French Finance Act for 2019: The Most Important Changes Affecting Businesses

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The French Finance Act for 2019 was enacted on December 28, 2018 (the “Act”). The Act introduces significant changes to the interest deduction rules and to the favorable tax regime applicable to Industrial Property (“IP”) income. The Act also made changes to the tax consolidation regime. Finally, new anti-abuse rules have been implemented.

The key tax measures of the Act are as follows:

- Changes made to the interest deduction rules

  Recent developments provided by the OECD and the European Commission on tax avoidance practices as well as the adoption of the Anti-Tax Avoidance Directive (Directive 2016/1164 - “ATAD”) by the European Union on July 12, 2016 have led to important changes.

  - Until now, up to 25% of the amount of net financial expenses incurred by a French company was added back to its taxable result. This general limitation applied to the extent the company’s financial expenses exceeded € 3 mio in the relevant fiscal year.
  - 10% of EBITDA x [(related party debt - 1.5 x net equity) / global debt] ; or
  - € 1 mio x [(related party debt - 1.5 x net equity) / global debt] if the latter amount is higher.

  Under the new legislation, this “general limitation to financial expenses deductibility” has been cancelled and replaced by the ATAD rule, which limits for each financial year the net interest deduction to (i) 30% of EBITDA (earnings before tax, interest, depreciation and provisions) or (ii) € 3 mio if this amount is higher.

Moreover the thin-capitalization limitation has been amended. From now on, when the average amount of related party debt exceeds 1.5 times the net equity of the company, the deductibility of net financial expenses relating to the related party debt exceeding the 1.5:1 debt-to-equity ratio is capped at the following thresholds:

- Until now, financial expenses incurred by a French company subject to Corporate Income Tax (“CIT”) in relation to the purchase of participation interests were
deductible for tax purposes provided that such company was able to demonstrate that
(i) the decisions related to such participation interest were made from France (or from
an other European Union (“EU”) state, Iceland, Lichtenstein or Norway) and (ii) where
control or influence was exercised over the acquired company, that such control was
exercised in France or in an other EU state (or in Iceland, Lichtenstein or Norway).
This limitation has been repealed.

- Changes made to the favorable tax regime applicable to IP income

Recent developments provided by the OECD (Base Erosion and Profit Shifting “BEPS” actions) have
led to important changes in order to make the IP tax regime compatible with the so-called “nexus”
approach.

The “nexus” approach allows a taxpayer to benefit from an IP regime to the extent that it can show
that it itself incurred expenditures, such as Research and Development (“R&D”), which gave rise to
the patent-related income.

Moreover:

- The favorable CIT rate applicable to IP income is reduced from 15 % to 10 % and now
applied on the net IP income (i.e. after deduction of the R&D expenditures).
- The favorable tax regime no longer applies to patentable rights, except for small and
medium-size enterprises under conditions.
- The favorable tax regime is extended to copyright protected software.

- Several changes are made to the tax-consolidated group regime

Under French tax law, dividends eligible for the participation exemption regime are
exempt from CIT, except for a 5% proportion of costs and expenses that is added
back to the taxable result. Within a tax consolidated group, the 5% add-back is
reduced to 1%.

Until now, dividends are subject to the 1% add-back when they are distributed either
by (i) a French subsidiary belonging to the same tax-consolidated group or (ii) an EU
or EEA subsidiary to a French company belonging to a tax consolidated group that
would meet the conditions required for belonging to such group if it were French.
The reform provides that, under the participation exemption regime, dividends are now
subject to a 1% add-back when they are distributed by an EU or EEA subsidiary to a
French company not belonging to a tax consolidated group but that would meet the
conditions required to form a tax consolidated group with the company making the
distribution if the latter was French.

Under French law a quasi-exemption regime applies to long term capital gains
realized upon the disposal of shares of a company. Capital gains eligible for the quasi-
exemption regime are exempt from CIT, except for a 12% fraction which is deemed to
represent costs and expenses that is added back to the taxable result.

Until now, upon a disposal of shares between companies belonging to a same tax-consolidated
group, the 12% add-back was taxable only upon exit of either the selling entity or the purchasing
entity. Under the new legislation, the 12% add-back becomes immediately taxable.

- Until now, debt waivers and subsidies made between companies belonging to a same tax
consolidated group and triggering a double taxation (non deduction for the first company /
taxation at the level of the second company) were not immediately taxed at the tax
consolidated group level. Under the new legislation, such amounts become immediately
taxable.

- The reform legalizes the ability to carry out sales and provide services at cost (i.e. without margin) within a tax consolidated group.
- New anti-abuse rules are implemented

Currently, the French Tax Authorities (“FTA”) are entitled to disregard or disqualify a legal transaction when the taxpayer has (i) entered into the transaction exclusively for tax purposes and (ii) used a provision in a way which is contrary to the objectives and spirit of the law (General Anti-Abuse Provision, “GAAP”, art. L 64 of the French Tax Procedure Code). Under the current French GAAP, an automatic penalty of 80 % is due on the reassessed amount.

Two new anti-abuse clauses are introduced:

- A general anti-abuse clause applicable for CIT purposes. Under this clause, arrangements or series of arrangements which are not genuine and have been put into place for the main purpose, or one of the main purposes, of obtaining a tax benefit that is contrary to the objectives and spirit of the law[^5], will be disregarded.

- An anti-abuse clause for all taxes other than CIT. Under this clause, the FTA will be allowed to disregard transactions which are driven by the main purpose of avoiding or reducing the tax burden which would have normally been borne by the taxpayers, if these transactions had not been carried out[^6].

Under these two new anti-abuse clauses, the 80 % penalty applicable under the current French GAAP will not apply automatically (unless in case of fraudulent acts). The FTA will now have the choice between using either the current French GAAR (restricted scope of application: utilization of the term “exclusively” / automatic penalty of 80 %) or one the two new anti-abuse clauses (wide scope of application: utilization of the terms “main purpose” / no automatic penalty).

[^1]: Applicable to financial years beginning on or after January 1, 2019.
[^2]: This excess related party debt is determined by applying the following formula: (related party debt - 1.5 x net equity) / global debt.
[^3]: Applicable to financial years beginning on or after January 1, 2019, except for certain particular provisions.
[^4]: Applicable to financial years beginning on or after January 1, 2019.
[^5]: Applicable to financial years beginning on or after January 1, 2019.
[^6]: Applicable to transactions carried out as from January 1, 2020 and subject to a tax reassessment notice issued as from January 1, 2021.