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French Finance Bills

International Tax Alert

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In late December 2005, the French Finance Bill for 2006 and the Amended Finance Bill for 2005 were enacted by French Parliament.

The most significant changes include reform of French thin capitalization rules.

Beginning after 2006, Section 212 of the French Tax Code may now limit the deduction of interest by a French entity paid on indebtedness from a related party. A related party includes an entity that holds directly or indirectly more than 50 percent of the borrowing company's share capital, an entity that manages the borrowing company, or a third company that also controls, directly or indirectly, the borrowing company. The prior version of Section 212 only applied to indebtedness of a borrower due to a direct shareholder.

The changes affect the interest rate that may be charged and the amount of any interest deduction.

The maximum amount of the interest rate that may be charged on debt between related parties is limited to the higher of:

1. the rate that is referred to in section 39-1-3 of the French Tax Code (average interest rate granted by banks on variable loans with a term of more than two years), or
2. the interest rate the borrowing company could have obtained from an independent bank under similar conditions.

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In addition, the interest deduction of a borrowing company is limited if the interest paid by the borrower exceeds the following thresholds:

1. the interest paid multiplied by the ratio of equity of the borrowing entity times 1.5 over the average amount of debt,
2. 25 percent of adjusted operating earnings or *resultant courant avant impots*. This amount is essentially earnings before interest, deductible amortization, allowances and certain lease expenses,
3. the amount of interest income received from related parties.

The portion of interest in excess of the higher of the three threshold amounts (described above) is not deductible for the given tax year unless the amount is less than Euro 150,000.

Certain limited exceptions apply to the rules. The new Section 212 is applicable to tax years beginning from January 1, 2007.

In addition, the finance bills enacted other provisions that limit the tax deductibility of reserve allowances on certain shares and real estate assets, tax consolidation, share exchanges/conversions, amendments to the Parent-Subsidiary Participation Exemption Regime, and the Research and Development Tax Credit.