NATIONAL FOREIGN TRADE COUNCIL, INC.

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M. Thierry Breton
Ministre de l'Economie, des Finances et de l'Industrie
Teledoc 151
139 rue de Bercy
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Dear Mr. Finance Minister:

The National Foreign Trade Council, organized in 1914, is an association of some 300 U.S. business enterprises engaged in all aspects of international trade and investment. Our membership covers the full spectrum of industrial, commercial, financial, and service activities, and have for many years been significant investors in many foreign countries, among which one of the most important is France where our members have created jobs and wealth.

The future economic health of the world relies upon the ability of firms to manage global enterprises in robust international markets. This requires tax policies that recognize the importance of the free flow of capital, rather than the imposition of rules that restrict – or discourage – cross-border flows of capital. Thus, we greatly welcome the initiative launched last year by your Ministry, resulting in a report entitled: “Improving the certainty and reputation of French tax law in order to make France more attractive to foreign firms”. We also applaud the passing into law of many of those proposals.

At the same time as that report was being written, however, the Direction de la Législation Fiscale proposed changes to the thin capitalization rules of section 212 of the Fiscal Code. Although these changes were not enacted into law last year, we understand that these changes are likely to be re-proposed shortly. At a recent meeting of the MEDEF, several of our largest US members doing business in France became concerned that some aspects of the possible changes to section 212 will discourage foreign investment. As this is exactly the opposite of what we believe your Ministry is seeking to achieve, we are writing to you about their concerns.

We do want to emphasize that our members do not have any issue with thin capitalization rules, as such. These rules are necessary to protect a country’s tax base. However, they should be proportionate to the threat. No country (including the United States) currently has rules that would be nearly as restrictive as those proposed last year by the DLF.

The main problem with the proposed changes to section 212 is that they penalize certain forms of legitimate cross-border borrowing between related companies. While the changes to section 212 proposed last year provide some protection for intra-group borrowing, this would be done, principally, through an exception for lending within a French fiscal unity. Obviously, for French companies owned by a foreign parent, where the foreign parent raises funds and then on-lends to the French subsidiary,

that provides no protection. This is despite the fact that borrowing by the parent company in its local financial market is, in fact, often the most efficient way for a multi-national group to raise debt. Additionally, there would be an exception for financial institutions, but that would not extend to financial services firms that are not directly regulated. Thus, for example, unregulated real estate operations, which rely on leverage in exactly the same way that other financial institutions do, nevertheless, may be caught by the proposed rule if a foreign parent provides their funding.

At a more technical level, our members believe that there are problems with both parts of the proposed test: the 1½:1 debt-to-equity ratio, and the "interest cover" test. With regard to the debt-to-equity ratio, there should be some provision for a realistic valuation of equity to take into account increases in value (such as goodwill). The interest cover test also seems too strict in a number of ways. Firstly, interest should be a "net" number, to take into account inflows as well as outflows of interest. Second, last year's proposal would have restricted the amount of interest that could be deducted on related-party borrowing to 25% of net income ("resultat courant"). The interest cover test is meant to measure a company's ability to support its debt. However, even the US rules – currently the strictest in the world – today allow amounts up to 50% of income to qualify. Furthermore, the US definition of income is much closer to the appropriate measure of ability to pay. The definition under the proposed changes to section 212 would calculate income after many deductions have already been made (thus making the base of income much smaller). The US definition of income adds back in amortization, depreciation and a number of other items ("EBITDA"), thus making for a larger base.

An additional observation on the proposed thin capitalization rules is that we appear to be close to a potentially damaging struggle that could curtail or even prevent the often very efficient debt-financing of foreign operations. Over the past 3 years the NFTC has supported foreign-owned corporations in the United States seeking to prevent further, disadvantageous tightening of the US thin capitalization rules under section 163(j) of the US tax code. We made successful arguments to the US Congress that this would prevent legitimate parent corporation financing. However, tax legislation passed in October 2004 required the US Treasury to produce a report on thin capitalization by June of 2005. We are concerned that reintroduction in their current form of the proposed changes to section 212 would adversely impact the debate in the United States – to the further detriment of international capital flows.

We understand the concerns giving rise to these proposed changes (including the need to respond to European Court of Justice decisions), but we would urge you not to penalize an important segment of business that can contribute to helping the French economy to grow and create jobs. Our members are eager to work with you to assure that any new thin capitalization rules will reflect the importance of the continued growth of capital investments in France. We respectfully ask you, therefore, to consider the changes suggested in this letter, and to let us know how we can help.

Sincerely,

William A. Reinsch
President