JONES DAY

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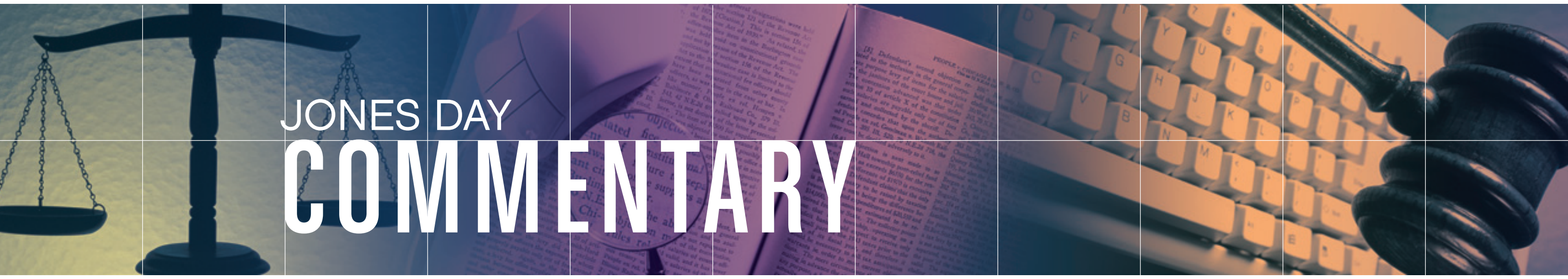

NEW LIMITATION OF INTEREST DEDUCTIBILITY BY FRENCH CORPORATE TAXPAYERS

Further to the introduction of thin-capitalization rules in 2007, which limited the deduction of interest accruing on intragroup debt financing and the enlargement of their scope in 2011 to third-party debt secured by guarantees provided by an affiliate, France has just introduced another limitation of the deductibility of interest expenses for holding companies. The new limitation of interest deductibility is probably one of the most worrying for multinational groups. This *Commentary* provides a short description of this new rule as well as the questions it raises and clarification needed.

The new measure's intended purpose is to counter tax optimization schemes where the taxable base of a multinational group's French subsidiary is eroded by interest deductions on loans financing the acquisition by that French enterprise—under the direction of the ultimate foreign parent of the multinational group—of foreign subsidiaries' stock generating income (dividends) and gains that are almost entirely exempt from French corporate income tax. In those situations, the French subsidiary of a multinational group would typically borrow from a bank to purchase a number of foreign subsidiaries and would be able to deduct the accruing interest in full from its French operational profits. The dividends received from the foreign subsidiaries and gains from disposition of their stock would be tax exempt, but for the residual recapture of a "service charge" resulting in an effective tax charge as low as 1.8 percent on the dividend income and 3.6 percent on long-term capital gains. However, the drafting of the new legislation will potentially apply to a wider range of situations, including fully legitimate "old and cold" structures.

New Art. 209 IX of the French tax code provides that interest expenses incurred by French corporate taxpayers that own French or foreign subsidiaries are tax deductible (always subject to the standard thin-capitalization rules introduced in 2007). However, this is the case only if the taxpayer is able to provide evidence that decisions regarding the ownership of the subsidiaries' stock are taken in France and that the management/control of those subsidiaries is actually performed from France, either by the taxpayer or by another related French corporate taxpayer. Absent satisfactory evidence that the decision process/control is actually performed in France, the interest expense of the French parent company will be denied for a period of nine years from the acquisition of each subsidiary, in the proportion that the acquisition price of the relevant subsidiary bears to the average indebtedness of the French taxpayer for the relevant tax year.

The new interest denial rule does not apply if the total value of the subsidiaries' stock is lower than €1 million. It also does not apply if the taxpayer is able to evidence that the acquisition of the subsidiaries' stock was not actually financed with debt incurred either by the French corporate taxpayer itself or by any related entity, or that the financial leverage of the French corporate taxpayer is not higher than that of its multinational group. It shall also be noted that the new rule does not apply with respect to stock of subsidiaries that are excluded from the scope of the long-term capital gains tax exemption regime, in particular stock of real estate subsidiaries.

The new rule may hurt standard LBO transactions where a dedicated French holding company is created by foreign investors to purchase with borrowed funds the stock of a French target company. It was indeed impossible under EU principles to limit the scope of the new rule to the acquisition of foreign subsidiaries. French LBO acquisitions by foreign investment funds may therefore face interest denials unless sufficient substance exists at holding level, in particular in terms of senior management capabilities, to prove that the decision process and control/supervision of the target company take place in France at the holding level rather than abroad. In that respect, note that it is still unclear whether it will be necessary to evidence that the initial investment decision itself is made from France rather than by a foreign investor.

The new rule may hurt existing structures. New Art. 209 IX does not apply only to the acquisition of subsidiaries' stock occurring from January 1, 2012. French corporate taxpayers that have acquired subsidiaries in the last eight years may also be subject to interest denials for the remainder of the nine-year period from the acquisition if they fail to show that decisions regarding the ownership of the subsidiaries' stock and control/supervision are, beginning January 1, 2012, performed in France. Intermediate French holding companies belonging to a multinational group should therefore take measures to be able to demonstrate that they do have, or that they will have, the authority to make themselves decisions regarding the ownership of their subsidiaries and that they actually control/supervise those subsidiaries.

The exact scope of the new measure remains largely uncertain pending administrative comments and guidelines. In particular, the concept of "decisions regarding the ownership of stock of subsidiaries" and that of "management and control" have not been precisely defined yet. Legislative history and debates show that the lawmakers intended to enact criteria similar to those used to characterize the existence of a French permanent establishment and attribution of subsidiaries' stock to a permanent establishment. However, this would need confirmation from the tax administration and would not necessarily provide reliable guidance since permanent establishment characterization is traditionally the source of numerous disputes between the tax administration and foreign taxpayers. Safe harbor provisions, in particular the possibility to provide evidence that the acquisition of the subsidiary's stock was not debt-financed, will also need clarification. Some commentaries tend to indicate that the tax administration will require that any and all companies belonging to the same multinational group as the French borrower (*i.e.*, companies included in the same consolidated accounts reporting group) provide evidence that their indebtedness was used for purposes other than the direct or indirect acquisition of the relevant subsidiary.

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