Thin capitalisation Q&A: France

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Thin capitalisation Q&A: France

1. What are the main characteristics of thin capitalisation rules in your jurisdiction?

French thin capitalisation rules limit the tax deduction of interest (whether actually paid or unpaid and/or capitalised) accrued on French companies' debt that has been granted by "related entities". Subject to certain exceptions, loans granted by third parties but secured or guaranteed by "related entities" also fall within the scope of the rules.

For the purposes of thin capitalisation rules, two entities are deemed to be "related" if either:

- One controls the other, that is it holds (directly or indirectly) the majority of the other's share capital or has a factual decision-making power in that other entity.
- Both entities are controlled (as defined above) by a common third entity.

Interest accruing on loans falling within the scope of thin capitalisation rules is tax deductible up to the highest of three limits (see *Question 8*).

French tax law provides for a number of other rules limiting the tax deductibility of interest. Such rules apply in addition to the thin capitalisation rules (see *Question 19* for a brief description of these other rules).

2. What is the main national legislation regulating thin capitalisation in your jurisdiction?

The main national legislation in France which regulates thin capitalisation is codified in Article 212-II of the French Tax Code.

The other main rules limiting the tax deductibility of interest can be found in Articles 39, 209, 212-I, 212 bis and 223 B bis of the French Tax Code.

3. What is the relationship between thin capitalisation and transfer pricing rules in your jurisdiction?

In France, thin capitalisation rules and transfer pricing rules are applied separately.

However, it is worth noting that French tax law includes a specific provision (*Article 212-I, French Tax Code*) whereby interest accruing on loans granted by "related entities" is not tax-deductible if it is computed at a rate which exceeds a market rate. Determining a market rate for the purpose of this rule is closely related to transfer pricing analysis.

4. Are there any additional regional / local state legislation and tax authority guidance relevant to thin capitalisation in your jurisdiction?

The French tax administration has published a statement of practice on the thin capitalisation rules. These guidelines are available in the French language at: *http://bofip.impots.gouv.fr/bofip/4399-PGP.html?identifiant=BOI-IS-BASE-35-20-20130329*.

5. What type of loans do the rules apply to?

Loans granted by related entities

The rules apply to any loan granted by a "related entity" (see *Question 1* for a definition of a related entity).

Loans secured or guaranteed by related entities

The rules also apply to any loan that is granted by a third party but the repayment of which is directly or indirectly secured or guaranteed by entities "related" to the borrower. The portion of such third-party loan that is deemed to be a "related-party" loan (that is, a loan granted by a related entity or loan granted by third parties but secured or guaranteed by a related entity) for the purpose of the thin capitalisation tests depends on the nature and value of the security or guarantee granted by the "related entities".

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By exception, third party loans secured or guaranteed by entities "related" to the borrower may still be excluded from the scope of the thin capitalisation limitations in certain situations such as:

- Loans whose repayment is exclusively secured by a pledge over any of:
  - the shares of the borrowing company;
  - amounts receivables by other parties from the borrowing company (such as under a shareholder loan); or
  - shares of a company that holds, directly or indirectly, shares in the borrowing company, when the holder of these shares and the borrowing company are members of the same French tax consolidated group.
- Loans entered into to refinance a mandatory prepayment of existing debt caused by a change of control clause.

Loans potentially falling within the scope of thin capitalisation rules include all types of financial advances that may generate tax-deductible interest, whatever their form (for example, standard loans, current accounts, bonds and so on).

6. Are any loans excluded? Are there any safe harbours?

Third-party loans not secured or guaranteed by "related entities" do not fall within the scope of the thin capitalisation rules.

With respect to "related-party" loans, the French Tax Code makes several safe harbour provisions. For example, the thin capitalisation rules do not apply to interest due under a cash-pooling arrangement by the entity that is in charge of managing the arrangement in question. The rules also do not apply to borrowing companies that are able to demonstrate that the overall debt/equity ratio of the group to which they belong is higher than their own debt/equity ratio.

Certain safe harbours also apply with respect to third-party loans secured or guaranteed by an entity "related" to the borrower (see *Question 5*).

7. What is the tax treatment of loans caught by the rules? Is the interest paid on the loan non-deductible in the borrower's hands?

The tax deductibility of interest accruing on loans caught by the rules is capped (see *Question 8*). The portion of interest which exceeds this cap must be added-back to the borrower's taxable income, unless such excess interest is lower than EUR150,000 in a given tax year.

8. How is the disallowed interest calculated? Is it by reference to a maximum amount of debt or a maximum amount of interest? If it is by reference to a maximum amount of debt, is that amount determined by an arm's length approach or a ratio approach? If it is by reference to a maximum amount of interest, is there a specific debt-to-equity ratio and are there any procedures that can be followed for a different debt-to-equity ratio to apply?

Disallowed interest is calculated by comparing the amount of interest accruing on all loans falling within the scope of the thin capitalisation rules (that is, related-party loans and all or part of third-party loans secured or guaranteed by entities "related" to the borrower) with the three following amounts/limits:

- Debt/equity test. This limit is equal to the amount of arm's length interest within the scope of the thin capitalisation rules multiplied by the ratio between (i) 1.5 times the borrower's net equity at the opening or the closing of the financial year (or, subject to conditions, share capital at the end of the financial year if higher); and (ii) the average amount of indebtedness in respect of loans from "related entities" (or of such portions of third-party loans secured or guaranteed by related entities) throughout the relevant financial year.
- Interest coverage test. This limit is equal to 25% of the operating profit (loss) before taxes of the borrower increased by (i) the amount of arm's length interest accruing on loans from "related entities" (or of such portions of third-party loans secured or guaranteed by related entities); and (ii) the amount of the depreciation allowances taken into account to determine the operating profit before taxes and the portion of finance lease payments taken into account to determine the sale price of the leased assets at the end of the contracts.
- Interest received test. This limit is equal to the amount of interest earned by the borrowing entity from "related entities".

The portion of interest that exceeds the highest of these three limits is non tax-deductible (unless the exceeding portion is lower than EUR150,000, in which case it remains tax deductible).

Where the borrower is a member of a consolidated tax group, additional rules apply at the level of the tax group (the rules would generally be expected to have the effect of enabling the tax deduction of interest that is non tax-deductible at the borrower's level but corresponds to interest paid to a member of the same tax group).

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9. Can any disallowed interest be carried forward to future years for set-off?

Excess interest, if any, is carried forward and may be deducted from the taxable income of the borrower over the following tax years, within certain limits.

The amount of carried forward interest that can be set-off in a given financial year is equal to the difference between (i) 25% of the net operating income of the borrower (before depreciation and deduction of interest on "related-party" loans and certain lease payments); and (ii) deductible interest on "related-party" loans incurred during the year in question.

The amount of interest carried forward is reduced by 5% every year from the second year of deferral.

Where the borrower is a member of a consolidated tax group, excess interest recognised at the individual level of the borrower is transferred to the parent of the group and its tax deduction can be achieved at the level of the tax group under certain conditions (in particular if the amount of interest due by all members of the tax group to "related entities" that are not members of the tax group is less than 25% of the adjusted net operating income of the tax group).

10. How is the lender taxed on receipt of the interest?

Interest income earned by companies subject to corporate income tax in France is in principle subject to corporate income tax at the standard rate (currently 33.1/3%, possibly increased by additional contributions).

The fact that interest would not be tax deductible under the thin capitalisation rules at the borrower's level would in principle not have an impact on the taxation of such interest at the lender's level (specific rules may apply in certain cases, for example if interest is treated as non-tax-deductible under the maximum interest rate limitation mentioned in *Question 19*).

11. How are the rules applied to hybrid instruments?

The French tax authorities do not apply the thin capitalisation rules differently to hybrid instruments.

Please note however that, under a separate set of rules, the French tax code provides that interest accruing under a loan granted by a "related entity" (see the definition at *Question 1*) will only be tax deductible if the borrower can demonstrate, on request from the French tax authorities, that the "related" lender is taxable on the interest during the same tax year at a rate equal to at least 25% of the applicable French corporate income tax rate.

If the lending entity is tax transparent or is a collective investment fund, the minimum taxation condition is assessed at the level of its "related" shareholders / unitholders, if any.

According to a statement of practice published by the French tax administration, this minimum taxation condition should be assessed "objectively". If interest due to the lending entities is fully included in their corporate income tax basis and if the rate of applicable corporate income tax is sufficient, then this condition should be met (*BOI-IS-BASE-35-50*).

12. Is it possible to obtain any clearances from the revenue authorities in respect of transactions?

Any taxpayer is generally entitled to ask the French tax authorities to take a formal position on the interpretation of a specific point of law or on its application to the particular situation of the taxpayer.

The request must be submitted in writing. The identity of the taxpayer and all relevant factual elements must be detailed clearly and comprehensively. The taxpayer must also be acting in good faith.

If these conditions are met, the French tax authorities are meant to reply to the request within three months. This response is then binding on the tax authorities. However, there is no real consequence if the French tax authorities do not respond within this three-month period (it is not rare for the tax authorities to fail to respond at all).

Seeking tax clearance is not very common in France, especially with respect to thin capitalisation rules.

13. What are the main international treaties and agreements that apply in your jurisdiction?

France has one of the most extensive double tax treaties networks. Being an EU member state, EU Directives and EU Regulations also apply.

In addition, the OECD multilateral convention will be applicable once it enters into force (the ratification process of the law implementing the OECD multilateral convention in French law began on 19 April 2018).

14. What impact do international treaties and agreements have in your jurisdiction? Do double tax treaties apply?

Double tax treaties should generally have no impact on the French thin capitalisation rules (see *Question 20* on possible impact of the EU Anti-Tax Avoidance Directives).

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15. What are the reporting and other administrative obligations that apply to help authorities evaluate thin capitalisation?

Corporate income tax returns filed by French taxpayers include a specific form detailing the computation of the thin capitalisation limitations.

When a borrower has non tax-deductible interest to be carried forward, such interest should also be reported annually in a specific tax form.

16. Where the revenue authorities make an adjustment of the deductibility of interest for tax purposes due to thin capitalisation rules, can other penalties also be imposed?

Where the French tax administration reassesses the amount of tax-deductible interest of a borrower and the reassessment results in additional amounts of corporate income tax being due, the taxpayer is liable for late payment interest computed at the rate of 0.20% per month.

Penalties of 40% or 80% of the additional amount of corporate income tax due as a result of the reassessment may also apply in cases of wilful misconduct or fraud.

17. What are the relevant national courts and what dispute resolution mechanisms exist for thin capitalisation issues in your jurisdiction? Can thin capitalisation rulings be appealed?

The French administrative courts (the *tribunaux administratifs*, the *cours administratives d'appel* and ultimately the *Conseil d'Etat*, the French administrative supreme court) are the competent national courts with respect to corporate income tax issues, including thin capitalisation.

Rulings issued by the French tax authorities can in principle be appealed, but it is rather uncommon to seek rulings on thin capitalisation issues in France.

18. What are the most significant case law developments on thin capitalisation in your jurisdiction?

French thin capitalisation rules are mainly governed by French law, as interpreted by the French tax authorities. No recent case law developments have significantly influenced such rules.

Although technically not part of the thin capitalisation rules, it is worth noting that a significant flow of litigation is ongoing around how to determine a "market interest rate" under a "related-party" loan.

19. Does your jurisdiction place any further restrictions on the deductibility of interest?

Yes. The French tax code provides for several other restrictions on the deductibility of interest, which are potentially cumulative.

Maximum interest rate rule

As a general principle, the portion of interest that is above a "market rate" is not tax-deductible and cannot be carried forward by the borrower. Interest incurred on loans granted by a "related" party is deductible up to a rate published from time to time by the French tax authorities (*Article 39-1-3°-1 §, French Tax Code*) or, if higher, up to the rate that the borrowing company could have obtained from independent financial credit institutions in similar circumstances (that is, a "market rate"). Interest accruing on loans granted by minority shareholders (that is, not qualifying as "related" entities) is deductible only up to the above mentioned published rate.

"Anti-hybrid" rule

See *Question 11*.

"Carrez rule"

This rule may limit the tax-deduction of interest incurred by a company in relation to the acquisition of a participating shareholding interest in a subsidiary if the purchasing company is not able to demonstrate that this shareholding interest is "managed" from an EU member state or another state that is party to the agreement on the European Economic Area and has signed a tax treaty containing a clause of administrative assistance to combat tax evasion and avoidance.

Where the Carrez rule applies, a portion of the interest expense borne by the purchasing company is added-back to its taxable income for a maximum period of nine years.

"Charasse rule"

This rule limits the tax-deduction of interest expenses borne by all members of a consolidated tax group where a company acquires (for a cash consideration) from a "controlling party" shares in another company which subsequently enters into the same consolidated tax group as that to which the purchasing company belongs.

Where the Charasse rule applies, a portion of interest expenses born by all members of the consolidated tax group in question is added-back to the taxable income of such tax group for a maximum period of nine years.

"Rabot rule"

This rule imposes a general limitation on the deduction of financial expenses incurred by French companies.

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The tax deductibility of net financial expenses incurred by a company in a given year (that is, the difference between its financial expenses and its financial income) is limited to 75% of their amount, unless the amount of the net financial expenses does not exceed EUR3 million (in which case the net financial expenses are fully tax-deductible) (*Articles 212 bis and 223 B bis, French Tax Code*). If the EUR3 million threshold is exceeded, the limitation applies to the total amount of the net financial expenses.

Financial expenses taken into consideration for the purpose of this limitation correspond to financial expenses of the year less any non tax-deductible interest or expenses under other specific rules (for example, the thin capitalisation rules, the Charasse rule and so on).

Within a consolidated tax group, this general limitation applies to net financial expenses remunerating sums advanced to the tax consolidated entities by persons or entities that are not members of the tax group.

The limitation applies to the aggregated net financial expenses of the tax group, that is, the sum of the net financial expenses of the tax consolidated entities. The EUR3 million threshold is also appreciated at the level of the tax group overall.

Non-cooperative States or Territories

A specific limitation to the tax deductibility of interest applies where interest is paid to an entity established in a non-cooperative State or Territory, as set out in the list referred to in Article 238-0 A of the French tax Code. The limitation does not apply if the borrower demonstrates that both:

- The corresponding interest represents normal consideration for genuine transactions.
- The main purpose and effect of the underlying transactions is not to locate expenses in a non-cooperative State or Territory.

Interest paid on an account managed by a financial institution established in a non-cooperative State or Territory also falls within the scope of the limitation on tax deductibility, irrespective of the location of the beneficiary of the interest payment. The list of non-cooperative States or Territories currently includes Botswana, Brunei, Guatemala, Marshal Islands, Nauru, Niue and Panama. This list is updated from time to time.

20. Are there any current trends, developments or reform proposals that have or will affect the area of thin capitalisation in your jurisdiction?

The EU member states have approved two Anti-Tax Avoidance Directives (ATAD) which, among other things, provide for new rules limiting the tax deductibility of interest.

Very broadly, these rules provide that where net financial expenses of an entity exceed EUR3 million, such net financial expenses will only be tax deductible up to 30% of the borrower's EBITDA. When implemented under French domestic law, the new rules may either replace existing limitations, including the thin capitalisation rules, or apply on top of them.

At this stage, it is unclear whether the ATAD provisions will be implemented under French law by 1 January 2019 or by 1 January 2024.

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