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CLIENT UPDATE

FRENCH DRAFT BUDGET FOR 2013

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On September 28, 2012, the French government released its much-awaited draft budget for 2013, which, unsurprisingly, contains significant tax increases, targeting wealthy individuals and large businesses. The government's draft budget will be debated and amended by the Parliament during the coming months. The principal tax measures proposed by the government are summarized below.

ADDITIONAL INCOME TAX BRACKET

French income tax brackets currently range from 5.5% to 41% for taxable income above €70,830. A new 45% bracket, which would apply to income received as from January 1, 2012, would be created for taxable income exceeding €150,000.

INCREASED TAXATION OF FINANCIAL INCOME

French resident individuals may currently choose between including their interest and dividend income in their overall income subject to progressive income tax rates (in which case, dividends may generally benefit from a 40% reduction), or being subject to a final withholding tax of 21% on dividends from certain entities and 24% on interest. In all cases, social contributions are payable for a total of 15.5%, 5.8% being deductible for income tax purposes when the income is subject to progressive income tax rates.

Under the proposed finance bill, French resident individuals would no longer benefit from a final withholding tax on their dividend and interest income, which would have to be included in the ordinarily taxable income, and subject to progressive tax rates. In addition, social contributions for a total of 15.5% would be payable, the deductible portion of such contributions being reduced from 5.8% to 5.1%. The 40% reduction on certain dividends would still be applicable.

Income tax on dividends and interest would be paid in two steps: first the 21% or 24% withholding tax would be mandatorily applied on the date of payment; second, the financial income would be included in the basis subject to progressive income tax rates for the relevant year, with a credit for the tax previously withheld.

This measure would be applicable to income received as of January 1, 2012.

INCREASED TAXATION OF CAPITAL GAINS, STOCK OPTIONS AND CARRIED INTEREST

Capital Gains

Under current rules, capital gains on shares realized by individuals are subject to a flat tax rate of 19%. Social contributions for a total of 15.5% are also payable. Subject to applicable tax treaties, foreign residents holding a substantial participation in a French company are also generally subject to the 19% tax (but not the 15.5% social contributions).

Under the proposed finance bill, capital gains realized as from January 1, 2012 would be included in the ordinarily taxable income, and subject to progressive rates. In addition, social contributions for a total of 15.5% would be payable, 5.1% being deductible.

Capital gains would benefit from a reduction in basis depending on the holding period of the shares: such reduction would amount to 5% for shares held for at least two years, and would be progressively increased to a maximum of 40% for a twelve-year holding period. The holding period would be calculated as from January 1, 2013.

The tax rate applicable to non-resident individuals holding a substantial participation would be increased to 45% for gains realized as from January 1, 2013. A refund could, however, be claimed if such tax is higher than the income tax resulting from the application of the progressive rates to such gains.

Stock Options and Free Shares

Currently, subject to certain conditions, the acquisition gain on stock options and free share grants (i.e., for stock options, the difference between the fair market value of the shares at the date of exercise of the option and the strike price, and for free shares, the fair market value of such shares at the date of their effective attribution) may be taxed as a capital gain in the year during which the shares are sold, at a flat rate of 18 or 30%.

These reduced tax rates would no longer apply to acquisition gains on shares sold as from January 1, 2012. Such acquisition gain would be subject to the progressive rates of income tax.

Carried Interest

The 2009 finance law introduced specific tax provisions pursuant to which, subject to stringent conditions, distributions received from and gains realized on the disposal or redemption of carried interest shares are taxed as capital gains and subject to income tax at a flat rate of 19%, and social contributions for a total of 15.5%. Distributions and capital gains on carried interest shares which do not meet the conditions set out by the 2009 finance law are subject to the progressive income tax rates as compensation income. In addition, a specific social contribution of 30% is due by the manager in this situation.

The proposed finance bill repeals these provisions, and provides that distributions and gains on carried interest from January 1, 2012 would in all cases be subject to progressive income tax rates as compensation income.

In addition, the government announced on October 1, 2012 that, as part of the social security finance bill for 2013 (an official draft of which should be released mid-October), the 30% special social contribution would be replaced with the imposition of "*CSG*" and "*CRDS*" taxes for a total of 8% (of which 5.1% would be deductible). An additional 20% tax, the "*forfait social*," would be due by the employer.

75% TAX ON INCOME FROM PROFESSIONAL ACTIVITIES

The 75% tax was a symbolic measure of François Hollande's electoral campaign. Since his election, the nature and scope of this tax has been the subject of intense discussions within the presidential majority. As it is currently presented in the government's draft budget, it would take the form of a temporary contribution separate from income tax, which would apply to the 2012 and 2013 income. The rate of this contribution would be 18%, the symbolic 75% rate being the addition of the 45% maximum income tax rate, "*CSG*" and "*CRDS*" taxes on compensation income for a total of 8%, and the 4% tax on high income introduced last year. The contribution would apply to professional income exceeding €1,000,000. It would not apply to capital gains and financial income. Consistent with their characterization as compensation income (see above), carried interest income and gains would be subject to the contribution.

INCREASED WEALTH TAX RATES

Wealth tax rates essentially similar to those that were in force prior to 2011 would be introduced: such rates would range from 0.50% for taxable net assets above €800,000 to 1.5% for taxable net assets above €10,000,000.

In order to comply with constitutional principles forbidding confiscatory taxation, a cap would be introduced to limit to 75% of a taxpayer's net income the total of wealth tax and taxes payable on income (including certain capitalized income).

LIMITATION OF INTEREST DEDUCTIONS BY COMPANIES

Interest rate limitations and thin-capitalization provisions already restrict the ability of French resident companies to deduct interest expenses from related-party debt or third-party debt guaranteed by related parties. In addition, a recent anti-abuse rule imposes restrictions on the deductibility of interest expenses incurred by a French company on certain share acquisitions if it is not demonstrated that the center of decision in relation to such shares is in France.

The draft finance bill for 2013 introduces a further limitation which would apply to fiscal years closed as of December 31, 2012. The deduction of interest expenses on any type of debt, after taking into account the above-mentioned restrictions, would be limited to 85% of their amount in 2013, and 75% as from 2014.

For companies that are members of a French tax consolidated group, this limitation would apply to net interest expenses from transactions with parties outside of the group.

Finally, this limitation would not be applicable to net interest expenses below €3 million.

INCREASED TAXATION OF LONG TERM CAPITAL GAINS REALIZED BY COMPANIES

French companies are partially exempt from corporation tax on long-term capital gains realized on certain shares of subsidiaries held for at least two years. Such exemption, which initially amounted to 95% of the gain, was reduced to 90% in 2011, leading to an effective tax rate of approximately 3.4%. The 10% taxable portion is calculated on net capital gains, i.e., after offsetting long-term capital losses against long-term capital gains.

Such offset would no longer be possible; therefore, the 10% portion of taxable gain would now be assessed on gross capital gains.

ADDITIONAL LIMITATION OF TAX LOSSES CARRIED FORWARD

The second amended 2011 finance law circumvented the ability for companies to fully use their tax losses carried forward by limiting the basis against which such losses can be offset to €1 million, increased by 60% of the excess of the amount of taxable income over €1 million. This rate would be further reduced to 50%.

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Please do not hesitate to contact us with any questions.

October 3, 2012