Current issues concerning the tax deductibility of financial expenses

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Since December 2018 and the vote of the French Finance Act for 2019, the legal framework surrounding the deductibility of financial expenses has been reviewed. New issues are emerging that require an adapted financial and tax analysis, especially for financial structures drawing on hybrid instruments.

The French Finance Act for 2020, adopted by the National Assembly on December 19, 2019, implements the anti-hybrid provisions of the European Union's *Anti Tax Avoidance Directive 2* (ATAD). This new measure is part of the more global project *Base Erosion and Profit Shifting* (BEPS) put forth by the OECD in 2012. This latter aims at correcting tax asymmetries related to differing schemes on the international level. By transcribing the European Union's ATAD directive, the 2019 Finance Act has amended the deductibility of financial expenses for companies. In this sense, it has notably limited the undercapitalization test to the application of a comparison ratio between equity and the related-party debt. The latter correspond to loans between two companies exhibiting capital ties among each other as defined in Article 39 of the French General Tax Code.

In addition, new parameters also come into effect in the calculation of the deductibility of financial expenses such as the fiscal EBITDA, the safeguard clause, the group accounting scope, etc... Within this scope, the 2019 Finance Act has put forward two major possible scenarios in the undercapitalization test. In the first scenario, the company is sufficiently capitalized and will be able to deduct the maximum amount between **€3 million and 30% of its taxable EBITDA** from its net financial expenses (NFE). The NFE exceeding this deductible amount will have to be reintegrated but can be carried forward to subsequent years.

In the second scenario, the company is undercapitalized and subject to a more constraining deduction mechanism of its NFE. Indeed, its NFE will be subject to more restrictive ratios and amounts than in the first scenario. A portion of the NFE will not be deductible or carried forward. Moreover, additional mechanisms such as safeguard clauses and unused deductibility capacity will have to be considered to fine-tune the deductible NFE.

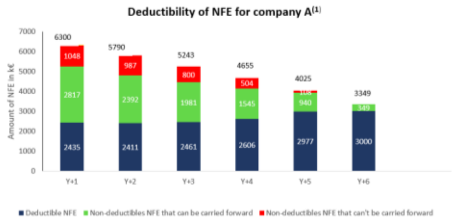
Putting the underfunding test into practice

Let us simulate a concrete case of the undercapitalization test for two companies A and B, to understand the financial implications of this new framework as a function of different financial structures. For company A, the structure is highly indebted, with a considerable proportion of related-party debts.

Regarding company B, for the same level of indebtedness, the debt structure is mainly composed of external debts. These two companies are presented in the tables below, showing the structure and results in year 1.

Structure of the operation year 0 (in Million €)	Company A	In % of total	Company B	In % of total
Shareholders' equity	24	22%	24	22%
Related debts	60	55%	30	28%
8% convertible bonds	60		30	
External debts	25	23%	55	50%
single tranche at 6%	25		55	
Total	109	100%	109	100%
Undercapitalized	Yes		No	

Results year 1 (in Million €)	Company A	Company B
Fiscal EBITDA	5,8	5,8
Shareholders' equity	6,3	5,7
Shareholders' equity	24	24
Related-party debts (y-1)	60	30
External debt (y-1)	25	55



(1) Chart extracted from the NG Finance model

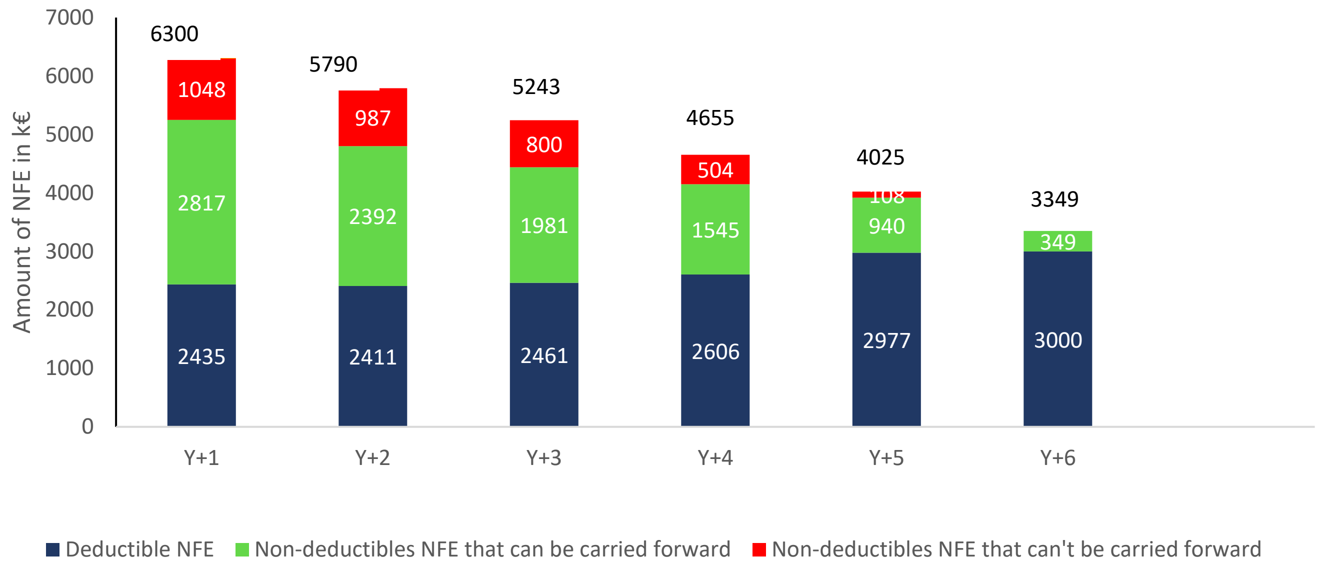
Company A	Y+1	Y+2	Y+3	Y+4	Y+5	Y+6
Undercapitalized	Yes	Yes	Yes	Yes	Yes	No
Fiscal EBITDA	5 800	7 018	8 492	10 275	12 433	15 044
NFE	6 300	5 790	5 243	4 655	4 025	3 349

The structure of company B, exhibiting less related-party debt, prevents the company form being undercapitalized in the sense of the Finance Act. Company B is thus subject to a more flexible deduction mechanism (maximum between €3 million and 30% of fiscal EBITDA, (see opposite illustration).

Within this scope, Company B does not record any non-deductible NFE that cannot be carried forward, representing a dry loss of tax savings, unlike Company A (1M€). Indeed, a poor structuring of a transaction may lead a situation of undercapitalizationed and hence to the lower tax saving, related to lower deductible financial expenses.

Similarly, an initial financial structure that is well aligned with the company's business plan allows the amount of NFE resulting in deduction to be optimized over several years. Indeed, the financial implications of the undercapitalization test can be simulated using modeling. To illustrate, the graph below shows the deductibility of Company A's NFE over six years.

Deductibility of NFE for company A[1]



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Until the fifth year, we observe that Company A is making dry losses because it was undercapitalized. It is not until the sixth year that its financial structure allows it to qualify for a less restrictive mechanism. Similarly, the deductibility of NFE has also improved, notably due to the increase in the company's fiscal EBITDA. However, these examples do not consider tax specificities of the respective companies. Therefore, it is necessary to obtain the complementary expertise of tax lawyers within the scope of these financial engineering schemes in order to take into account other tax provisions governing the deductibility of NFE (examples : Charasse Amendment, cap on the deductible interest rate, etc.).

Be accompanied by financial and tax experts

In its implementation, the 2019 Finance Act creates a complexity for companies that call for the intervention of financial and tax experts. Indeed, the determination of financial parameters, such as fiscal EBITDA, the level of shareholders' equity and the accounting scope, have taken a predominant place in the new system. These parameters require in-depth expert analysis when structuring a transaction, particularly when the company does not prepare consolidated financial statements. Similarly, the life of a company is subject to one-off events, such as the acquisition of a new company or the subscription to loans. In these kind of contexts, it is crucial to dynamically monitor the impact on the deductibility of NFE.