FRANCE — Acquisition Financing

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I. Limitations on Deductibility of Interest and Other Financing Expenses Incurred by French Acquisition Vehicle With Respect to Shareholder Loans From Foreign Country Investor and Funds Borrowed From Third-Party Banks

France is a high tax jurisdiction. Using debt to finance a French acquisition vehicle (France Acq) can, however, allow the taxation of the target's profits to be limited to the net income derived after the deduction of the interest payments on that debt, regardless of whether the lenders are shareholders of France Acq or unrelated third-party banks. The interest expense deductions, which compensate for the high rate of taxation, may be limited under several provisions of the French Tax Code (FTC), the number of such limitations having increased significantly in recent years.

This article describes some of the most significant considerations that could apply to debt used to finance France Acq's acquisition of a French target (France Target).

A. Consolidation

An initial consideration relevant to the acquisition structure is whether France Acq and France Target should file consolidated returns for French tax purposes or whether the two corporations should remain separate for such purposes. Tax consolidation allows interest expense (provided it is deductible) to be matched against the target's income.

When one corporation holds at least 95% of the stock of another corporation, measured by both vote and value, the two corporations can elect to be taxed on their net consolidated income. If such an election is made, the two corporations file two separate tax returns but the income effectively taxed is computed by adding the two positive or negative income amounts, with some adjustments for intra-group operations. The tax on the net consolidated income is payable by the head corporation of the group (typically France Acq). The allocation of the tax burden between the entities can be freely organized in an agreement between the entities belonging to the group. For example, France Target can either agree to pay to France Acq the amount of tax that would be theoretically due on its own income, or it can be decided to take the expense of tax in the target company only when the tax is effectively paid.

B. Earnings Stripping Rules (Related-Party Debt)

The earnings stripping rules apply with respect to interest paid to shareholders or related parties of the borrowing entity.

For purposes of the rules, a related party in relation to a corporation is defined as a person that, directly or indirectly, owns the majority of the capital of the corporation or has effective control of, and the power to decide in relation to, the corporation (here France Acq). Two corporations are also related parties if they are controlled by the same person.

In addition, the thin capitalization rules described below apply to loans granted by an unrelated party but financed back-to-back or secured by a related party.

1. Limit on Interest Rate

Articles 39-1-3° and 212 of the FTC limit the interest rate that can be charged on loans granted by a shareholder or a related party to the average variable rate used by credit institutions for loans to corporations over more than two years (i.e., 2.03% in 2016 and 1.67% in 2017). However, in the case of a loan granted by a related party, the limitation does not apply if the borrowing corporation shows that the rate that would have been charged by an independent credit institution would have been higher

2. Thin Capitalization

Thin capitalization rules have applied since 2007 with respect to interest paid to a related party (they do not

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