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NEWS ALERT

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CLARIFICATION OF THE RULES LIMITING THE TAX DEDUCTIBILITY OF FINANCIAL EXPENSES ARE NOW CLARIFIED

The Budget Bill for 2013 has introduced a fiscal austerity package which has mainly attempted to increase the taxable basis retained for Corporate Income Tax (herein after the "**CIT**") purposes, mainly by restricting the ability of companies to deduct some of their expenses.

In particular, for Fiscal Years ("**FY**") closed as from 31 December 2012, the companies subject to CIT are no longer able to deduct the full amount of financial expenses incurred (article 212 *bis* of the French Tax Code (the "**FTC**")). The drafting of the current provision was fairly unclear and raised many questions amongst the practitioners. Therefore, the French Tax Authorities (the "**FTA**") first released on 29 March 2013, a draft of administrative guidelines subject to a public consultation of circa 1 month.

On 7 August 2013, the FTA published the final version of the administrative guidelines (BOI-IS-BASE 35-40; BOI-IS-BASE-35-10; BOI-IS-GPE-20-20-110).

The developments below only describe the rules applicable to companies taken on a stand-alone basis as specific rules apply to entities belonging to a tax consolidated group.

Quick overview of the 212 bis limitations

For FY ending as from 31st December 2012, the deductibility of financial expenses is capped at (i) 85% of their net amount for FY 2013 and at (ii) 75% for FY starting as from 1st January 2014.

The limitation does not apply if the annual amount of financial expenses incurred by the taxpayer is lower than €3m. The FTA expressly clarify that the €3m has to be considered as a triggering threshold and not as a rebate.

Accordingly, if the net amount of financial expenses is below €3m, the limitation does not apply. Conversely, if the net amount of financial expenses exceeds €3m, the limitation applies to the whole amount.

1. Entities subject to the 212bis limitation

The limitation applies to entities or companies subject to CIT. It also applies for the computation of the taxable income derived by a shareholder from a tax transparent company up to this shareholder's pro-rata share of profits/losses in the company.

For not-for-profit bodies or organizations that developed a profitable business for which a separate segment of business has been recognized for CIT purposes, the limitation only applies to financial expenses related to this business segment.

The FTA did not clarify how these expenses had to be distinguished and how the organizations could evidence which part of the expenses are related to the profitable segment and which part of the expenses are related to the not-for profit segment.

2. Identification of the net financial expenses subject to the limitation

The net financial expenses caught by the limitation consist in:

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(i) the total amount of financial expenses that are paid in consideration for any amounts made available to the taxpayer; reduced by
(ii) the total amount of financial income received by the taxpayer in consideration for having made amounts available to another company.

2.1 Financial expenses

1. General definition of financial expenses

The FTA expressly clarified that for the purpose of article 212 bis of the FTC, the amounts made available to a company have to be construed as any cash out made to it but also as any payables bearing interest.

This being said, any amounts paid in consideration for ancillary services related to the release of funds falls out of the scope of the 212bis limitation. Thus, any fees or remunerations taken into consideration for the computation of the average annual proportional interest rate set forth by article L.313-2 of the Consumers Code ("*taux effective global*") such as file expenses, brokers fees or insurance premiums, are excluded from the 212bis limitation.

2. Swap arrangements

Regarding swap arrangements, the FTA expressly indicated that any amounts paid or received in respect of interest rate swaps ("**IRS**") shall be taken into account for the computation of article 212 bis of the FTC. As currently drafted, the limitation shall not only apply to monthly/quarterly payments made in respect of an IRS but also to any early termination penalty or other amounts payable in respect of the swap arrangement. This provision is therefore critical to bear in mind especially in the context of M&A or Real estate transaction involving the early repayment of the existing financing.

The clarification brought by the FTA is, in our view, contrary to law. Indeed, a swap arrangement does not, *per se*, involve the release of funds from one party to another party and does not, as such, qualify as a receivable. Accordingly, the remunerations paid in respect of a swap arrangement are not, technically, the remuneration of amounts made available to the taxpayer. This is exactly what the FTA retained in their previous administrative guidelines regarding withholding tax on interest payments (Inst. 24 janvier 2008, 5 I-1-08).
There would thus be good grounds for taxpayers to challenge the content of the administrative guidelines in view of excluding the amounts paid in respect of interest rate swaps from the limitation set forth by article 212 *bis* of the FTC.

Conversely, amounts paid in respect of currency swap are excluded for the computation of the 212bis limitation.

3. Miscellaneous

It is important to mention that interest which deduction was deferred based on thin capitalization rules and which are deducted from the company's taxable income should be taken into account to compute the 212 bis limitation.

Also, the fact that the interest are non-deductible does not result in those interest being deemed distributed for tax purposes.

2.1 Financial income

Financial income that have to be considered for the purpose of article 212 bis of the FTC consist in any income that are received by the taxpayer in consideration for having made monies available to another entity.

Therefore, the following income fall out of the scope of the 212 bis provision:

- Dividends;
- Interest from commercial notes;
- Late payment interest or penalties;
- Foreign exchange gain;
- Net gain on the disposal of securities.

3. *Specific situations*

3.1 *Financial lease and lease of movable assets between related parties*

In addition to the expenses and income mentioned above, the limitation basis should include the amount of financial lease expenses or rents. In this respect, rental expenses should be reduced by (i) an amount equal to the amortization accounted for by the lessor with respect to the good rented and by (ii) ancillary expenses invoiced by the lessor to the lessee (which do not constitute financial expenses).
Rents paid in respect of business-lease ("*location-gérance*") between related parties are not within the scope of article 212 bis of the FTC.

The amount of the amortization expenses to be retained normally consists in the straight line depreciation allowance booked by the lessor. If the latter chooses a financial amortization, the amount to be retained is the amount effectively deducted by the lessor for tax purposes. The lessor has to make these information available to the lessee.

In the event where the lessee would not have the necessary information to compute the pro-rata share of expenses subject to the 212 bis limitation, specific rules are provided by the administrative guidelines. As an example, in case of real estate financial lease, the lessee is allowed to retain the whole amount of interest expenses as disclosed in the amortization schedule provided by the lessor. Correlatively, the lessor will have to increase its financial income by the amount of the interest expenses received by the lessee as shown in the amortization schedule provided to the lessee.

3.2 *Concession, Delegation and Public-Private partnership agreements*

The 212 *bis* limitation does not apply to financial expenses borne by the partner if certain requirements are met and when the agreements are executed before 29 December 2012. The fact that amendments have been brought to the technical specifications after this date does not have any consequence.

Only the expenses related to the contracts signed before 29 December 2012 could be disregarded for the computation of the limitation. Therefore, the partner has to distinguish the expenses resulting from the agreements entered into before and after the 29 December 2012.

Considering the specific case of holding company created to hold the shares of SPV that effectively enters into a public concession or delegation agreement or a public-private partnership agreement, the FTA indicate that the 212 *bis* limitation does not apply to the financial expenses incurred by the holding companies if their exclusive purpose is the holding of entities that fulfills the requirements mentioned above. In other words, if the holding companies have developed ancillary businesses, the whole amount of their financial expenses will be caught by the 212 bis limitations (eventhough they relate to the financing of entities that have entered into eligible concession/ delegation/partnership agreements before 29 December 2012).

Besides, the holding companies that hold the shares of entities having entered into agreements before and after the 29 December 2012 shall be in a position to identify the financing related to the "eligible entities" (contract signed before 29 December 2012) and the financing related to the non-eligible entities.

4. *Combination of the article 212 bis limitation with the other rules restricting the deductibility of financial expenses.*

The 212 *bis* limitation applies in addition to other rules that restrict the companies' ability to deduct financial expenses (e.g. thin capitalization rules).
Thus, non-deductible interest based on thin capitalization rules are not taken into account with a view to computing the financial expenses that need to be added back to the taxpayer's taxable income under these new rules.
More specifically, the hierarchical order of application of the various rules is the following:

(i) Interest rate limitation provided by article 212-I and 39-1-3° of the FTC;
(ii) Limitation based on thin capitalization rules (212-II of the FTC)
(iii) Limitation of financial expenses incurred for the acquisition of certain shareholdings; and then
(iv) General 212 *bis* limitation.

All of these rules should be applied successively based on the net financial expenses reduced by the portion of expenses already added back to the entity's taxable income.

The clarifications brought by the FTA are binding. Therefore, the FTA are normally entitled to successfully challenge a taxpayer who would not comply with the rules included in their guidelines. This being said, some of the rules laid down by the FTA are illegal and could potentially be set aside by the administrative courts further to litigations. Besides, some of the rules have not been sufficiently clarified from a practical standpoint and are likely to raise some more uncertainties in the future.

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