MARCH 9, 2011

News Analysis: U.S. Debt Push-Down in a French Subsidiary -- The Good and the Bad

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Summary by taxanalysts

France's committee on the abuse of tax law recently published two rare and interesting nonbinding opinions on France-U.S. debt push-down schemes involving millions of euros.

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France's committee on the abuse of tax law recently published two nonbinding opinions issued in the context of France-U.S. debt push-down schemes.[1] These opinions are interesting for many reasons:

- The debt push-downs are purely intragroup and were implemented for massive amounts (more than €300 million and €400 million, respectively).
- The companies used diverse strategies (the distribution of an exceptional dividend and the issue of bonds redeemable in shares on the one hand, and the redemption of shares and the issue of a participating loan on the other hand) which led to diverging opinions from the committee.
- Opinions or judgments on debt push-down schemes are relatively rare in France, although many international industrial groups and leveraged buyout groups have implemented debt push-downs in France.
- One of the matters analyzed by the committee also provides an interesting example of an application of the substance test in the context of the interposition of a passive EU holding company.

The Committee's Opinions

Debt Push-Down Can Be Considered Abusive if No 'Real' Debt is Injected

In the first matter submitted to the committee, a U.S. parent company assigned its French subsidiary to a new Danish holding company in exchange for shares and a €315 million vendor note. Shortly afterward, the French subsidiary distributed a €315 million dividend to its new Danish parent. Simultaneously, the Danish parent subscribed to bonds redeemable in shares (*obligations remboursables en action*) for the same amount, with a seven-year term. The bonds carried interest at the euro interbank offered rate plus 50 basis points. The amount of interest was capped for each financial year at an amount not exceeding the profits of the French subsidiary and its own 95 percent-owned subsidiaries. The subscription price of the bonds was paid by the Danish parent to offset its €315 million dividend receivable. Shortly after the subscription, the Danish holding company assigned the bonds to its U.S. parent company in exchange for the repayment of its vendor note. The French subsidiary also distributed a second exceptional dividend one year later for €277 million.

The French tax authorities challenged the tax deductibility of the interest accrued on the bonds under the abuse of tax law theory (article L64 of the French Tax Procedure Code) and argued that the interest should be recharacterized as dividends. The French tax authorities also argued that the Danish holding company had been interposed solely for the purpose of avoiding the French withholding tax on the dividend distributions made by the French subsidiary.

The committee upheld the French tax authorities' position on the recharacterization of the interest into dividends[2] and identified the following aspects of the case that, in its view, proved that the scheme was implemented solely for tax reasons:[3]

- the decisions of the French subsidiary to distribute an exceptional dividend of €315 million and to issue the bonds did not generate any financial cash flow, but merely resulted in accounting entries between the relevant companies;
- those two decisions did not change the financial situation of the French subsidiary insofar as the bonds had to

be redeemed in shares and were accounted as equity; and

- the transactions were carried out between related parties and consisted of the temporary conversion of equity into debt. The overall cash situation of the French subsidiary remained the same, as did its shareholders.

On the issue of withholding tax, however, the committee disagreed with the French tax authorities' position about the existence of a treaty shopping abuse situation.

The tax authorities' position was because, to its knowledge, the Danish holding company did not have any real activity or any employees. The holding company was managed by a third party and had no turnover or operating income. The tax authorities also noted that the holding company had been interposed after the entry into force of an amendment to the U.S.-Denmark income tax treaty granting an exemption from withholding tax on dividends distributed by 80 percent-owned Danish subsidiaries.

In its response, the committee noted that the group's 140 subsidiaries were held by the Danish holding company and that those companies were located in more than 20 countries. It also noted that the Danish holding company was carrying out its activity "in accordance with its corporate purpose" -- that is, as a holding entity. The committee therefore refused to characterize the Danish company as fictitious.

The tax authorities have indicated that they will follow the committee's opinion.

Debt Push-Down Can Be Implemented if 'Real' Debt Is Injected

In the second matter reviewed by the committee, a U.S. group formed a Luxembourg partnership (SNC). The SNC formed a Luxembourg limited liability company (SARL). The U.S. parent company transferred the shares of its French subsidiary to the Luxembourg SARL shortly thereafter. After that transfer, the French subsidiary bought back its own shares for €110 million, €147 million, and €150 million in 2003, 2004, and 2005, respectively, and then cancelled the shares.

The first share capital redemption was financed by way of a shareholder loan bearing a 4.5 percent interest rate in favor of the Luxembourg SARL parent. The loan was repaid in May 2004 using a participating loan of €112 million granted to the French subsidiary by the SNC[4] (that is, the French subsidiary's "grandmother"). The participating loan provided for a 1 percent fixed interest rate and a variable component equal to 80 percent of the consolidated profits of the French subsidiary. The interest was capped at 50 percent of the consolidated cash flow of the French subsidiary and could not exceed 6 percent per year. The financial terms of the participating loan were therefore very different from the financial terms of the bonds redeemable in shares mentioned in the previous case.

The other two share capital redemptions were financed using the French subsidiary's own cash and with new drawings made under the participating loan for €50 million and €80 million in 2004 and 2005, respectively. Overall, out of €407 million in share capital redemptions, it is understood that 60 percent were financed through the participating loan granted by the SNC and 40 percent were financed using the cash of the French subsidiary.

Contrary to the views of the French tax authorities, the committee refused to characterize the successive share buybacks as abusive. The committee noted the following points:

- The payment of the redemption price of the shares was made through a real exchange of cash, as opposed to mere accounting entries, in that a portion of the redemption price of the shares was paid using the cash of the French subsidiary. In addition, the French subsidiary effectively repaid the participating loan issued by the Luxembourg SNC in 2007.
- The participating loan entered into in May 2004 enabled the French subsidiary to replace the 2003 short-term shareholder loan financing with long-term financing which improved the overall financial situation of the French subsidiary.
- The share buybacks effectively reduced the French subsidiary's equity insofar as the participating loans qualified as financial debt and were finally repaid.

As a result, based on its knowledge of the facts, the committee held that the series of transactions could not be viewed as exclusively tax-driven. In particular, the committee found that the share buybacks and the participating loan were not contrary to the provisions of section 39.1 of the French Tax Code, which allows the deduction of interest due on real financial debts.

The French tax authorities again indicated that they will follow the committee's opinion.

General Considerations

Each debt push-down scheme has its own particularities and must be analyzed on a case-by-case basis. In addition, the committee's opinions are not binding on the French courts, though the opinions have an impact on the burden of proof before the judges.

The fact that the French tax authorities have agreed to follow the committee's opinion in the share buy-back matter (the second matter reviewed above) confirms the committee's decisive influence in the context of abuse of law.

The two opinions are relatively surprising, however, because they seem to reopen the debate about French companies' freedom to choose the most appropriate financing structure in accordance with the management freedom principle. Indeed, that freedom was confirmed by the French Supreme Court in its *Andritz* decision of December 30, 2003, subject to the limitations provided by the French thin capitalization rules provided under article 212 of the French Tax Code. (For prior coverage, see *Doc 2004-16151* or *2004 WTD 165-7*.) In addition, the Paris administrative tribunal in 1998 ruled that a French subsidiary had not committed an abuse of law by distributing a merger premium to its Dutch parent even though the distribution had been financed by way of a bond issue subscribed by the Dutch parent.[5]

The committee's opinions confirm that the corporate route implemented to carry out the debt push-down (that is, dividend distribution or share buy-back followed by the cancellation of the shares) is irrelevant when assessing the abuse of law risk, given that both routes reduce the company's equity (although a share buy-back could be viewed as being more aggressive because it requires a reduction of share capital).

In addition, the opinions seem to illustrate that the category of debt instrument used to finance the debt push-down is key, in the committee's view, in assessing the abuse of law risk, as well as the existence of real cash flows. Therefore, to justify its analysis, the committee noted in its opinions that bonds redeemable in shares have to be accounted as equity, whereas participating loans are accounted as indebtedness.

However, the distinction made by the committee between the two matters leads to a paradox situation. The debt push-down that is financed through a participating loan that is ultimately repaid using the borrower's cash is not viewed as being abusive. On the other hand, a debt push-down transaction that is financed through a convertible debt instrument that is converted back into the company's equity -- and which therefore does not reduce the company's equity, unlike a participating loan -- is considered to be abusive.

In practice, the committee's views, which seem to rely on a strict appreciation of the concept of financial debt, encourage definitive debt push-downs as opposed to temporary equity decreases.

The committee seems to give little attention to the fact that from a legal viewpoint, the redeemable bond holders remain creditors of the company until the date of redemption of the bonds and their conversion into shares of the issuer.

It is true that there are other significant factual differences between the two matters that can explain the committee's diverging opinions, such as the absence of any real cash flow in the first matter, where bonds redeemable in shares were issued. However, it will be interesting to see if the judges confirm the committee's position in that scenario, considering that it restricts the management freedom principle.

Finally, the confirmation that the interposition of the Danish holding company does not constitute a withholding tax exemption abuse is an interesting precedent. Indeed, the facts stated by the French tax authorities[6] seem to prove that the substance of the holding was not significant, especially considering the fact that the holding was supposed to manage shareholdings in 140 subsidiaries located in 20 countries. The committee's position seems to be relatively pragmatic when it comes to the analysis of the substance of a holding company. One can hope that the committee's position would be the same in the context of the interposition of a mere holding company owning a lot fewer subsidiaries.

Conclusion

Using an *a fortiori* reasoning, the committee's opinions implicitly confirm that debt push-down transactions financed through third-party debt (as opposed to intragroup debt) should very rarely be considered an abuse of law. Indeed, such transactions are financed through cash advances lent by unrelated parties and effectively decrease the company's equity.

Assuming that such transactions are implemented with care, the opinions also show that intragroup debt push-down can be implemented in France without being considered an abuse of tax law.

However, in all cases, it must be remembered that the shareholders and directors of a company must also comply with the principles of French company law and, in particular, must act in the corporate interest of the company when implementing such transactions.

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FOOTNOTES

[1] BOI No. 9, dated February 3, 2011, 13L-1-11; matter No. 2010-12 "X France Holding" and matter No. 2010-13 "SAS Z France Holdings."

[2] As a result, a penalty of 80 percent is due on the tax reassessment and the burden of proof is reversed against the taxpayer in case of litigation.

[3] In addition to these elements, the French tax authorities had noticed that the U.S. parent had "checked the box" in the U.S. with respect to the French subsidiary, resulting in the denial of the bonds redeemable in shares for U.S. tax law purposes.

[4] According to the facts mentioned in the committee's opinion, the SNC was used to manage the cash of approximately 20 of the European companies of the U.S. group.

[5] *Van Ommeren Tankers*, October 29, 1998.

[6] Although regular meetings were organized among the legal bodies of the company, the Danish holding company had no employees, no sales, and no operating profits, and was managed by a local management company.

END OF FOOTNOTES

Tax Analysts Information

Jurisdictions: France; United States
Subject Areas: Tax policy issues
Corporate taxation
Dividends
Entity characterization
Interest income
Withholding taxes
Author: Delaurière, Jérôme
Cross Reference: For prior coverage of the French Supreme Court's December 30, 2003, decision in *Andritz*, see *Doc 2004-16151* or *2004 WTD 165-7*.
Tax Analysts Document Number: Doc 2011-4468
Tax Analysts Electronic Citation: 2011 WTD 46-3