SULLIVAN & CROMWELL LLP

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French Tax Reform

On November 15, 2017, the French government released a proposed reform of the tax regime applicable to mergers and spin-offs. The draft legislation would remove some of the most stringent requirements currently applicable to both cross-border and domestic reorganizations.

SUMMARY

The proposed reform aims at making French tax law compliant with the EU Merger Directive, and is expected to be enacted by the end of the year. It would apply as from January 1, 2018.

The most important changes relate to (i) spin-offs/demergers, for which taxpayers would no longer be subject to a 3-year holding period following the reorganization, and (ii) cross-border reorganizations, for which taxpayers would no longer need to get a ruling from the French tax authorities in order to benefit from the tax deferral regime.

3-YEAR HOLDING REQUIREMENT

A. CURRENT FRENCH REGIME

The benefit of the tax deferral regime with respect to contributions, spin-offs and demergers is currently subject to the requirement that taxpayers must commit to (i) hold the shares received in the exchange for a period of three years and (ii) compute future capital gains based on the historic tax basis of the transferred assets/shares. In addition, the reorganization must involve a "branch of activity" (*i.e.*, a standalone business).

If any of these conditions is not met, the reorganization may still benefit from the tax deferral regime subject to obtaining a prior ruling from the French tax administration confirming that (i) the transaction is motivated by business purposes, (ii) the transaction does not have as its principal objective, or one of its principal objectives, tax evasion or tax avoidance, and (iii) capital gains in respect of which taxation has been deferred will continue to be taxable in France after the transaction.

B. PROPOSED CHANGES

The draft legislation would eliminate the 3-year holding period requirement noted above, provided that the transferred assets constitute a "branch of activity" (*i.e.*, a standalone business). This holding period requirement would be repealed for both contributions of assets and spin-offs/demergers.

The proposed legislation does not address the situation of a non-French company having a French permanent establishment and contemplating to contribute its French business to a French subsidiary. Under the current doctrine of the French tax administration, the tax deferral regime is available only if the shares in the French subsidiary are held by a French permanent establishment or a French holding company owned by the non-French company. No change is contemplated in this respect in the proposed legislation. We believe that there are good arguments to consider that this condition is contrary to the EU Merger Directive.

If the assets transferred in the reorganization do not qualify as a branch of activity, the transfer would be eligible for the deferral regime subject to a prior approval by the French tax administration. Such approval will be granted only if the transferring company commits to a 3-year holding.

CROSS-BORDER REORGANIZATIONS

A. CURRENT FRENCH REGIME

Under current French tax law, a prior ruling from the French tax administration must be obtained in order for a merger, spin-off or demerger involving non-French resident companies to be eligible for the tax deferral regime. The position of the French tax administration has been to refuse to grant such ruling in respect of outbound transactions if the assets transferred were not held by a French permanent establishment and, as such, would not remain taxable in France.

B. PROPOSED CHANGES

A prior ruling by the French tax administration in respect of cross-border reorganizations is no longer required, although in the event of a post-transaction tax audit the tax deferral eligibility of an outbound transaction may be reviewed by the tax authorities.

The requirement that the transferred assets must be booked in the accounts of a French permanent establishment is expressly set forth in the proposed legislation. The scope of this obligation is extended in comparison with the current position of the French tax administration, as the new codified requirement covers iboth assets that were taxable in France before the transaction and those that were not. We believe that this point was not intentional, and may be addressed during the Parliamentary debates and amendments.

Cross-border reorganizations would also trigger specific reporting obligations under which the business purposes and tax consequences of such transactions would have to be disclosed to the French tax administration. As the Amended Finance Bill is currently drafted, the scope of this filing requirement covers not only cross-border reorganizations for which an election for the tax deferral regime is made, but also those for which no such election is made.

PRACTICAL CONSIDERATIONS

The new rules are of particular interest in situations where a corporation contemplates disposing of a business. Instead of selling the business directly, which would trigger the taxation of capital gains at the rate of 34.43%, the corporation may drop down the relevant business into a subsidiary under the tax deferral regime and subsequently sell the shares in such subsidiary without losing the benefit of the tax deferral regime on the drop-down. The tax basis of the shares received in the drop-down would be the historic tax basis of the transferred assets, but if the sale of these shares occurs at least two years after the drop-down, capital gains would benefit from the participation-exemption regime. Therefore, under the proposed legislation, and subject to abuse of law rules, corporations may dispose of a business with the benefit of the reduced taxation provided under the participation-exemption regime, by first contributing this business into a subsidiary and then after two years selling the shares received in exchange.

Taxpayers may also benefit from the proposed new rules in the situation where a French resident corporation held by a non-French resident parent company contemplates disposing of a business. The French corporation may first carry out a spin-off of the relevant business, by contributing this business to a newly-formed company and then distributing the shares in such company to its non-French shareholder. The shareholder would then be able to sell the shares in the newly-formed company without triggering taxation in France of the gain recognized on the spin-off.

The repeal of the holding period requirement is also of particular interest for listed corporations contemplating to carry out a spin-off. Under the current rules, shareholders holding more than 5% of the share capital of the corporation must commit to keep both the shares of the listed corporation and the shares of the spun-off company for three years. If one of such shareholders breaches its holding period commitment, the deferral regime is revoked in respect of all shareholders and the company, which may result in significant adverse tax consequences. In particular, it is generally impossible to retroactively levy a withholding tax on the value of the shares distributed to non-resident shareholders. The proposed reform addresses this concern since there is no longer any holding period requirement.

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CONTACTS

Paris

Gauthier Blanluet	+33-1-7304-6810	blanluetg@sullcrom.com
Nicolas de Boynes	+33-1-7304-6806	deboynesn@sullcrom.com
Marie-Aimée Delaisi	+33-1-7304-5832	delaisima@sullcrom.com
Alexis Madec	+33-1-7304-5834	madeca@sullcrom.com
Jérôme Rueda	+33-1-7304-5806	ruedaj@sullcrom.com