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Global Tax Alert

French Government releases draft Finance Bill for 2019

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Executive summary

On 24 September 2018, the French Government presented the draft Finance Bill for 2019 (the draft Bill). This draft will be discussed by the French Parliament over the following weeks and may be subject to amendments; the final version will be enacted by the end of December 2018.

This Alert summarizes the main direct tax reforms included in this draft that may affect corporations.

Detailed discussion

Interest deduction limitation rules

In an effort to comply with the European Union (EU) Anti-Tax Avoidance Directive (ATAD),[1] the draft Bill provides for the following major changes to the current French interest deductibility limitation rules:

- **New general limitation**: net interest expenses would be deductible from the taxable income of a company only to the extent that they do not exceed the higher of the two following thresholds: (i) €3 million or (ii) 30% of the adjusted taxable income of the company (i.e., taxable income before the offset of tax losses and without taking into consideration net financial expenses and – to some extent – depreciation, provisions and capital gains/losses).

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- **Safe harbor provision**: 75% of the net financial expenses exceeding the higher of the abovementioned thresholds would still be tax deductible provided that the equity-to-asset ratio of the company is at least equal to or is not lower by more than two percentage points than the equity-to-asset ratio of the consolidated group to which it belongs.
- **Debt-to-equity ratio**: should the company be thinly capitalized and exceed a specific 1.5 debt-to-equity ratio (i.e., similar to the current debt-to-equity thin-cap ratio), the safe harbor provision would not apply and the net interest expenses would only be tax deductible to the extent that they do not exceed the higher of the two following thresholds: (i) €1 million or (ii) 10% of the abovementioned adjusted taxable income.
- **Interest expense carryforwards**: interest expenses that are excluded from the deductible expenses of a given fiscal year (FY) can be carried forward indefinitely (subject to the abovementioned limitations).
- **Deduction capacity carryforwards**: when, for a given FY, a company does not fully utilize its deduction capacity (i.e., the amount of net interest expense is lower than the abovementioned thresholds), the unused portion of deduction capacity (i.e., amounting to the positive difference between the applicable thresholds and the net interest expenses) can be carried forward for the five following FYs. However, this deduction capacity carryforward cannot be used to deduct non-deductible interest expenses that have been carried forward.
- **Tax consolidation**: the abovementioned new limitation rules would also apply at the level of French tax-consolidated groups, subject to certain conditions.
- **Repeal of certain current limitation rules**: the 25% general reduction, the so-called *Amendement Carrez* (i.e., applicable upon the purchase of a new shareholding) and the three current thin-cap ratios (i.e., debt-to-equity ratio, adjusted earnings threshold and interest income threshold) would be repealed.

Subject to potential changes during the upcoming parliamentary debates, these adjustments of the French interest deductibility limitation rules would apply to FYs open as from 1 January 2019.

Adjustment of the favorable tax regime applicable to patent-related income

Currently, French corporations benefit from a reduced 15% tax rate that applies to:

- Income derived from the licensing of patents and patentable rights.
- Capital gains realized on patents and patentable rights held for at least two years, unless the disposal takes place between related companies.

The draft Bill proposes to modify this favorable tax regime in an effort to make it compatible with the so-called nexus approach of BEPS[2] Action 5, therefore conditioning its application to the actual performance by the claiming taxpayer of research and development (R&D) activities in France.

The reduced 15% rate would now apply, on an election basis only, to the net income derived from the licensing of qualifying patents, after deduction of R&D expenses, and after the application of a ratio comparing: (i) the R&D expenses incurred for the creation, the development, or the acquisition of the qualifying patent, either by the claiming taxpayer or by non-related parties to (ii) the total R&D expenses incurred for the creation, the development, or the acquisition of the qualifying patent. The same tax treatment could apply, still on an election basis, to the net income derived from the sub-licensing of qualifying patents, and to the net gains derived from the transfer, to non-related parties, of qualifying patents, provided that the latter have not been acquired less than two years before.

The favorable regime would no longer cover patentable rights, but exclusively patents. Yet, it would be extended to copyright protected software that have not generated any income before 1 January 2019.

This modified regime would apply to FYs open on or after 1 January 2019, irrespective of the date of creation or acquisition of the qualifying patent.

Improvement of the capital gain participation exemption regime

For FYs open as from 1 January 2019, the participation exemption regime applicable to qualifying disposals of participations would be improved so that only a 5% share of expenses would be non-deductible instead of the current 12%.

See below developments in "Adjustment of the tax consolidation regime."

Adjustment of the tax consolidation regime

Further to recent decisions issued by the European Court of Justice, the draft Bill amends the current French tax consolidation regime in order to ensure its compliance with EU law.

In particular, the draft Bill provides for the following adjustments:

- **Waivers of debts and subsidies between members of a tax-consolidated group**: these transactions which are currently neutralized at the tax-consolidated group level would no longer benefit from such neutralization.
- **Capital gains on share transfers**: the current neutralization at the tax-consolidated group level of the taxable portion of capital gains on share transfers eligible to the participation exemption regime would be repealed. To counterbalance such amendment, the taxable portion, or non-deductible share of expenses (*quote part de frais et charges*) included in the taxable income of a given FY under the French capital gain participation exemption regime would be decreased from 12% to 5% for all companies, whether tax consolidated or not.
- **Dividends not subject to the parent-subsidiary regime**: such dividends would no longer benefit from the current neutralization at the tax-consolidated group level. To counterbalance this adjustment, these dividends would be subject to the same tax treatment as the one currently applicable to dividends eligible to the parent-subsidiary regime within a tax-consolidated group (i.e., tax exemption except for a 1% non-deductible share of expenses (*quote part de frais et charges*)).

Also, in the absence of tax consolidation, the non-deductible share of expenses applicable to certain dividends that benefit from the parent-subsidiary regime would also be reduced from 5% to 1%. This decrease would apply to dividends received by French companies, that are not members of a French tax-consolidated group, from foreign companies that are resident for tax purposes in the EU or in the European Economic Area (EEA) (provided that the EEA country has concluded a treaty with France which includes a mutual assistance provision) and that could be part of a French tax-consolidated group if they were subject to corporate income tax (CIT) in France. However, this reduced non-deductible share of expenses would only apply as long as the non-tax consolidation of the French beneficiary companies does not result from the absence of the option for a French tax-consolidated group.

Subject to potential changes during the upcoming parliamentary debates, these adjustments of the French tax consolidation regime would apply to FYs open as from 1 January 2019.

Implementation of the general anti-abuse provision from the EU ATAD[3]

The draft Bill proposes to transpose into French domestic law the general anti-abuse provision provided by article 6 of the ATAD.

Consequently, regarding the assessment of the CIT liability, no account would be taken of an arrangement or a series of arrangements which, having been put into place for the main purpose, or one of the main purposes, of obtaining a tax benefit that is contrary to the object or purpose of the applicable legal provisions, are not genuine considering all relevant facts and circumstances.

This new provision would apply to FYs open on or after 1 January 2019.

Increase of the last CIT installment to be paid by large companies

The last CIT installment[4] due by large companies is based on a percentage of the estimated profits for the current FY (instead of the previous FY). For FYs open between 1 January 2019 and 31 December 2019, this last installment will be due on the basis of higher rates:

- 95% (instead of 80%, currently) for companies with revenue over €250 million, but less than or equal to €1 billion
- 98% (instead of 90%, currently) for companies with revenue over €1 billion, but less than or equal to €5 billion

The 98% rate currently applicable to companies with revenue over €5 billion would remain unchanged.

Endnotes

1. Article 4 of the EU Directive 2016/1164 dated 12 July 2016.
2. Base erosion and profit shifting.
3. EU Directive 2016/1164 dated 12 July 2016.
4. The last installment is equal to the difference between (i) various rates – depending on the revenue of the companies – applied to the forecasted profits for the current FY and (ii) and the total amount of the first three installments already paid.

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