

France: Amending Finance Law for 2011 and Initial Finance Law for 2012

The Amending Finance Law for 2011 and the Initial Finance Law for 2012 confirm the austerity measures for enterprises and individuals that the French Government set up in 2011.

24 January 2012

On 28 December 2011, the French Constitutional Court validated the fourth Amending Finance Law for 2011 (AFL 2011) and the Initial Finance Law for 2012 (IFL 2012).

Following the measures announced by the Prime Minister on 24 August 2011, the French State hopes to reduce the public deficit to 4.5% of France's gross domestic product (GDP) in 2012, then to 3% of the GDP in 2013. The two laws thereby implement certain fiscal measures from the Public Deficit Reduction Plan, such as the creation of an exceptional contribution on high incomes and an increase of the tax rate on investment income.

We have summarized below the principal measures of these finance laws affecting companies and individuals.

I. Company Taxation

a) New contribution based on corporate tax (art. 30, AFL 2011)

Article 30 of the AFL 2011 establishes an exceptional contribution of 5% based on the amount of corporate tax payable by companies that generate sales of more than €250 million. This contribution is payable for fiscal years ending between 31 December 2011 and 30 December 2013 and should, in principle, remain temporary.

The tax credits, the annual flat tax (*imposition forfaitaire annuelle*), and the carry-back credit are not chargeable on the contribution, which is not deductible from the results subject to corporate tax. The exceptional contribution does not replace the social contribution of 3.3% but rather is in addition to it.

For tax-consolidated groups, the contribution is liquidated at the level of the group's results.

b) Reintegration of financial expenses relating to the acquisition of equity shares (art. 40, AFL 2011)

In order to combat schemes whereby international groups purchase participating interests through French enterprises or companies with the aim of assigning to these French entities a right of deduction of corresponding financial expenses, article 40 of the AFL 2011 has set up a mechanism of staggered reintegration of these charges along the lines of the so-called *amendement Charasse*.

This new anti-abuse measure requires the French enterprises and companies that are transferees of the participating interests to demonstrate that they actually make the decisions relating to these interests and that they exercise, if applicable, a control or influence on the issuing companies. The French enterprises and companies may also comply with this obligation by demonstrating that the decision-making and control are carried out by one of their parent or affiliated companies incorporated in France.

This proof must be provided

- as regards interests acquired during the course of a fiscal year commencing before 1 January 2012, within the first fiscal year commencing after that date.
- as regards interests acquired during the course of a fiscal year commencing on or after 1 January 2012, either within the fiscal year or within the fiscal years covering a period of 12 months starting from the acquisition date of the securities.

If they fail to provide sufficient proof of control, the French transferee enterprises and companies shall reintegrate to their taxable result a fraction of their global financial expenses, according to the following formula:

$$\begin{aligned} & \textbf{Amount of the reintegration} = \\ & \text{Amount of the financial expenses for the fiscal year} \\ & \times \text{ Price of acquisition of participating interests} \\ & / \text{ Average amount of debts during the fiscal year} \end{aligned}$$

The amount of the reintegration is therefore fixed and the transferee enterprise or company may not substitute the actual amount of the financial expenses relating to the participating interests in question. The amount of the reintegration should, however, be limited to the amount of the financial expenses for the fiscal year, even if the purchase price of the securities is greater than the debt of the transferee enterprise or company.

This measure is not applicable when

- the total value of the participating interests held by the transferee enterprise or company is less than €1 million.
- the acquisition of the securities has not been financed by borrowings for which the transferee enterprise or company, or another company of the group to which it belongs, bears the charges.

- the debt ratio of the group to which the transferee enterprise or company belongs is greater than or equal to its own debt ratio.

This new measure should penalize leveraged buyout transactions in France and impose new evidentiary obligations.

c) Transfer of equity shares between related companies (art. 41, I. 2° and 3° AFL 2011)

The short-term gains and losses on transfers of equity shares between related companies were, until now, subject to a tax deferral.

The new law excludes short-term gains from this measure; these shall now be taxable immediately at the standard corporate tax rate. The short-term losses, however, remain subject to this tax deferral, and the transferor company must file a specific statement or incur a fine equal to 5% of the amounts undisclosed or omitted.

These new measures become effective for the determination of the results for the fiscal years commencing on or after 1 January 2012.

d) Thin capitalization: new exception in case of insolvency proceedings (art. 41, AFL 2011)

The finance law for 2011 has extended the scope of the thin-capitalization rules to all of the loans taken out from a third-party company for which the repayment is guaranteed by a related entity of the debtor company, subject to certain exceptions.

In order to facilitate the reorganization of distressed companies, article 41 of the AFL 2011 creates a new exception in favor of loans taken out in performance of a safeguard procedure or court-supervised reorganization.

These measures will become effective for fiscal years ending on or after 31 December 2010.

e) Thin capitalization: *SCI de construction-vente* (art. 13, IFL 2012)

Interests paid under loans taken out from financial institutions by *Sociétés civiles de construction-vente* (SCCVs), which are partnerships whose purpose is the building and sale of real estate with a guarantee given by their partners, are excluded from the scope of the thin-capitalization rules, for the fiscal years ending on or after 31 December 2011, up to the level of the partners' equity in the capital of the SCCV.

f) Amendments to the regime of tax losses (art. 31 and 32, AFL 2011)

The carry forward and the carry back of tax losses of French companies were considerably tightened by the law 2011-1117 of 19 September 2011. Articles 31 and 32 of the AFL 2011 clarify this reform on the following points:

- **Effective date.** The new rules of carry—forward or back—of tax losses apply not only to losses incurred for the fiscal years ending on or after 21 September 2011, but also to losses remaining at the end of the previous fiscal year.

- **Allocation of losses on a widened basis.** Article 32 specifies that the loss ceiling also applies where an option is made for the allocation of losses on a widened basis in the case of restructuring a tax-consolidated group.

g) Licenses of intellectual property rights between related companies (art. 11, IFL 2012)

The tax system for the concession and subconcession of intellectual property rights is amended on the following two points:

- In the case of a license of intellectual property rights between related companies, the licensee may only deduct all of the royalties paid if it provides proof of the profitability of the transaction, in addition to the actual character of the exploitation. Failing this, it can only deduct from its taxable net profit an amount corresponding to 15 / 33⅓ of the amount of the royalties paid to the company to which it is related.
- In the case of a sublicense, the licensee company is taxed at a reduced rate of 15% on the difference between the royalties received from the sublicensee and the royalties paid to the licensor.

These provisions are applicable to results for fiscal years commencing on or after 13 October 2011.

h) Young innovative enterprises (art. 37, AFL 2011)

The term of the tax exemption for young innovative companies has been reduced; it is only applicable for a period of two years, instead of the current five. The first profitable fiscal year is totally exempt, while the second year is 50% exempt.

In consideration, the amount of the tax exemption ceiling of employers' contributions is increased.

II. Taxation of Individuals

a) Exceptional contribution on high incomes (art. 2, IFL 2012)

The new article 223 sexies of the French General Tax Code introduces an exceptional contribution, in addition to income tax. It is assessed on the fiscal reference income (*revenu fiscal de référence*) of the wealthiest taxpayers. Its rate amounts to the following:

- 3% of the part of the reference income between €250,000 and €500,000 for single, widowed, separated, or divorced taxpayers and to the part between €500,000 and €1 million for taxpayers subject to joint taxation.
- 4% of the part of the reference income greater than €500,000 for single, widowed, separated, or divorced taxpayers and to the part greater than €1 million for taxpayers subject to joint taxation.

Specific calculation methods are, however, planned in cases of exceptional income.

The contribution is applicable to taxation of income as of 2011 for an indefinite period.

b) Increase of withholding tax on passive income (art. 20, AFL 2011)

The rate of withholding tax on dividends has increased from 19% to 21% for French taxpayers (that is, a global rate of 34.5%, taking into account Social Security contributions at a rate of 13.5%).

The rates of withholding on dividends for non-French taxpayers has also increased:

- 30% (instead of 25%) for the standard rate
- 21% (instead of 19%) for the reduced rate (distributions towards a member state of the European Union or the European Economic Area)
- 55% (instead of 50%) for the increased rate (distribution toward noncooperative states or territories)

The standard rate of withholding tax on interest has increased from 19% to 24%. The specific rates, however, remain unchanged. The rate of 50% of the withholding tax in case of payment to a noncooperative state or territory also remains unchanged.

These provisions will apply for income received on or after 1 January 2012.

c) Capital gains on transfers of securities: abrogation of the rebate for duration of the ownership; introduction of a deferred taxation subject to reinvestment (art. 80, IFL 2012)

The general rebate on capital gains based on the duration of the ownership of securities that should have started to take effect in 2012 has been abolished. The rebate reserved for retiring managers has been maintained, and a new measure for the deferred taxation of capital gains subject to reinvestment has been introduced.

The deferral of taxation is subject to compliance with the following conditions:

- The company for which the securities are transferred (i) is subject to corporate tax, (ii) undertakes a professional activity, and (iii) has its registered office in a member state of the European Union or the European Economic Area.
- The transferor shall have held (with its family group, as the case may be) at least 10% of the voting or financial rights of the company for which the securities are transferred.
- The deferral shall be subject to a formal option.
- The gain from the transfer of securities shall be invested within a period of 36 months and up to 80% of its amount in the subscription in cash in a company's capital.
- The company beneficiary of the contribution must satisfy the same conditions as the company for which the securities are transferred, and the transferor, as well as the members of its family group, shall not hold a management position.

- The securities paid in remuneration of the contribution must be held for at least five years and shall represent at least 5% of the voting and financial rights of the company beneficiary of the contribution.

After this five-year period, the capital gain is definitely exempted. But, if the securities are sold before the end of the five-year period, the deferred tax on the capital gains becomes immediately payable.

This new measure shall apply to capital gains realized in and after 2011.

d) Broadening of scope of the “exit tax” (art. 38, AFL 2011)

The mechanism introduced by Article 48 of the law 2011-900 of 29 July 2011 taxes the French residents who transfer their tax residence outside of France when they hold an interest of at least 1% in the profits of a company, that is, a participation for which the value exceeds €1.3 million.

The new provisions take into account all of the participations held by individuals in order to assess the €1.3 million threshold.

These provisions came into force beginning 30 December 2011.

e) Reduction of income tax for investment in SMEs (art. 18, AFL 2011)

The new provisions reserve the benefit of reduction of income tax for subscription in capital of small and medium enterprises (SMEs) to amounts invested in small companies in the development, start-up, or expansion phase, unless these companies are solidarity companies within the meaning of Article L3332-17-1 of the French Labor Code.

However, the threshold for payments giving the right to a tax reduction increases. They increase to €50,000, instead of €20,000, for singles, and to €100,000, instead of €40,000, for married taxpayers. The rate of reduction is, however, brought down to 18% (see below).

These provisions apply to payments made on and after 1 January 2012.

f) Reduction of wealth tax for investment in SMEs (art. 27, AFL 2011)

The law eases the conditions for maintaining the benefit of the reduction of wealth tax for investment in SMEs.

Thus, in case of noncompliance with the retention period of securities due to an exchange offering of stocks, the benefit provided for in Article 885-0 V *bis* of the French General Tax Code has been maintained.

g) Dividends distributed by SIICs and SPPICAVs: ineligibility for PEA (art. 8, IFL 2012)

Dividends coming from exempt profits of SIICs and SPPICAVs (real estate investment companies) are, as from taxation of income received in 2011, compulsorily taxed at the progressive scale for income tax (without the possibility of an option for a flat-rate withholding tax) and without the allowance of 40%.

Moreover, these securities may no longer be recorded on a PEA (share saving plan) commencing 21 October 2011.

h) Taxation of defined benefit pension plans (art. 28, AFL 2011)

The contribution payable by the beneficiary of a pension paid pursuant to a defined benefit pension plan has increased. An additional rate of 21% for the fraction of pensions greater than €24,000 has been set up.

The new rate (21%) is applicable to pensions paid on and after 1 January 2012.

Moreover, the deductibility of this contribution is limited to €35 or €70 per month, depending on the situation.

i) Prolongation of tax scales (art. 16, AFL 2011)

Article 16 of the AFL 2011 prolongs, for the 2011 tax year, the tax scale applicable to incomes for the year 2010. Besides its effect on the liquidation of income tax, the mechanical effect of this measure is to maintain the scales for wealth tax and gift/inheritance duties. This freeze should continue until 2013.

j) Reduction of global ceiling of certain tax allowances (art. 84, IFL 2012)

The global ceiling of certain tax allowances has been reduced to €18,000 plus 4% of the amount of the taxable income as from the taxation of income of 2012.

k) General reduction of 15% of rates of reductions and tax credits (art. 83, IFL 2012)

Following the reduction of 10%, known as “*coup de rabot*,” a new 15% reduction of tax advantages from certain provisions for reductions or tax credits has been planned.

This new reduction is applicable to the rates of reductions and tax credits that fall within the scope of the general ceiling of certain tax advantages (see above), apart from those relating to employment of home help, child-minding costs, or investment in rental property in public housing in overseas territories.

This concerns income tax for 2012 for expenditures made on and after 1 January 2012.

III. Registration Duties

a) Reform of the stock (*actions*) transfer regime (art. 3, I IFL 2012)

The system for the transfer of stocks has been reformed. The sole proportional rate of 3% has been replaced by a decreasing scale:

- 3% for that part of the taxable base less than €200,000
- 0.5% for the part between €200,000 and €500 million

- 0.25% for the part exceeding €500 million

The ceiling of €5,000 per transfer has been abolished.

Moreover, registration duties are found to be applicable to transfers carried out abroad, and a tax credit is, where applicable, chargeable to French transfer duties.

These provisions came into force beginning 1 January 2012.

b) Exemption of certain transfers of equity shares (*actions, parts sociales*) (art. 3, II IFL 2012)

The following transfer of shares or stocks are henceforth exempt from registration duties:

- Acquisitions of shares or stocks pursuant to a repurchase by a company of its own securities or to a capital increase.
- Acquisitions of shares or stocks of companies placed under a protective measure or under court-supervised reorganization.
- Acquisitions of shares or stocks when the transferor and the transferee are members of the same tax-consolidated group.
- Transactions coming within the scope of Article 210 B of the French General Tax Code, that is, transactions of partial contribution of assets benefitting from exemption of corporate tax.

These measures came into force for transfers on and after 1 January 2012.

c) Transfer of investments in real estate companies (art. 5, IFL 2012)

The tax base for registration duties is now determined from the real value of the asset elements, after deduction of the sole liabilities relating to the acquisition of underlying real property.

This measure came into force for transfers on and after 1 January 2012.

IV. VAT

a) Creation of a new reduced rate (art. 13, AFL 2011)

Article 13 creates a new reduced rate of value-added tax (VAT) in addition to the existing one. The new rate of 7% will be applicable to the majority of transactions that were previously subject to the existing reduced rate of 5.5%.

The products and services of basic necessities (water, products intended for human consumption, gas, and electricity supplies, in addition to power supply networks, equipment, and services for handicapped persons) will nevertheless continue to be taxed at the rate of 5.5%.

The rate of 7% will apply, with some exceptions, to transactions for which the VAT is payable beginning on 1 January 2012.

V. Measures in Favor of Housing

a) Transfer of housing property other than the principal residence (art. 5, IFL 2012)

Commencing 1 February 2012, the capital gains made on the first sale of housing property are exempt when the seller is not the owner of his or her principal residence and invests the proceeds from the sale in the acquisition of his or her principal residence.

b) Exemption of capital gains of transfer of *droits de surélévation* (the right to construct a residential building on top of an existing building) (art. 42, AFL 2011)

Individuals and companies that transfer *droits de surélévation* between 1 January 2012 and 31 December 2014 are exempt from capital gains tax when the purchaser undertakes to complete the residential premises within four years.

c) Transfer and transformation of professional premises in residential buildings (art. 42, AFL 2011)

The capital gains made by companies due to the transfer of professional premises to a purchaser undertaking to transform them into residential premises within three years will be taxed at a reduced rate of 19%.

If you have any questions or would like more information on the issues discussed in this LawFlash, please contact the following Morgan Lewis attorney:

Paris

Olivier Couraud

+33 1 53 30 44 05

ocouraud@morganlewis.com

About Morgan, Lewis & Bockius LLP

With 22 offices in the United States, Europe, and Asia, Morgan Lewis provides comprehensive transactional, litigation, labor and employment, regulatory, and intellectual property legal services to clients of all sizes—from global Fortune 100 companies to just-conceived startups—across all major industries. Our international team of attorneys, patent agents, employee benefits advisors, regulatory scientists, and other specialists—nearly 3,000 professionals total—serves clients from locations in Beijing, Boston, Brussels, Chicago, Dallas, Frankfurt, Harrisburg, Houston, Irvine, London, Los Angeles, Miami, New York, Palo Alto, Paris, Philadelphia, Pittsburgh, Princeton, San Francisco, Tokyo, Washington, D.C., and Wilmington. For more information about Morgan Lewis or its practices, please visit us online at www.morganlewis.com.

IRS Circular 230 Disclosure

To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

For information about why we are required to include this legend, please see <http://www.morganlewis.com/circular230>.

This LawFlash is provided as a general informational service to clients and friends of Morgan, Lewis & Bockius LLP. It should not be construed as, and does not constitute, legal advice on any specific matter, nor does this message create an attorney-client relationship. These materials may be considered **Attorney Advertising** in some states. Please note that the prior results discussed in the material do not guarantee similar outcomes.

© 2012 Morgan, Lewis & Bockius LLP. All Rights Reserved.

