred and may be deducted at group level in fiscal year N + 2 after a 5% write-off (**1.9**) or in subsequent fiscal years – subject to a 5% annual write-off.

This Client briefing does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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