



Restructuring of indebtedness: French tax points

This briefing sets out the key French corporate income tax issues in respect of debt restructurings. In summary, debtors and creditors may be faced with material tax consequences in case of a debt waiver, debt transfer, conversion of debt into equity or debt buy-back, so that such operations may require an appropriate structuring in order to mitigate potential tax issues.

Introduction

This briefing summarises key French tax points relating to restructuring of indebtedness.

Unlike some other European countries, the main French tax issues arising in a restructuring indebtedness transaction generally come more from the tax treatment of the transaction itself for the creditor (and for the debtor) than from the post-restructuring tax situation of the debtor (subject to the application of related-party debt rules such as thin capitalisation rules).

Broadly speaking, a debt restructuring can take various forms, but generally triggers one or more of the following operations:

- amendment of the terms and conditions (T&Cs) of a debt instrument;
- debt-for-debt exchange;
- debt waiver (partial or total);
- debt transfer (to a related party or not);
- conversion of a debt into equity (by the initial creditor, or by a new creditor following a debt transfer); or
- debt buy-back (by a party related to the debtor or directly by the debtor).

It should however be noted that the most difficult tax issues to assess are those arising as a result of debt transfers and debt-for-equity exchanges, in particular where these operations are performed on a debt purchased at discount to the principal amount.

Restructurings not impacting the debtor's net equity

Amendment of the T&Cs and debt-for-debt exchange

In principle, amendments of the T&Cs of a debt instrument based on negotiations between creditor and debtor would mostly be treated in the same way as a debt-for-debt exchange in which one debt instrument is exchanged for another debt instrument with different conditions.

Generally, assuming that creditor and debtor have negotiated such changes on an arm's-length basis, only limited amendments may lead to material tax consequences. In particular:

- deferral of interest payments should in principle not negatively affect deductibility of interest paid by the debtor, because interest is normally deducted on an accrual basis;
- adding additional security cover (or amending it) should not by itself affect the tax position of the debt instrument, bearing in mind that the potential exercise of the securities may have a significant impact, notably as regards transfer taxes;
- adding a new guarantor, even though such guarantor is a related party to the debtor, should not affect negatively the tax situation of the debtor;
- an extension of the maturity term should also not affect the tax position of the debt instrument by itself (as long as this does not make reimbursement of the debt unrealistic);

- if covenants have been breached and the creditor agrees not to exercise its right to demand full repayment – but renegotiates the applicable interest rate given increased risks – this should also normally be acceptable from a tax perspective (to the extent the debtor remains in a position to evidence that the new interest is at arm’s length); and
- adding conversion rights to compensate the creditor should be possible without material tax consequences for the debtor; however, no deduction is generally allowable for the conversion premium or (future) conversion costs (except by way of a provision, subject to certain conditions).

The amendments that may result in material tax consequences are generally the following:

- an amendment in the currency of the principal amount of the debt should be considered as triggering the realisation of currency gain/loss in the financial year during which this amendment has occurred; and
- the addition of a profit-sharing element may trigger withholding tax issues.

Restructurings impacting the debtor’s net equity

Debt waiver

For French legal purposes, a waiver of debt entails the extinguishment of the claim held by the creditor against the debtor. However, under French law, a debt waiver may be granted under certain conditions, eg, a so-called ‘clause de retour à meilleure fortune’ (RMF clause) which is generally analysed as a situation in which the waived debt may be reinstated if and when certain conditions are satisfied as regards the debtor’s financial situation. As a general rule, there is no immediate impact on the analysis of such a debt waiver where it is subject to an RMF clause. For French GAAP (generally accepted accounting principles) purposes, a debt waiver subject to an RMF clause does not appear as an asset or a liability in the creditor or the debtor balance sheet until the RMF is triggered.

For French standalone tax purposes, and except in the case of debt-for-equity exchange (see below), a partial or full waiver of the principal amount of a debt instrument (and/or accrued interest) generally triggers a taxable profit for the debtor, irrespective of the existence of

an RMF clause. For the creditor, the debt waiver may be deducted from its taxable profits, provided it is commensurate and justified by valid business reasons (ie such debt waiver does not result in mismanagement). Where the creditor is the parent company of the debtor, the tax deductibility of the debt waiver may also be justified by purely financial reasons (as opposed to business reasons), to the extent of the negative balance of the debtor’s net equity. Where the debt waiver exceeds the debtor’s net equity, it remains deductible from the creditor’s taxable profits only to the extent of the proportionate part of the waiver that corresponds to the rights of other shareholders of the debtor (the excess of that waiver, if any, is not deductible from the taxable profits of the parent, nor taxable for the subsidiary, but increases the tax basis of the subsidiary’s shares for the parent).

A debt waiver granted within a French tax group must be neutralized, ie such waiver is not considered as deductible for the creditor or taxable for the debtor for the purpose of determining the tax group’s taxable profits or losses of the financial year during which the waiver is granted. Such waiver is de-neutralized when the tax group is terminated or if the grantor or beneficiary of the waiver exits the tax group, but only if any such event happens during the five financial years following that in which the waiver was granted. The waiver is not de-neutralized if any such event occurs after the fifth financial year following that in which the waiver was granted.

Debt-for-equity exchange

As a matter of principle, a debt-for-equity exchange does not trigger adverse tax consequences for the French debtor. However, such transaction may result in recognition of a taxable profit at the level of the French creditor, in particular when the latter acquired the debt at discount price.

Indeed, from an accounting standpoint and based on a recommendation of the French accountants’ professional organisation (Compagnie Nationale des Commissaires aux Comptes), the shares issued by the debtor to the creditor in consideration for the debt-for-equity exchange have to be booked for their facial value, ie, for an amount corresponding to the debtor’s share capital increase (and not for the cost price of the

receivable). Such an accounting treatment may lead the creditor to recognise, for accounting purposes, a capital gain or loss where the cost price of the contributed receivable is different from its facial value. If, after the share capital increase of the debtor, the market value of the issued shares is below their book value, the creditor generally has to make a provision for depreciation on such shares. Such a provision is not tax deductible where the concerned shares qualify for the French participation exemption regime (ie, among other conditions, where they represent more than 5 per cent of the share capital of the debtor).

Tax-wise, according to the position of the French supreme tax court, the capitalisation of a receivable (plus accrued interest, if any) is regarded as an equity contribution. The result for the subscriber may be a taxable gain or a tax deductible loss corresponding to the difference between the acquisition tax cost basis of the contributed receivable and the market value of the shares received in exchange (as opposed to the facial value of these shares as provided by accounting rules described above). However, although the position of the French supreme tax court makes sense from an economical standpoint, in practice and to our knowledge, the French tax authorities generally continue challenging such operations on the ground that the capital gain or loss realised by the subscriber corresponds to the difference between the cost price of the contributed receivable and the facial value of the shares issued by the debtor (ie the French tax authorities adopt the same analysis as for accounting purposes).

Accordingly, where the market value of the shares received in consideration for the receivable is below their nominal value, French case law would allow the subscriber to recognise a tax deductible loss, while the (unofficial) position of the French tax authorities is generally to deny the tax deduction of such a loss (bearing in mind that a provision for depreciation on shares eligible to French participation exemption is not tax deductible either). In such a case – and considering the unclear position of the French tax authorities as regards the French supreme tax court case law – it is generally advisable to contemplate alternative tax efficient solutions (where possible) in order to avoid any discussion (and potential litigation) with the French tax authorities.

Another important point in a debt-for-equity exchange where a debtor is the parent company of a tax group, is to ensure that the operation does not lead the creditor to hold more than 95 per cent of the debtor's share capital, since this may affect the continuity of the tax group, resulting in serious tax disadvantages (eg forfeiture of the group carry-forward tax losses, de-neutralisation of certain intra-group operations, etc).

Debt transfers

Notification requirement

As a matter of French civil law, article 1690 of the French civil code provides that any debt transfer has to be notified to the debtor by bailiff or accepted by the debtor in a notarised transfer deed.

In principle, a company whose debt is transferred merely replaces the initial creditor with a new creditor, so that no profit may be recognised. However, in the absence of notification to the debtor as set out in article 1690 of the French civil code, such a transfer is deemed to be a waiver of the debt followed by a grant of a new debt to the debtor by the new creditor. This then triggers the immediate recognition of a taxable gain for the debtor corresponding to the amount of the transferred debt (including accrued interest, if any). For this reason, particular attention should be paid to this notification requirement, even where the transferor and/ or transferee are not French tax resident.

Receivable kept until maturity by the new creditor

In the event the new creditor is not French tax resident, it has to be ensured that the French domestic withholding tax exemption on interest remains available for the new creditor (notably if no interest withholding tax exemption is available under an applicable double tax treaty). Most of the issues raised in the past on the conditions of application of this domestic interest withholding tax exemption have recently been clarified in a favourable way by the French tax authorities: to the extent the exemption was available when the borrowed funds have been put at the disposal of the debtor, in most cases, it remains applicable for interest paid to the new creditor.

Where a creditor has purchased a debt at a discount price, it may be expected that, at maturity, it is

reimbursed with the full principal amount of the debt (plus accrued interest, if any), so that the creditor receives an amount higher than the original discount cost price of the receivable. Such a difference will, in principle, qualify as a capital gain for French tax purposes but – in practice and depending on the features of the debt instrument – this difference may be deemed to be an ‘income’ attached to the initial debt and, as such, may be subject to French withholding tax if the creditor is not a French tax resident.

Transfer followed by a debt-for-equity exchange by the new creditor

This is subject to the accounting and tax treatment described above (in ‘debt-for-equity exchange’), with the same uncertainty regarding the position of the French tax authorities concerning the tax treatment of the gain or loss realised by the creditor as a result of the capitalisation of its receivable.

Debt buy-backs

Buy-back by the debtor

A debt buy-back by the debtor itself at discount to the principal amount would normally lead to taxable profit on the discount for the debtor (or the fiscal unity to which it belongs).

In this respect, a new temporary regime has been implemented by the second Rectificative French Finance Act for 2009: until 31 December 2010 (and subject to certain conditions) the taxable gain recognised by a company as a result of the buy-back of its medium and long-term bank debts for a discount price, can be spread over the financial year during which that buy-back has been performed and the next five financial years.

Buy-back by a party related to the debtor

Acquisition of debt by a related party may also lead to the triggering of the related-party debt rules, which would mean that the thin capitalisation rules could become applicable, potentially leading to the denial of interest deductibility. In addition, if such operation is followed by a debt-for-equity exchange, other adverse tax consequences may arise (see above).

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