LBO: the legislator gets to grips with fiscal leveraging

A new **mechanism (known as "anti-abuse")** has just been introduced by the legislator, where **interest on loans for the purchase of equity shares is no longer deductible**.

The interest charges on loans contracted to acquire equity shares[1] must be added back for eight fiscal years when the purchasing company used as the acquisition vehicle has no say in the decision to purchase the shares or in any subsequent decisions concerning them. Actual control or influence over the target company is also a requirement.

The interest charges include the financial expenses incurred by the purchasing company on advances granted by its shareholders (shareholders' current accounts and convertible bonds), mezzanine debts, senior debts and other bank borrowings contracted to acquire the equity shares.

This limitation, inspired by the system in the "Charasse amendment", applies to fiscal years starting from January 1, 2012, but also to **share purchases made during the previous eight fiscal years for the remainder of the adding back period.**

If the purchasing company, a company controlling it or a sister company, within the meaning of Article L.233-3 of the Commercial Code, established in France wants to avoid having to add back the interest charges of the purchase of the equity shares, it will have to prove:

- that the decisions concerning the purchased shares are actually taken by it, and

- if the purchasing company has control or influence over the target company, that it actually exercises this control or influence (condition necessarily met).

This system is aimed principally at **LBOs with the presence of foreign investors** using a French acquisition vehicle.

To support his amendment, Gilles Carrez quoted the case of a US corporation intending to "take over a company in Germany or the Czech Republic. To do this it used a French entity as the support vehicle, which took out a loan and therefore, under French tax law, benefited from the full deductibility of its interest, whereas it had no say in the decision-making chain resulting in the takeover of the Czech or German company".

The avowed objective is to reduce situations where the interest charges are fully deductible in France although the capital gains and/or dividends relating to the shares are not taxable in France.

The legislator also turned his attention to restructuring operations (mergers, demergers, etc.) occurring during the adding back period, where the entity vested with the rights of the company which initially purchased the shares has to add back the non-deductible interest charges.

In addition, as discussed during the Parliamentary debates, **once this proof has been produced** for a fiscal year, **it would still be valid for the following fiscal years**, which supposes that if the power of decision or control is then lost, there would be no adding back. The question also arises of what happens in the opposite case, i.e., when a company which is forced to add back its interest charges because of lack of proof subsequently obtains power of decision over the shares and control over the target company. The tax administration will have to issue a formal opinion on these points.

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[1] Equity shares are understood to be shares representing more than 5% of the capital and voting rights, although holdings in real estate companies and venture capital companies are excluded.

If the company does not have any proof, it will have to **add back a fixed fraction of its interest charges** equal to the ratio of the share purchase price to the average amount of its indebtedness during the fiscal year.

However, **this mechanism is not applied** when (i) the total value of the equity shares held by the company is less than 1 million euros, (ii) the purchase of these shares is not financed by a loan taken out by the company, and (iii) the debt/equity ratio of the group to which it belongs is at least the same or higher than its own debt/equity ratio.

From now on the purchasing company has to take the decisions concerning the purchased shares and, to be able to deduct the related interest charges, demonstrate that it is an **independent decision-making centre** (within the meaning of the definition given by case law to the concept of a permanent establishment) for the management of these shares.

Power of decision is understood to be the **ability to dispose freely** of the purchased shares without having to obtain the prior agreement of a foreign shareholder.

In this situation, insofar as a French company, with no parent or sister company, within the meaning of Article L.233-3 of the Commercial Code, established in France, has to take the decision to acquire the shares, **such company should be created before looking for a target company.**

A decision-making process must also be set up, giving a prominent position to the purchasing company, and the demonstration made that this company has **power of decision over the purchased shares**, particularly through the group's internal organization. Thus the **mandate given to look for a target, the documentation to negotiate the financing and the purchase documentation, including the letters of intent, will have to be signed by the French purchasing company.**

As **the actual notion of the substance** of a company is being highlighted, if the purchasing company has **permanent representative bodies** (on the board of directors and at general shareholders' meetings of the target company) and **sufficient material and human means** (presence in the purchasing company of the decision makers of the group which initiated the purchase), this could be sufficient proof of its power of management over the purchased shares. In some configurations, where the holding company already has management resources, particularly for VAT-related reasons, this new condition might then be satisfied if they are given power of decision.

Now **legal ownership goes hand in hand with actual power of decision and control.**

Unfortunately this text **increases the legal insecurity of leverage operations in a context where obtaining financing is already quite difficult.**