WTS

Overview of the major provisions of the Finance Law for 2011 and Rectifying Finance Law for 2010

Like every year the Finance Law and Rectifying Finance Law provide significant changes. For the special issue of our newsletter, we have made a selection of some of the most striking tax changes that might have a significant impact on your business and which merit to pay attention.

Taxation of partnerships ("sociétés de personnes"):

French government will release a special report by the end of April 2011 on the tax consequences of a reform of French partnerships ("sociétés de personnes"). This must be followed closely as this report could lead to the recognition of a greater tax transparency in partnerships.

Corporate income tax:

• Repeal of the cap on fees and charges on dividends paid to a mother company

The mother/daughter tax regime allows to exempt from corporate income tax dividends received by a parent company from French or foreign subsidiaries. A share corresponding to fees and charges is however taxed. This share was capped at the total costs and expenses incurred by the parent company for that period. The cap is now removed. The taxable amount is now always equal to 5% of the dividend received. Mother companies will in effect suffer from an additional corporate income tax burden when the amount of expenses really incurred is less than 5%.

• Measures combating tax avoidance and tax optimisation – Extension of the thin capitalisation rule

In principle, the deductibility of interest paid to associated companies is limited, especially when the borrowing firm is undercapitalized. Now the thin capitalization rule is extended to interests paid to unrelated companies when the loan is secured by a related company. This measure applies to fiscal years beginning on December 31, 2010.

• Measures combating tax avoidance and tax optimisation – Capital gains or losses on sales of equity securities held for less than 2 years between related companies

Currently, capital gains or losses resulting from the sale of equity securities by a legal entity subject to corporate income tax are subject to a specific tax treatment depending on the holding period of these equity securities. Equity securities are normally defined as the securities whom ownership is considered useful to the company's activity, particularly because it can influence the issuing company or ensure control over this company (French notice 4-B 1-08, 4 April 2008, n°. 16 et seq.)

The capital gains and losses on the sale of equity securities are called short-term if the securities are

held for less than two years. Short-term capital gains are taxed as ordinary income. Short-term capital losses are deducted from corporate income tax at the standard corporate income tax rate.

Now, the Finance Law for 2011 provides that capital gains or losses on the sales of equity securities, between related companies, held for less than 2 years will no longer be deductible but will be subject to a tax deferral until:

- The date the transferor ceases to be subject to corporate income tax or is absorbed by a company that, after absorption, is not related to the company holding the securities sold;
- The date on which the securities stop to be held by an affiliated company of the transferor;
- The expiration of 2 years.

This new tax regime is compulsory as far as capital losses are concerned. It applies to capital gains provided that the status of the securities is monitored.

It appears that this new tax regime is intended, among other things, to limit the deduction of dormant capital losses in intra-group sales. Indeed, previously, companies belonging to a same group had an incentive to sell securities to members of the group and thus deduct a short-term capital gain from their corporate income tax at the standard rate (whereas these securities remained anyway in the same economic group).

- **Measures combating tax avoidance and tax optimisation – Distribution followed by exchange of securities: It is not possible anymore to cumulate the corporate income tax exemption on dividends received and the deduction of a capital loss on the sale or exchange of securities of the subsidiaries that distributed the dividends**

Currently, under the mother/daughter tax regime, dividends received by a parent company from subsidiaries of which it owns at least 5% are exempt from corporate income tax (except for a share of fees and charges). Furthermore, the capital losses on the sale of securities held for less than 2 years are deductible from corporate income tax at the standard rate. Therefore, a mother company may benefit from the exemption of dividends received from its subsidiaries and, in connection with the absorption or disposition of these subsidiaries, deduct from its taxable income capital losses at the standard rate.

Finance Law for 2011 introduces a new provision that applies to financial years ending December 31, 2010.

The new system aims to prevent the cumulative effects of an exempt distribution under the mother/daughter tax regime or consolidated tax regime and the deduction of a short-term capital loss on the sale or exchange of securities of the subsidiaries that distributed these dividends (the loss resulting from the depreciation of such securities as a result of prior distributions).

This new tax provision applies differently to integrated groups and other groups. In integrated groups, the price of the securities is reduced by the amount of the distribution (no deduction of the capital loss). In other groups, the mother/daughter regime is denied (no exemption on dividends received).

• Tax credit for research and development

Several measures adjust the mechanism of the tax credit allowed for research and development, although in a way that is less favorable to businesses. For instance, the measure allowing to immediately refund the tax credit is terminated (except for SMEs, innovative and new companies or businesses facing difficulties: those can still benefit from an immediate refund). Also, the increased rate of the tax credit during the first two years is reduced from 50% to 40% and 40% to 35%. The evaluation method of operating expenditures is also changed: these are set at 50% of the staff cost and 75% of the depreciation allowance (instead of 75% of operating expenditures, as this was the case previously).

• Imputation of foreign tax credits

The rules governing the imputation of tax credits attached to dividends received from foreign sources by French companies (which are subject to corporate income tax) have changed.

Under the rule known as the "butoir" (that is to say, the “buffer” rule), the tax credit allocation is limited to the amount of corporate income tax due for the year and is based on the amount of income that is received. This tax credit is not refundable and cannot be carried forward. This led some companies having losses to sell with a buy-back option their securities a few days before the dividends were paid. In order to avoid the development of a foreign tax credits market, the new system implemented by the Finance Law for 2011 aims at restricting the amount of tax credit allocation in situations where securities were subject to a buy-back agreement prior to the distribution of dividends. For instance, expenses incurred for the acquisition of securities are deducted from the amount of the dividends when calculating the amount of the tax credit.

Personal income tax:

• Withholding tax on dividends and on fixed rate investment products

The rate of withholding taxes is raised from 18% to 19% knowing that this increase is not taken into account for the computation of the excess tax to be refunded under the "tax shield" (“bouclier fiscal”). The "tax shield" allows normally for the refund of taxes when more than 50% of the income of the taxpayer is taxed.

• ISF reduction

ISF (“Impôt de Solidarité sur la Fortune”) is a special tax on high net worth individuals. Finance Law for 2011 has implemented several changes to prevent abuses. Notably, the rate of ISF reduction when investing in SMEs is decreased from 75% to 50%. Eligible investments are refocused. Real estate activities, financial activities, portfolio management and activities providing a guaranteed income as a result of regulated prices are now excluded from the list of eligible investments. Companies whose assets consist predominantly of precious metals, artworks, collectibles or antiques, horse racing, wine or alcohol are also excluded. Finally, the ceiling of the tax reduction is lowered from 50 000€ to 45 000€.

New tax on financial institutions:

Finance Law for 2011 introduced a systemic risk tax on banks equal to 0.25% of the minimum assets held by the bank institution in the previous year. This tax is intended to prevent excessive risk behaviours from banks. This initiative follows a statement by the European Council of June 17, 2010

according to which Member States should introduce systems of levies and taxes on financial institutions to ensure fair burden-sharing and to set incentives to contain systemic risk. Such tax was already introduced in Sweden since 2009. The United Kingdom, Germany and France have decided to create an ad hoc taxation of the financial sector. This tax is in France deductible from the corporate income tax. By contrast, in Germany and in the United Kingdom, a specific provision expressly excludes the deductibility of this tax.

VAT:

• VAT "Group"

French Rectifying Finance Law for 2010 has introduced a new regime of VAT payment consolidation for groups provided that some conditions are fulfilled. This will be effective as from January 2012. If the option is exercised, the head company will file a consolidated VAT return and pay the difference between the amount of taxes due and of tax credits resulting from the VAT returns filled by the members of the group. In case of a negative balance, the head company will ask for the refund of the VAT or report the credit on following consolidated VAT returns.

In conclusion, this French version of the VAT grouping is not a real VAT group that would have allowed ignoring intra-group transactions. It is only a consolidated payment scheme. This is nevertheless a welcomed simplification.

• Debt transmissions

As a general rule, VAT on services is due upon receipt of the price. The difficulty is to define the time of the collection. Thus, for factoring transactions, collection was considered achieved when the debt was paid by the debtor and not when the debt was transferred to the factor. Conversely, VAT was due at the time of the sale when debt was sold to a third party.

French rectifying finance law for 2010 has harmonized the rules regarding the chargeability of VAT. VAT becomes chargeable at the date of the payment of the debt in the hands of the beneficiary of the transmission, whether this debt has been transferred or sold.

• Tradable permits for reducing emissions of greenhouse gases

Emission Trading Schemes (ETS) are classified as intangible movable goods. Their sale is regarded as a supply of services subject to VAT. In June 2009, suspicious activities – carrousel fraud – were detected in Amsterdam, London and Paris. France provided a response in emergency by applying a VAT exemption – without right to deduct the corresponding input VAT – to sales of permits. In March 2010, the EU Council has allowed Member States to apply the reverse charge on supplies of ETS.

French Rectifying Finance Law for 2010 is transposing into national law that option. Now, the recipient has to reverse charge the VAT on domestic sales of ETS (the recipient already had to reverse-charge the VAT on cross-border supplies of ETS).

• Supplies of heat and cooling energy

Supplies of gas, electricity, heat or cooling energy are regarded as supplies of tangible movable goods.

French Rectifying Finance Law for 2010 transposes the provisions of Directive 2009/162/EU into French law. Territoriality rules applicable to supplies of heat and cooling energy and to services related to them are aligned with the rules applicable to supplies of natural gas and electricity. According to these rules, the place of supply is in France when these goods are consumed in France

or when the purchaser is established in France (i.e. when the purchaser has in France its place of business or a fixed establishment to which the goods are supplied or – in the absence of one of those – where it has its permanent address or usually resides).

Access to heating and cooling networks and distribution through these networks or any related services are regarded as supplies of intangible services which are taxable at the place of the recipient.

• Triple play services

The measure allowing applying the reduced rate to triple play services (providing high-speed internet access, television and telephone over a single broadband connection) has been repealed by French Finance Law for 2011. As a reminder, the European Commission sent a letter of formal notice to France in March 2010 in which it accused France of circumventing the prohibition to apply reduced rates to electronic services. The reduced rate can now only be applied to the economic value of television services.

Territorial economic contribution (“Cotisation Economique Territoriale” / CET)

The CET was established by the Finance Law for 2010 to replace the business tax (“Taxe Professionnelle”). It consists of two distinct elements: a property tax (“Cotisation Foncière des Entreprises” / CFE) and a contribution on the value added by businesses (“Cotisation sur la Valeur Ajoutée des Entreprises” / CVAE). CFE strikes normally self-employed persons having their own business in France (the tax base is normally made of the rental value of goods subject to a property tax). The CVAE is paid in addition to the CFE but obeys to different rules (the CVAE is determined by the turnover and value added production).

The Finance Law for 2011 brings many changes to the CET. If some of the new provisions are intended to clarify existing rules, others are significantly strengthening the tax. Without going into details, it is worth mentioning that the rental value floor (that is to say, the minimum rental value) to calculate the CFE is increased when transactions happen between related companies. On the other hand, the ceiling of the minimum contribution of CFE is increased for taxpayers whose turnover exceeds 100 000€. When calculating the CVAE, the turnover of the member firms belonging to a consolidated tax group is globalised (in order to reduce the CVAE relief open to businesses with a turnover below 50 000 000€).

Control and litigation:

The Rectifying Finance Law for 2010 has significantly strengthened procedures against tax evasion and unlawful activities.

The Rectifying Finance Law for 2009 had created a judicial tax investigation procedure. This investigation may be conducted by tax officers specially empowered by prosecutors (“Parquet”). Agents conduct these investigations when there is a risk of dying of evidence in cases of suspected tax evasion involving the use of falsifications or accounts held in tax havens. The Rectifying Finance Law for 2010 extends judicial tax investigation to offenses related to fraud and allows for the lump-sum assessment of unlawful income on the basis of information supplied by prosecutors or judges.

Finally, the right of communication of the Administration is extended (amongst other things to gambling establishments).

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