Recent changes in French tax regulations on deductibility of interest on intra-group financing

Many groups of companies do finance their subsidiaries through inter company loans.

French tax regulations on deductibility of interest paid by French subsidiaries changed recently.

The following is an abstract of the new regime:

Condition to deductibility:

Interests charged on shareholders' loans can be tax deductible if the following conditions are met:
- French company's capital is fully paid-up;
- Interest rate does not exceed the annual average of adjustable rate loans granted by French credit institutions for more than two years (there are however some exceptions in case the company is in a position to show that it might have obtained loans from independent banking institutions at an interest rate higher than the limit rate mentioned above);
- The company receiving the shareholders' loans (the French subsidiary in those cases), is not considered to be thin capitalized (see below).

Thin capitalization test:

Thin capitalization of a subsidiary is characterized under French tax law if the three following conditions are met:
1. loans granted by affiliated companies exceed 150% of stockholder's equity ("*capitaux propres*"),
2. interests paid to those affiliated companies (see below explanation of that concept) exceed 25% of the company's profits before depreciation, income tax and interest paid to affiliated companies (the 25% Limit), and
3. interests paid to those firms exceed interests received from them.

Shall a subsidiary be considered as undercapitalized for a given year, the portion of interest exceeding the highest of these three limits will not be tax deductible.

However, if the portion of interest exceeding the highest of these three limits is lower than 150'000 Euros, or if the subsidiary can show that its global indebtedness does not exceed the global indebtedness of the group to which it belongs, then this interest will remain fully tax deductible.

The portion of interest which is not tax deductible due to the thin capitalization rule can be deducted from subsequent years' profits, within the 25% Limit reduced by the amount of interests already deducted the year they were generated. Starting the third year, the amount of deferred interests is subject to an annual 5% discount.

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