Restrictions on Tax Deductions for Acquisition Financing

Sara Luder of Slaughter and May, Sébastien de Monès of Bredin Prat and Paul Sleurink of De Brauw Blackstone Westbroek look at recent developments in the way that the various EU member states are seeking to restrict tax deductions for acquisition debt.

The UK has made great strides in reforming its corporate tax rules to make it competitive for UK based multinationals. Corporates are exempt from tax on dividend income and on gains arising on the sale of subsidiaries, but they are still, broadly speaking, entitled to claim an interest deduction in respect of acquisition debt.

The UK Government has considered whether it should restrict the right to an interest deduction on a number of occasions, but each time has decided against any such restriction. There are a number of specific anti-avoidance rules restricting interest deductibility, as well as the more general transfer pricing/thin cap rules and the "debt cap" regime (which looks at the leverage of the UK as compared to the worldwide group). The general principle, however, is that acquisition debt is deductible for tax purposes, even if it is funding the acquisition of assets that are unlikely ever to generate any UK taxable profits.

These rules have proved useful for highly-leveraged acquisitions, with the interest deduction on the acquisition debt being offset (by way of group relief) against the target company’s profits.

In some jurisdictions a general interest restriction has been introduced, with "excessive" interest being denied if the total interest deduction exceeds a certain percentage of taxable profits. This type of rule could have an impact on acquisitions where the target companies are not generating profits taxable in the borrower’s jurisdiction.

Other jurisdictions have started to take a different approach.

Most recently, France has just introduced a new rule that restricts the interest deduction on debt to fund the purchase of shares unless the French borrower can demonstrate that the decisions in relation to such shares and the control of the relevant target companies are made by the borrower or another French-based group company.

Although primarily designed as an anti-abuse provision aimed at the artificial injection of debt-financing into French subsidiaries of worldwide groups, the effect is much wider. Indeed, any French company that has acquired a shareholding since 2004 will have to prove that the decision-making process relating to this shareholding is effectively carried out in France.

The concepts here are vague in nature, and it is yet to be seen what needs to be done in practice to ensure that such decisions and control are accepted as being exercised in France. Is it enough to ensure that there is adequate local management and/or that group senior management based outside of France attend meetings in France at which crucial decisions are made? And how is all this going to be dealt with in practice by those who have been used to making strategic group wide decisions at board meetings or in investment committees? International groups with centralised governance may struggle to show that a French acquirer has sufficient autonomy.
Where the restriction applies, for eight years following the acquisition the French borrower will have to add back to its taxable income a portion of its interest expenses calculated by applying the average debt financing cost of the acquiring entity to the acquisition price of the relevant shareholding. This can mean that interest is disallowed even if the acquisition had significant equity financing, and can result in the interest deduction being deferred to periods after the financing has been repaid.

The Netherlands has also recently introduced a new rule that restricts the offset of acquisition funding costs against a Dutch target’s profits. The effect of this rule will, for example, mean that where such debt is incurred by a single-purpose Dutch holding company which will be part of the same fiscal unity as the Dutch target, the interest deduction will be restricted if and to the extent that (i) the acquisition-debt-to-purchase-price ratio exceeds an “acceptable” ratio, which is 60% in the first year, reduced by 5% annually over the course of seven years, down to a fixed percentage of 25% by year eight, and (ii) the annual amount of interest due on the acquisition debt exceeds €1 million. This will primarily affect private equity funds and also foreign corporate groups without existing Dutch operations that acquire Dutch operating companies.

There is a significant EU issue here. One of the axiomatic freedoms of the EU is that of freedom of establishment. In other words, a company should be free to decide where in the EU it is to be based, and should not be penalised for that decision. Is a rule that restricts interest deductions by reference to “local” profits (so encouraging the group to build up its activities in that jurisdiction) or requires significant local presence contrary to that freedom?

This is not an issue that is going to go away. Each country is clearly concerned about excessive debt being “dumped” in its jurisdiction simply to create tax shelters. The French and Dutch changes are interesting examples of how different jurisdictions are seeking to deal with this, but there is currently no common approach. EU member states will also be concerned that some of these proposals could end up being challenged successfully before the ECJ.

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