2019 French budget introduces ATAD and BEPS provisions

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In brief

The French parliament on December 28, 2018, approved the Finance Act for 2019 (the Finance Act). The Finance Act was published in the French legal gazette on December 30, 2018.

The Finance Act includes corporate tax measures that transpose into French law Articles 4 and 6 of EU anti-tax avoidance directive no. 2016/1164 dated July 12, 2016 (ATAD) with respect to interest limitations and general anti-abuse rules. It also amends the French tax consolidation rules, the participation exemption, and the French patent box regime pursuant to the nexus approach set out by OECD BEPS Action 5.

Most of the measures apply as of January 1, 2019, and affect multinational enterprises (MNEs) with French operations or subsidiaries.

The Finance Act also includes a number of other provisions affecting wealth tax, individual taxation, personal local taxes, value-added tax (VAT), and various other items. Those provisions are outside the scope of this Insight.

In detail

Transposition of ATAD Article 4 on interest limitations into French law (Article 34)

The Finance Act first repeals the following interest limitations:

- the current thin-capitalization rules
- the so-called 'rabot' (25% haircut limitation)
- the 'Carrez Amendment' (anti-abuse rule preventing interest deductions related to a controlling interest acquired by a French entity when such interest is managed and controlled outside of France, the EU, or European Economic Area (EEA) Member State).

The following limitations still apply:

- interest rate limitation (for interest payments to related parties, maximum rate set forth by Section 39-1-3 of the French tax code)
- French 'anti-hybrid mismatch' / 'subject-to-tax' rules provided by Section 212 (I)(b) of the French tax code
- the so-called 'Charasse Amendment' (anti-debt pushdown provision within a French tax consolidation).

The new rules provide the following:

For stand-alone entities

The deductibility of net financial expenses relating to (i) non related-party debt and (ii) related-party debt that does not exceed 1.5 times the entity's equity (see below) is now limited to either EUR 3M or 30% of the entity's 'tax' EBITDA, whichever is higher.

Note: The 'tax' EBITDA defined by the new law is different from the notion of EBITDA used for financial reporting purposes.

Under the new law, net financial expenses notably take into account related and third-party interest, foreign exchange losses on financings, interest paid on hedging contracts, guarantee fees, debt-related costs, and generally any type of cost or income that is equivalent to interest.

For entities being part of a group that files eligible consolidated financial statements, a safe-harbor provision allows an additional deduction equal to 75% of the net financial expenses not deducted pursuant to the above limitation. Thus, the entity's equity-to-assets ratio must remain equal to or higher than the equity-to-assets ratio of the consolidated group to which the tested entity belongs. However, this safe-harbor is not available to thinly capitalized entities.

French thin capitalization rules have been adjusted by the Finance Act and apply cumulatively to the main 30% EBITDA test.

If the tested entity's debt-to-equity ratio exceeds 1.5-to-1, the amount of related-party interest incurred in connection with related-party debt exceeding 1.5 times the entity's equity will be deductible up to either EUR 1M or 10% of the entity's 'tax' EBITDA, whichever is higher.

If an entity is over-leveraged, it will be able to rely on a specific safe harbor if its debt-to-equity ratio is lower than that of the consolidated group to which it belongs.

If the over-leveraged entity cannot benefit from such safe harbor, it will have to determine its respective third-party and related-party debt ratios to which the corresponding 30% tax EBITDA and 10% tax EBITDA rule apply (basket mechanism that will also be used for tracking and carryforward purposes).

Note: Third-party debts guaranteed by related parties no longer are assimilated to related-party debts.

Financial expenses that are disallowed by virtue of the above rules now can be carried forward indefinitely and deducted in the future under the same conditions. However, in case of thin capitalization, the non-deducted net financial expenses under the 10% tax EBITDA limit will only be eligible for carryforward for one third of its amount.

The unused interest deduction capacity of a current tax year can be used over the following five tax years, but only against financial expenses incurred in those tax years. This measure is not available to thinly capitalized entities.

For entities taking part into a French tax group

A tax group is regarded as a stand-alone entity for purposes of the new limitation.

The tax group's net financial expenses — i.e., the sum of the group member's stand-alone financial income and expenses — are now deductible up to EUR 3M or 30% of the tax group's 'tax' EBITDA, whichever is higher.

The safe-harbor provision available for entities being part of a group that files eligible consolidated financial statements also is available to a French tax group that is part of a financially consolidated group. ***Note:*** Specific consolidated financial statements may have to be prepared at the French tax group level for the purpose of this safe-harbor provision.

The thin-cap exception described above also applies to a French tax group based on the tax group's debt-to-equity ratio. If the French tax group is thinly capitalized, a portion of its net financial expenses will be deductible up to EUR 1M or 10% of the tax group's 'tax' EBITDA, whichever is higher.

The group consolidated safe harbor exception is not available for thinly capitalized tax groups.

The same safe harbor, ratio determination and basket mechanism described above for stand-alone entities will apply in the case of a thinly capitalized tax group.

Carryforward and unused capacity rules provided for stand-alone entities also apply in the tax group's situations.

Specific rules cover entities entering and exiting a French tax group.

The new ATAD limitations do not include a grandfather provision (subject to specific exceptions).

The new rules apply for tax years beginning on or after January 1, 2019.

Transposition into French law of ATAD general anti-abuse rule (Article 108)

The Finance Act added the following new article to the French Tax Code:

"For purposes of determining the corporate tax liability, shall be ignored an arrangement or a series of arrangements which, having been put in place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the applicable tax law, are not genuine having regard to all

relevant facts and circumstances. An arrangement may comprise more than one step or part.

An arrangement or a series thereof is regarded as non-genuine to the extent that they are not put into place for valid commercial reasons which reflect economic reality".

The transposition repeals the parent-subsidiary regime anti-abuse clause, which had a narrower scope than the new provision, but does not amend the existing domestic French general anti-abuse rules (GAARs), set out by Article L.64 of the Tax Procedure Code.

A new ruling process was created for taxpayers who want to confirm that a contemplated operation complies with the new anti-abuse rule.

This new provision applies for tax years beginning on or after January 1, 2019.

Changes to the French tax group regime (Article 32)

Pursuant to recent rulings issued by the European Union Court of Justice (EUCJ), the Finance Act amends the French tax group regime and aligns it with EU law.

Participation exemption on dividends

Prior to the Finance Act, a general 95% exemption was available with respect to dividends eligible for the participation-exemption regime.

Such exemption was increased to 99% for distributions made by tax group members or distributions made by a company located in the European Union (or in certain EEA Member States) to a company that is part of a French tax group, provided such company would meet the conditions to be a member of a French tax group if it was located in France.

The Finance Act extends the 99% participation exemption regime to distributions received by French companies that are not tax group members from companies located in the European Union (or in certain EEA Member States) provided both companies would meet the conditions to set up a tax group if the company paying the dividend were located in France. However, under this new regime, the 99% participation exemption is not granted in the event the French entity is not a member of a tax group, based solely on the absence of required elections and formalism needed to set up a tax group.

The tax treatment applicable to dividends not eligible for the participation exemption regime is aligned and a 99% participation exemption therefore is granted in the same three situations.

The Finance Act also provides new rules aimed at mitigating the potential adverse impacts resulting from events (such as Brexit and similar events) or restructurings (such as, for instance, an exit from a tax consolidation in case of a merger involving a foreign or intermediary entity or changes from a horizontal to vertical or vertical to horizontal tax consolidation) involving French tax consolidated entities.

Substantial shareholding exemption (SSE) applicable to capital gains

Under the new tax group regime, the 12% taxable portion of the capital gains eligible for the 88% SSE no longer will benefit from the so-called 'neutralisation' previously applicable and therefore will become taxable.

Treatment of subsidies and debt waivers for tax group result purposes

Financial grants and debt waivers between French tax group members no longer will be eliminated for tax group taxable result purposes (i.e., they will become fully taxable items).

These provisions apply for tax years beginning on or after January 1, 2019, except for the provisions related to restructurings, which apply to tax years ending on or after December 31, 2018.

French patent box regime reform (Articles 37 and 38)

In line with OECD recommendations (BEPS Action 5), the Finance Act modifies the existing French patent box regime — the preferential tax regime that applies to royalties and capital gains realized on disposals of patents and assimilated IP rights — and sets out the principle of a 'nexus' approach.

A nexus approach consists of using expenditures as a proxy for substantial activity and ensures that taxpayers can benefit from a preferential IP regime only if they actually engage in the corresponding R&D activities and incur the expenditures on such activities.

Prior to enactment of the Finance Act, income and gains from patents and assimilated IP rights benefited from a reduced 15% tax rate for entities subject to corporate income tax. No requirement applied with respect to the location of the R&D activities, whether or not in France.

Under the new rule, the preferential corporate tax rate decreases to 10%.

Income and gains from patentable inventions (not patented) are still eligible for the preferential regime but their patentability must be certified by the French National Institute of Industrial Property (INPI) and the regime now is available only to small-and-medium-sized companies (SMCs).

A significant change relates to copyrighted software, which is now eligible for the new regime.

Certain requirements still must be met in order to benefit from this regime.

The preferential tax rate applies to the net licensing income (or sub-licensing, etc.), determined by the difference between:

- the income generated from eligible assets during the financial year, and
- R&D expenses related to these assets and incurred, directly or indirectly, by the company during the same financial year.

A recapture mechanism is provided by the law for the first tax year during which an item of income becomes eligible for the special regime. This mechanism takes into account eligible expenses incurred in past tax years.

In order to include the nexus approach, the net income is then calculated annually based on the following ratio:

- Numerator: 130% of R&D expenses directly related to the creation or development of the intangible asset, directly incurred by the taxpayer or by unrelated companies
- Denominator: all R&D or acquisition expenses directly related to the intangible asset and directly or indirectly incurred by the taxpayer.

Specific rules apply for tax groups. For instance, the net income eligible for the preferential regime and the nexus ratio will have to be determined at group level.

The regime is subject to a formal election in the annual tax return for each asset, good, or service, or category of good or service.

In addition, the taxpayer must (i) add an appendix to its annual tax return showing how the net income and the nexus ratio were calculated for each asset or category of asset and (ii) prepare a defense file in case of a tax audit. Absent such file, the taxpayer incurs a penalty.

The Finance Act also provides that eligible royalties paid to related parties that are not located in a EU / EEA Member State and benefit from a privileged tax regime on the royalties must be subject to tax at an effective rate of at least 25% in the same tax year. Otherwise, a portion of the royalty is not deductible.

The new patent box regime applies to tax years beginning on or after January 1, 2019.

Increased corporate income tax installment payments for MNEs (Article 39)

The last corporate income tax installment payment due by large companies now must be equal to at least:

- 95% of the overall projected corporate income tax due for a given tax year, less installment payments already made (companies with yearly revenues between EUR 250M and EUR 1bn)
- 98% of the overall projected corporate income tax due for a given tax year, less installment payments already made (companies with yearly revenues exceeding EUR 1bn)

In practice, the new rule will apply for the first time to installment payments due to be paid by December 15, 2019 (for companies operating on a December 31 year-end).

The takeaway

MNEs operating in France should consider the impact of the Finance Act on their international financing flows, French compliance requirements, IP nexus, and structuring for cash repatriation purposes.

Let's talk

For a deeper discussion of how this might affect your business, please contact:

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