



[Intragroup financing & Transfer pricing]

Insights into the French Tax Authorities' practical guidelines on intragroup interests

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On January 27, 2021, the French Tax Authorities (“FTA”) have released [practical guidelines](#) (through eight data sheets) on how **intragroup interest rate arm’s length nature can be demonstrated**.

Those administrative comments will be applied by the FTA in the context of ongoing tax audits and litigations as well as in the context of requests for tax rulings or regularization which the subject is the limitation of the tax deduction of interest paid.

An initial consultation conducted by the FTA in 2019, internally and with several professional bodies, showed differences in the requirements of the FTA relating to the demonstration of the arm’s length nature of intragroup loans, in the framework of tax audits.

It must be stressed that that these comments, which take into account the OECD transfer pricing guidelines for financial transactions published in February 2020, do not fully reflect the position of companies and shall be regarded as soft law, meaning that they do not have any legally binding force.

As regards the limitation of the interest rate paid to a related company provided by Article 212-I, a) of the FTC, the legislation states that the interest paid by a company to a related company, within the meaning of Article 39-12 of the FTC, is deductible within the limit of interest calculated pursuant to the maximum legal interest rate (statutory rate) or the market interest rate if higher as applied by independent banks.

Whilst many specialists had raised concerns about the difficulty, even the impossibility, in most cases to obtain a firm offer from banks for similar loans, it is pleasing to notice that the FTA have now recognized that **intragroup interest rate relevance can be demonstrated by any means**.

In this article, we propose to develop the main technical points mentioned in these guidelines.

Data sheet n°1: Burden of Proof

If the statutory rate (stated at article 39-1 3° of the FTC) is applied between affiliated parties, then it is deemed normal and will only be challenged provided that the FTA can prove the existence of a mismanagement act.

If the interest rate is higher than the statutory rate, interest paid to affiliates may be deducted to the extent it does not exceed the rate that would be applied by a bank lending in the same conditions (Article 212, I, a, of the FTC).

If such evidence is provided, then the interest expense is fully tax-deductible.

However, if it is demonstrated that the market rate is higher than statutory rate but lower than the interest rate applied, the non-deductible interest fraction will be determined according to this market rate.

Failure to provide proper evidence results in deduction being capped to the statutory rate based on bank rate statistics.

Data sheet n°2: How to provide evidence?

Justifying the arm’s length nature of an intragroup loan rate can be a real issue for companies. However, the FTA have now recognized that **intragroup interest rate relevance can be demonstrated by any means**.

Thus, this evidence may result from the selection of one or more comparable loans.

Internal comparable can be used: the FTA refer to a similar loan granted by a bank to the taxpayer.

External comparable are also acceptable like a similar loan granted by a bank to another company.

The FTA also refer to the possibility of using a comparability study comprising realistic alternative transactions to intragroup loans with similar economic characteristics.

While it is recommended to perform a comparable search before the loan is granted, the FTA specify that a search performed ex-post is also acceptable and cannot be denied for this only reason.

Data sheet n°3: Comparability - methodological publications of rating agencies and credit risk

"The comparison criteria to be taken into account are all those that can have a significant impact on the interest rate; the borrower's credit risk is an essential criterion that must be given a special attention".

From a practical standpoint, the borrower's credit risk profile should be estimated by determining its own rating by means of the assessment systems developed by the big rating agencies to select appropriate comparable transactions. To do so, the FTA specify that the company may use the methodological publications of the rating agencies if documented.

Furthermore, the FTA also indicate that it is necessary to analyze the loan's characteristics such as repayment priorities or the existence of guarantees as they can have an impact on the intensity of risk incurred by the lender and on the rate applied.

Data sheet n°4 & n°5: Comparability - case of an adjustment improving the reliability of a comparable - presence of multiple and substantial differences

The FTA provide a list of characteristics to be taken into account when assessing loans analogy. *"These include the date, [...] and amount, the term, the type of rate, the currency, the country risk of the borrower, repayment and interest payment terms, ranking and subordination considerations, guarantee, the borrower's industry (particularly financial/non-financial) and use of funds, and the presence of optional elements. »*

In the guidelines, the FTA state on the admissibility of the selected comparables, that a comparable, with the same level of risk but with different terms and conditions can be qualified as admissible. Nevertheless, adjustments must be made by the company in order to improve the comparability of transactions as long as those adjustments are reliable and documented.

The case study in the data sheet n°5 illustrates this need. In fact, the contract concluded between related entities and the one concluded with the independent financial institution have three different characteristics, namely the type of rate, the maturity and the subordination. While the FTA accepted the internal comparable, the borrower will only be able to deduct interest expenses up to the rate adjusted for the difference in the type of rate and maturity. Indeed, failing to document the subordination adjustment, the borrower is not allowed to consider this adjustment.

Data sheet n°6: Comparability - Multi-Borrower Bank Loan Agreement

Data sheet n°6 illustrates the difference in terms of guarantee between a comparable agreement concluded between related entities and a contract concluded with a bank.

In situation where a loan agreement includes a guarantee, the risk assumed by the lender is lower. As a result, such characteristic must be considered when analyzing the characteristics of loans and should be subject to an adjustment.



Data sheet n°7: Comparability - "Mirror" loans

In this sheet, the FTA raise the question of the selection of the comparable in the case of a chain of loans within a group.

To this end, the FTA recall the importance of the criterion of independence of one of the parties to the loan for the purposes of admissibility. Obviously, a loan between two related entities cannot be regarded as arm's length comparable. Therefore, it is necessary to analyze the loans of group companies concluded with banks. If this approach enables to identify similar loan, it may constitute an admissible comparable and differences in characteristics will have to be analyzed in more detail to perform the necessary adjustments.

Data sheet n°8: Comparability - bond market

This sheet is about the possibility for a company to demonstrate the intragroup interest rate relevance by using bond market references.

In an opinion issued on 10 July 2019, taken up by FTA, the French Supreme Administrative Court stated as a principle that the intragroup interest rate relevance can be demonstrated by any means. Then, it definitively accepted bond market references (external benchmarks) to justify intragroup arm's length rates and rejected the taxpayer's obligation to provide FTA with contemporary bank loan offers to do so.

The FTA have now specified the conditions of such an approach.

A search for comparable bond financing tools should be carried out taking into account comparability criteria such as amount, issue date, subordination, currency, priority / subordination etc.

However, when searching for comparables on the bond markets, the FTA show now more flexibility: (i) it is possible to broaden the criterion of the sector of industry in which the potentials comparable operate and (ii) the amount of the bond issued cannot be a sole criterion for denial.

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To conclude, those administrative guidelines were highly expected by companies as they have experienced for many years a very dogmatic and restrictive position of the FTA when they had to justify the arm's length nature of their intragroup interest rates.

Fortunately, the FTA have recognized that pragmatism is now the order of the day even if a rigorous analysis is required from taxpayers in the comparability exercise.

The Transfer Pricing Department of Mazars Société d'Avocats is at your disposal for any further information. Next webinars:

- **March 18th on those subjects (French)**
- **March 25th on international and local regulations on the subject (English)**

Fell free to contact us should you wish to get details for the registration of these webinars.

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