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A Review of Key Legal Regulatory Issues Impacting the Global Private Equity Industry

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France: Introduction of New Anti-Abuse Rules on the Tax Deductibility of Interest and other Financing Expenses

The Rationale for the New Rules

Until recently, private-equity investment funds and international corporate groups investing in France enjoyed a very favorable tax environment, including *inter alia* the benefit of both EU Directives and the double tax treaties signed by France, as well as the ability generally to “push down” debt incurred in connection with their acquisitions through the combination of (i) the tax consolidation regime, (ii) the 95% exemption of dividends from subsidiaries, (iii) the full deductibility of interest and other financing expenses, subject thin capitalization and arm’s length interest rate requirements, and (iv) the unlimited carry-forward of losses.

Although still competitive with other jurisdictions, the French tax environment is becoming less favorable as the pressure grows on France’s budget.

In 2011, French thin capitalization rules were amended so as to limit the tax deduction of interest expenses incurred on third-party loans guaranteed by a party that is related to the borrower, and the amount of losses available for carry-forward was limited.

With a view to preventing international corporate groups from optimizing the tax deduction of interest and other financing expenses incurred in connection with the acquisition of shareholdings through the use of French acquisition vehicles, the fourth Amended Finance Act for 2011 (adopted on December 28) introduced a new anti-abuse provision referred to as the Carrez Amendment (the “New Rules”) that disallows the tax deduction of interest and other financing expenses incurred for acquisitions where the decisions relating to the acquired shareholdings are not made in France or the control or influence over the acquired company is not exercised in France.

Considering the scope of the New Rules, such limitation of the tax deductibility of interest and other financing expenses concerns all acquisitions of shareholdings made by international private-equity investment funds and corporate groups through French companies.

Synopsis

The French fourth Amended Finance Act for 2011 introduced a new anti-abuse provision (the “New Rules”) pursuant to which interest and other financing expenses incurred by a French company upon the acquisition of a shareholding benefiting from the French participation exemption will not be deductible for French tax purposes during an 8-year period following the year of acquisition, unless the French acquiring company can demonstrate that (i) the decisions relating to the shareholding are effectively made in France (by itself directly or by a French resident controlling company or sister company) and (ii) the control or influence over the acquired company is effectively exercised in France (by itself directly or by a French resident controlling company or sister company).

The interest and other financing expenses that could be disallowed as a result of the New Rules are equal to the product of the relevant French acquiring company’s interest and other financing expenses incurred during a relevant fiscal year and the ratio between the acquisition price of the shareholding and the average amount of the acquiring company’s debt for the fiscal year.

The New Rules will not apply where (i) the aggregate value of the shareholdings is less than €1 million, (ii) the acquisition is not financed with debt incurred by the acquiring company or by a related company, or (iii) the debt-to-equity ratio of the acquiring company is not higher than that of its group of companies.

The New Rules apply to fiscal years beginning on or after January 1, 2012, and may impact on any acquisitions made after January 1, 2004. The New Rules will primarily affect the French tax treatment of acquisitions by French companies held by international private-equity investment funds and corporate groups that have no autonomous decision-making center in France.

The Scope of the New Rules

Requirements for Achieving Tax Deduction of Interest and other Financing Expenses Incurred by French Companies upon Acquisition of Shareholdings

Pursuant to the New Rules, which are codified under Section 209 IX. of the French Tax Code (the "FTC"), interest and other financing expenses incurred by a French company upon the acquisition of any shareholding eligible for the French participation exemption regime will not be deductible for French tax purposes if the French acquiring company is not able to demonstrate, by whatever means, that:

(i) the "decisions relating to the acquired shareholding" are effectively made in France, by itself directly or by (a) a French resident company that "controls" the acquiring company, within the meaning of Section L. 233-3 I. of the French Commercial Code, or (b) a French resident company controlled by the company mentioned in (a) (*i.e.,* a sister company); and

(ii) the "control or influence exercised over the acquired company" is also effectively exercised in France by itself directly or by a French resident company mentioned in par. (i) (a) or (b) above.

Pursuant to Section L. 233-3 I. of the French Commercial Code, a company ("Company A") is deemed to control another company ("Company B"), where (i) Company A holds shares in Company B which represent directly or indirectly the majority of the voting rights at the shareholders' meetings of Company B, or (ii) Company A is, on a standalone basis, entitled to exercise the majority of the voting rights at the shareholders' meetings of Company B pursuant to an agreement entered into with other shareholders of Company B, or (iii) considering the voting rights it is entitled to exercise, Company A is in a position to pass any resolution at the shareholders' meetings of Company B, or (iv) Company A is a shareholder of Company B and has the power to appoint or revoke the majority of the board members of Company B.

The New Rules only concern shareholdings eligible for the French participation exemption regime pursuant to Section 219 I.a *quinquies* alinea 3 of the FTC (providing for a 90% exemption of capital gains realized upon the sale of subsidiaries). Those eligible shareholdings therefore include *inter alia* shareholdings in French or non-French companies representing at least 5% of the shares and voting rights of the relevant companies that are held for at least 2 years, but exclude shareholdings in companies the assets of which predominantly consist of real estate assets or shares in real estate companies.

The New Rules require the French acquiring company to demonstrate to the French tax authorities that the requisite decisions and control or influence are satisfied (i) for the fiscal year or the fiscal years covered by the 12-month period following the relevant acquisition date, for shareholdings acquired on or after January 1, 2012, and (ii) for the first fiscal year beginning "after" January 1, 2012, for shareholdings acquired prior to January 1, 2012. In practice however, for those shareholdings acquired prior to January 1, 2012 by companies with a fiscal year beginning on January 1, 2012, the French tax authorities are likely to require the evidence test be satisfied for the 2012 fiscal year (as opposed to the subsequent fiscal year).

While the New Rules do not contain any details regarding the nature and scope of the evidence that must be produced to demonstrate the requisite decisions and control or influence, the relevant French acquiring company would be expected to provide the legal and functional organizational charts of the group of which the company is a member, the minutes of the shareholders' meetings and board of directors' meetings of that company (and its French resident controlling or sister company if applicable), as well as any other documentation supporting the fact that the French acquiring company (or its French resident controlling or sister company if applicable) played a key role in the major decisions relating to the shareholding, including but not limited to the decision to acquire the shareholding, as well as to the management of the acquired company where controlled by the relevant French resident acquiring company (or its French resident controlling or sister company if applicable).

Consequences of Failure to Meet Evidence Requirements

Where the required evidence test is not demonstrated to the French tax authorities in due time (*i.e.* is not provided to them or otherwise acceptable to them), a portion of the interest and other financing expenses incurred by the relevant French acquiring company will be added back to its taxable income in respect of the fiscal year during which the test was required to be met and subsequent fiscal years until the expiration of an 8-year period following the relevant acquisition year, notwithstanding

the fact that the test may be met during those subsequent fiscal years.

If, on the other hand, the required evidence test is demonstrated to the French tax authorities for the applicable period, the interest and other financing expenses incurred by the relevant French acquiring company during subsequent fiscal years should be fully deductible (subject to the application of thin capitalization and arm's length interest rate rules).

For the purposes of the New Rules, the non- deductible portion of interest and other financing expenses will be deemed to be equal to the product of the French acquiring company's aggregate interest and other financing expenses incurred in the relevant fiscal year and the ratio between the acquisition price of the shareholding and the average amount of the acquiring company's aggregate indebtedness during the relevant fiscal year. The aggregate interest and other financing expenses are likely to include not only interest, but also all fees incurred by the acquiring company in connection with the acquisition debt.

The interest and other financing expenses and debt taken into account for this calculation will therefore have to be updated each fiscal year.

For example, assume that:

- a French company with fiscal years in line with calendar years ("FrenchCo") acquires in July 2012 an eligible shareholding for €20 million
- FrenchCo incurs aggregate interest and financing expenses of €1.2 million in 2012 and €1 million in 2013
- FrenchCo has an average amount of aggregate indebtedness of €30 million in 2012 and €28 million in 2013

If the required evidence test is not satisfied for the 12-month period ending in July 2013, the portion of the interest and other financing expenses to be added-back to FrenchCo's 2013 taxable income will be equal to €0.7 million (*i.e.* 1 x 20 / 28).

If the shareholding's acquisition price exceeds the average amount of aggregate indebtedness, the ratio will be deemed equal to one.

If the shareholding is subsequently transferred to another French company in a merger, spin-off or any similar transaction that takes place within the 8-year period following the relevant acquisition date, the outstanding interest and other financing expenses shall be added back to the taxable income of the relevant transferee company. In that case, the above ratio will be computed taking into account the average indebtedness of the relevant transferee company.

Safe-harbor provisions

The New Rules will not apply where:

(i) the aggregate value of the shareholdings held by the French acquiring company is less than €1 million;

(ii) the acquisition is not financed with debt incurred by the acquiring company or by a "related" company, within the meaning of Section 212 III. of the FTC (including *inter alia* any French and non-French directly or indirectly controlling company or sister company); in practice however, it may be difficult to establish the absence of acquisition indebtedness for acquiring companies which are members of international corporate groups;

(iii) the debt-to-equity ratio of the French acquiring company is not higher than that of its group of "related" companies, within the meaning of Section 212 III. of the FTC.

Pursuant to Section 212 III. of the FTC, companies are deemed to be related (i) where one company owns directly or indirectly either more than 50% of the share capital or more than 50% of the voting rights of the other company, or has the majority at board meetings or exercises the effective management of the other company, or (ii) if both companies are placed under the control of the same third-party company as mentioned in (i).

The Impact of the New Rules on French Transactions Entered into by Private Equity and Corporate Players

Application *Rationae Temporis* of the New Rules

The New Rules apply in respect of fiscal years beginning on or after January 1, 2012.

Considering that, where the required evidence test is not met, interest and other financing expenses will not be fully deductible during an 8-year period following the relevant acquisition year, the New Rules may adversely affect the

French tax treatment of any acquisition of eligible shareholdings that took place after January 1, 2004.

In particular, where (i) a shareholding held on January 1, 2012 was acquired after January 1, 2004 and (ii) the relevant French acquiring company incurs interest and other financing expenses in the first fiscal year beginning on or after January 1, 2012, the above evidence test required by the New Rules will have to be met during that first fiscal year beginning on or after January 1, 2012. Furthermore, the relevant evidence required in relation to such an acquisition is likely to include documentation relating not only to that first fiscal year beginning on or after January 1, 2012, but also to previous fiscal years commencing with the acquisition year.

If, however, the required evidence test in respect of acquisitions that took place after January 1, 2004 is not satisfied, the New Rules will only affect the tax deductibility of interest and other financing expenses incurred from January 1, 2012.

Ensuring Whether Evidence Requirements Can Be Met in Respect of Currently-Held and Future Shareholdings

While the New Rules do not contain any details regarding the nature and scope of the words "decisions relating to the shareholding" and "control and influence exercised over the company", the meaning of these words should be broadly interpreted and should therefore refer to all major decisions relating to the acquired shareholding, including but not limited to the decision to acquire the shareholding, as well as to the management of the acquired company where controlled by the relevant French acquiring company or its French resident controlling or sister company if applicable.

In practice, providing evidence that the French acquiring company (or its French resident controlling or sister company) played a key role in those decisions would require that the relevant French resident company constitute an autonomous decision-making center in relation to the relevant shareholding, as if it were to be regarded as a permanent establishment for French tax purposes.

In this respect, private equity investment funds managed by French resident management companies (such as French venture capital mutual funds, *i.e. Fonds Commun de Placement à Risques* or *FCPR*) that acquire shareholdings through French holding companies should be able to meet those evidence requirements, to the extent that the French management company can be viewed as a controlling company within the meaning of Section L. 233-3 I. of the French Commercial Code.

The same would be true for international corporate groups that have an effective place of management in France (*i.e.* with French resident key people that are effectively in charge of the supervision of the acquired shareholdings), provided that those groups prepare the appropriate legal and corporate documentation supporting the fact that the management of the French acquiring companies (or their French resident controlling or sister companies if applicable) play a key role in the decisions relating to the acquired companies.

On the other hand, private equity investment funds with no French resident management company or permanent establishment as well as international corporate groups that have no effective place of management in France might not be able to meet these new requirements.

Those private equity investment funds that wish to continue to invest in France and benefit from existing favorable tax treatment without creating a permanent establishment in France could for instance consider establishing a FCPR.

Further, as the compatibility of the New Rules with the free movement of capital required by the European Treaties is unclear, European-based private equity investment funds and corporate groups may also want to consider contesting the application of the New Rules before the courts.

Conclusion

The New Rules will primarily affect the French tax treatment of acquisitions by French companies held by private-equity investment funds and international corporate groups that have no autonomous decision-making center in France.

More generally, all acquisitions by French companies will need to be carefully prepared and structured and documented to satisfy the New Rules, to the extent possible. Furthermore, tax due diligence on French target companies will need to examine the documentation made available to the French tax authorities to ensure that interest and other financing expenses were deducted by the relevant target companies in accordance with the New Rules.

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