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Briefing note

October 2012

Draft Finance Bill for 2013 released by the French government

The second series of tax measures announced by the new French government in order to redress the public finances has been presented to the council of ministers on 28 September 2012 as part of the Finance Bill for 2013.

Tax increases affecting corporate income tax (**CIT**), personal income tax (**PIT**) and wealth tax are proposed, including the emblematic tax measures announced by President François Hollande after his election.

This Briefing summarizes the key features of the most notable tax measures included in the draft Finance Bill for 2013 (**Draft Bill**).

Key issues

- Provisions affecting CIT
- Provisions affecting PIT
- Wealth tax

Provisions affecting CIT

The three following main proposed tax measures affecting CIT are intended to apply to fiscal years closed on or after 31 December 2012. For companies closing their financial year on 31 December, these tax measures would thus apply retroactively to the fiscal year 2012.

- Non-deductibility of a portion of interest expenses

  In addition to existing thin-capitalization rules, which remain unchanged, the Draft Bill introduces a new proportional interest deduction limitation. The net interest expenses after set off of interest income would become non-tax deductible up to 15% of their amount for 2012 and 2013 and 25% as from 2014.

  The non-deductible interest in application of the thin capitalization rules and of the specific anti abuse mechanism for interest expenses incurred in relation to a share purchase would not be considered for the purposes of computing the portion of net interest expenses to be added back pursuant to the limitation. In order not to penalize small and medium-sized enterprises, the above restriction would not apply when the net interest expenses do not exceed € 3 million.

  If the company is a member of a tax-consolidated group (*intégration fiscale*), the new interest deduction limit would not apply to interest expenses between companies which are members of the same tax group.

  The € 3 million threshold would be appreciated at the group level considering the total net interest expenses of the group.

  Non-deductible interest would be lost (i.e. no carry forward).

- New limitation on tax losses carry-forward

  Under the current legislation, the amount of tax losses carried forward that can be set off against subsequent taxable income is capped to 60% of the amount of taxable profits of each subsequent fiscal year in excess of € 1 million. The Draft Bill would reduce this cap to 50%.

- Participation exemption regime applicable to long-term capital gains

  The Draft Bill slightly amends the 90% exemption applicable to net long-term capital gains falling within the participation exemption regime. Currently, 10% of the net capital gains (i.e. capital gains after set off of capital losses) must be added back to the taxable income subject to CIT.

  The Draft Bill provides that this lump-sum amount would be now equal to 10% of the gross long-term capital gains, these being no longer reduced by the long-term capital losses incurred.

Provisions affecting PIT

- New 45% income tax bracket

  The Draft Bill would introduce a new 45% income tax rate for the portion of taxable income exceeding € 150,000 per share.

  The exceptional surtax of 3% on the portion of income exceeding € 250,000 for a single person (€ 500,000 for a couple), increased to 4% for income exceeding € 500,000 for a single person (€ 1 million for a couple), introduced by the Finance Act for 2012 would be maintained.

- 75% rate of taxation for very high income

  Implementing President François Hollande's announcement to tax very high income at the rate of 75%, the Draft Bill would introduce a new exceptional temporary "solidarity" tax on income from activities, equal to 18% of the part of the income exceeding € 1 million.

  The rate of 75% is reached by the addition of this exceptional "solidarity" 18% tax plus the higher income tax rate (45%), the exceptional surtax (4%) and the social contributions (8%). This tax would apply only to income from activities, i.e. mostly employment and business income. It would apply to income of years 2012 and 2013.

- Alignment of taxation of revenues from capital, including capital gains, and revenues from employment

  The Draft Bill abolishes the proportional rate of 19% for capital gains on shares and securities realized as from 1st January 2012, i.e. retroactively for the year 2012. These capital gains would become subject to PIT at the progressive tax rates (i.e. tax rates ranging from 0% to 45% plus exceptional surtax of 3%/4%).

  Social contributions would remain due at the global rate of 15.5%.

  The favorable regime applicable to shares held through a stock saving plan (*Plan d'épargne en actions)* would be maintained.

  The specific tax regime applicable to income derived from carried interest (taxation at the proportional capital gain tax rate of 19% plus social contributions of 15.5%) would be abolished. Income derived from carried interest would now be taxed as salary income and would be subject to the progressive rates of PIT.

  The French domestic rate of taxation of non-residents on disposal of substantial shareholdings (over 25%) would be raised from 19% to 45% for capital gains realized as from 1st January 2013. A mechanism of possible restitution of the excess tax would be introduced for individuals when the 45% taxation exceeds that which would be due when applying the progressive PIT tax rates to French source income including these capital gains.

  The existing specific mechanisms applicable to directors of small and medium-sized enterprises retiring and to stockholders reinvesting a significant part of their capital gains in an enterprise would be maintained unchanged.

  In order to encourage long-term equity investments, a new mechanism of progressive rebate after a 2-year holding period would be introduced, the holding period starting 1st January 2013 for shares acquired prior to that date.

  The Draft Bill also provides that revenues from capital, i.e. dividends and interest, would be subject to PIT at the progressive tax rates, the withholding tax in full discharge of PIT (*prélèvement libératoire*) at the rate of 21% for dividends and 24% for interest being abolished. This would apply to income earned as from 1st January 2012.

- Abolition of the stock options and free shares special tax regimes

  The Draft Bill provides for the abolition of the special tax regimes applicable to so-called "acquisition gains" of stock options and free shares.

  As a reminder, until now, the acquisition gain of stock options, equal to the difference between the market value of the shares on exercise and the exercise price, less any gain taxed on exercise, is subject to tax at a flat rate of 30% or 18% as up to € 152,500 and

41% or 30% above that amount (plus additional contributions) subject to certain holding conditions. The acquisition gain of free shares, equal to the market value of the shares at the time of the vesting (i.e. at the end of the vesting period), is subject to tax at a flat rate of 30% plus additional contributions.

The Draft Bill provides that these acquisition gains would be subject to PIT at progressive tax rates.

This provision would apply – regardless of the grant date – to all disposals of shares resulting from stock options and free shares as from 1st January 2012.

- Ceiling on the use of tax credits

  The cap on the use of designated tax credit items would be reduced from the lower of € 18,000 plus 4% of total income used to calculate the PIT to only € 10,000.

Wealth tax

The Draft Bill abolishes the reduction of wealth tax introduced by the previous government and reintroduces wealth tax brackets ranging from 0.50% to 1.50% (the latter for net taxable value of assets exceeding € 10 million) where taxable value of assets exceeds the threshold of € 1.3 million for the wealth tax due as from 2013. A cap is also reintroduced limiting the total amount of tax in the previous year to 75% of the worldwide revenues.

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The government only recently disclosed the provisions of the Finance Bill for 2013 and it has therefore not yet been debated or voted by Parliament. Discussions will start mid October with a final vote around mid December and publication during the last days of December. Amendments are of course possible but we do not anticipate that the new rules summarized above should be materially amended by Parliament.

Consequently, taking into account their potential impact and retroactive effect, we believe that it is advisable for companies and individuals that may be concerned to assess as of now the possible consequences of the entry into force of these new rules as soon as possible.

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