Tax leverage: shareholder's loans under surveillance

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1. Introduction

For several years now, the French tax administration has been paying growing attention to intragroup financing strategies. Numerous litigations arose around the issue of the tax deduction of interest charges paid to related parties, with particularly acute impacts for companies involved in leveraged buy-out transactions. Indeed, in such debt-financed deals, the junior financing raised by the acquisition vehicle is often borrowed at least in part from the shareholders and investors. Furthermore, the very nature of this financing is to bear interest at a rate higher than bank loans, since it is specifically designed to supplement these loans, pushing the leverage level beyond what financial institutions have granted.

In light of the ever-growing number of disputes, setting up strong supporting documentation to secure interest rates applied on shareholders' loans has become a key requirement. Indeed, as a reminder, the tax deductibility of intragroup financial expenses incurred by French corporate taxpayers is in principle capped to a rate set by tax regulations (ca. 1.2% in 2020), unless the group can evidence that the interest rate effectively applied matches the rate that would have been obtained from an independent financial institution or entity in similar circumstances.

2. Initial Litigations: The "impossible proof" quandary

The burden of proof laid on taxpayers was initially made an ordeal by a number of tax audit departments, who demanded that companies provide a firm and binding financing offer from a bank, contemporaneous to the shareholder's loan implementation. According to these audit services, this was the only way by which a taxpayer could prove that the interest rate applied on the loan indeed matched the rate it would have obtained from a financial institution. Yet in most instances no such offer is sought at the time of the transaction, partly because the junior financing under consideration is precisely used to supplement the bank loans and increase the financial leverage beyond what the financial institutions have agreed to fund, but also – and mainly – because seeking such an offer would involve negotiations and efforts too onerous to be carried out solely to support an intragroup financing decision.

Lacking such binding offers from financial institutions, taxpayers usually resorted to financial experts to provide studies allowing to identify the rates applied on the financing market for borrowers with similar risk profiles. Due to the absence of readily available data in respect of bank financing, these studies were (and still are) logically established based on bonds and notes issued by companies. However, for a long time, both the tax authorities and the judges ruling on the disputes rejected the validity of these studies, arguing that rates applied on bond markets could not be viewed as reliable comparables.

3. Freedom of proof confirmed at last … within a strict framework

Only when the French *Conseil d'Etat* (administrative Supreme Court) was called upon to rule on this issue in July 2019 in the *Wheelabrator Group* case was it clearly asserted that the taxpayer was free to provide the required proof in any relevant manner and that, therefore, the production of studies based on bond markets comparables was perfectly valid in principle. However, the *Conseil d'Etat*, conscious of the need to guarantee that the comparables used would indeed be pertinent, set boundaries to this newly-proclaimed freedom of proof.

The limitations essentially cover two aspects: first, the impact of the existence of a group on the assessment of an arm's length rate and, second, the characteristics of the comparables that may be used in studies to estimate this rate.

As regards the first aspect, it can hardly be doubted that the rate a taxpayer can obtain on the financing market is necessarily influenced by the fact that the borrower is a member of a group of companies. In practice, independent lenders obviously take into account the support, implied or express, that the other group members can provide to the borrower, and the latter's credit rating is often assessed using the group's rating as a starting point. However, the *Conseil d'Etat* ruled in March 2019 (*SNC Siblu* case) that a market rate could only be assessed based on the borrowing company's own situation, i.e., disregarding the fact that it belonged to a group. This rules out as comparison elements not only financings obtained by the group itself on the free market but also those drawn by a leveraged acquisition vehicle and on-lent by the latter to lower-tier companies via a back-to-back arrangement.

This approach was then applied by trial judges. The Paris Administrative Court of Appeals thus ruled in March 2020 in the *Apex Tool* case that the borrower's credit rating, based on which external comparables could be identified on the financing market, could not be determined by reference to the financial statements of the sub-group to which the controlled borrowing company belonged.

With respect to the second aspect, the *Conseil d'Etat* acknowledged in its *Wheelabrator Group* case that bond comparables are valid in principle, but imposed, on the one hand, that these bonds be issued by companies placed in economic conditions similar to those of the intragroup borrower and, on the other hand, that the use of a bond issue be a realistic alternative to the intragroup financing. The French tax authorities promptly used these two requirements as a way to move the discussions to a new area: deprived from its arguments regarding the nature of the proof supplied by taxpayers, the administration started to challenge the methodology applied by the financial experts. Challenges were thus made to the assessment of a borrower's credit rating through scoring software, or to the fact that some of the companies selected as comparable operated in business fields different from the borrower's.

Several courts again followed the path drawn by the tax authorities. In a BSA decision dated 25 June 2019, the Versailles Administrative Court of Appeals thus rejected the use of a rating software provided by *Moody's*. The same position was taken by the Paris Administrative Court of Appeals in the *Willink* case in September 2020. The Paris court also ruled in the above-mentioned *Apex Tool* case that the borrower had failed to evidence that "*the so-called comparable companies included in the study sample, which belonged to diverse business sectors, would, for a banker, have presented the same risk level as the one which [the borrower] faced at that time*".

4. The evolution towards more economic common sense

Although the recent evolution of case law shows a growing attention paid by tax judges to the relevance of the documentation set up by taxpayers to support their intragroup financial flows, one cannot but acknowledge that the overall trend towards a more flexible approach shows a desire to give precedence to economic realism over general principles.

This is illustrated by the decision from the Paris Administrative Court of Appeals in the *Studialis* case on 22 October 2020. Quashing the particularly strict position taken in this case by the Paris Administrative Tribunal, the Court of Appeals acknowledged the relevance of a study in which the financial experts relied on the *Riskcalc* software and determined the borrower's credit rating using the consolidated accounts established by the borrower and its French subsidiaries. It is difficult not to see in this decision the signs a favorable and welcome evolution of case law towards better legal safety and economic rationality.


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