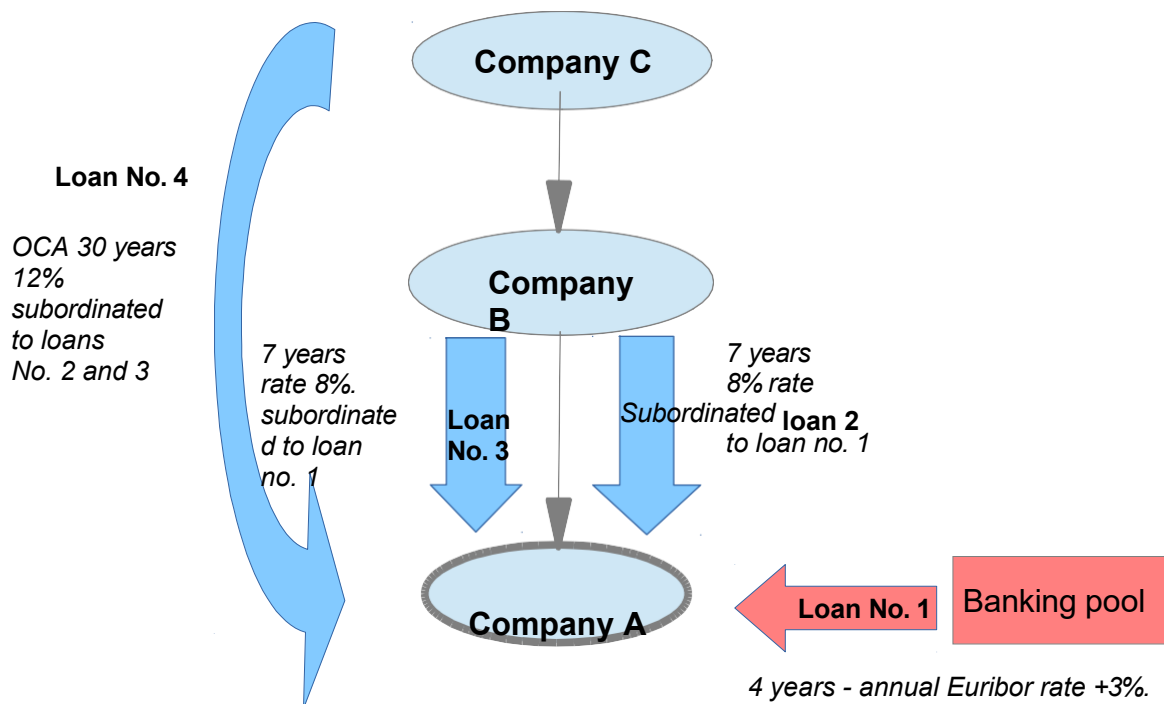


Dialectic of evidence

Situation under review

Company A has concurrently taken out the following loans to finance the acquisition of equity securities:

- a loan from a banking pool (loan no. 1) with a term of 4 years at the annual interest rate of Euribor +3%;
- a loan from related company B (loan no. 2) for a period of 7 years at an interest rate of 8%; its repayment is subordinated to the repayment of loan no. 1;
- a loan from related company B (loan no. 3) with a term of 7 years at an interest rate of 8%; its repayment is subordinated to the repayment of loan no. 1;
- a 30-year bond convertible into shares subscribed by the foreign affiliate C (loan no. 4) at a rate of 12%; its repayment is subordinated to the repayment of loans no. 2 and 3.



The interest rates for intra-group loans 2, 3 and 4 exceed the rate provided for in Article 39-1-3° of the General Tax Code (CGI)¹. The company did not make any extra-accounting reintegration of interest charges.

¹ Rate equal to the annual average of the average effective rates charged by banks for variable-rate business loans with an initial maturity of more than two years.

The company explains that the rate for loans 2 and 3 was set by reference to the bank loan rate adjusted upwards by several adjustments (nature of the rate, duration, subordination).

For loan 4, the company does not have the data to make precise adjustments for differences in duration, subordination and the presence of a conversion option. Consequently, it used the upper limit of a range of interest rates obtained by a panel of companies without taking into account the credit risk rating criterion.

In the course of its investigations, the department found that loan no. 3 had in fact been used to finance the acquisition of a second home by the director of company A.

Can the service call into question interest deducted below the limit provided for in Article 39-1-3° of the CGI?

Principle

In accordance with the provisions of Article 39-1 of the CGI and the case law of the Conseil d'Etat², only expenses incurred in the direct interest of the company and justified in their principle and amount are deductible from the results.

In addition, pursuant to Article 212-I-a of the CGI, when a loan is granted by an affiliated company, the interest recorded by the borrowing company is deductible within the limit of that calculated according to a rate defined in Article 39-1-3° of the CGI. However, the borrowing company benefits from a mechanism of proof to the contrary: it may deduct interest calculated on the basis of a higher rate if it demonstrates that the latter corresponds to the rate it could have obtained from independent financial institutions or organisations under similar conditions.

Where all or part of the interest expense recognised by a company in respect of sums left or made available by a related company has been deducted by a company, the **dialectic of proof** is therefore as follows.

The borrowing company must first produce sufficiently precise information on the nature of the charge (e.g. loan agreement) and on the existence of the consideration (e.g. proof of funds received). It must also produce the elements for calculating the interest charge (e.g. detailed interest calculation table showing the interest rate actually applied).

If the borrowing company produces sufficiently precise information on these points, the interest rate provided for in Article 39-1-3° of the CGI is a **presumed normal rate** that the administration cannot question **unless it demonstrates that the expense was not deductible**³.

If the borrowing company deducts interest within the limit of that calculated according to the rate provided for in Article 39-1-3° of the CGI, it does not therefore have to provide any evidence to justify the rate used in the intra-group loan contract.

On the other hand, if the company intends to deduct interest at a rate higher than that defined in Article 39-1-3° of the CGI, it must demonstrate that the rate applied corresponds at most to the rate it could have obtained from independent financial institutions or organisations under similar conditions.

If it fails to do so but demonstrates that the market rate was necessarily higher than the rate provided for in Article 39-1-3° of the CGI, the non-deductible interest fraction is calculated in relation to this market rate (between the rate defined in Article 39-1-3° of the CGI and the rate applied).

² For example, CE ruling 27 July 1984 n° 34588, Renfort Service and CE ruling 21 December 2018 n° 402006, Croë Suisse.

³ Following, in particular, the demonstration by the administration of the existence of an abnormal management act (it being specified that, in accordance with the provisions of Article 212-I-a of the CGI, the mere fact that a company has not justified the interest rate applied is not sufficient to reject the deduction of interest calculated according to the rate of Article 39-1-3° of the CGI), or a reclassification of the transaction, the application of Article 205 A of the CGI, or the implementation of the tax abuse procedure provided for in Article L64 of the LPF.

If the market rate could not be determined with sufficient reliability, the non-deductible portion of interest is calculated by reference to the rate which the company has demonstrated could not be higher than the market rate. Thus, where there are realistic alternative transactions to the intra-group loan whose yield is necessarily lower than or equal to the interest rate that the borrowing company could have obtained from independent financial institutions or organisations under similar conditions to the intra-group loan, their rate may be accepted as a reference. The accepted rate may, for example, be calculated on the basis of the rate of loans with a shorter duration than the intra-group loan but similar in their other characteristics to the intra-group transaction (the company cannot be blamed for not having made an upward adjustment of the rate due to the longer duration of the intra-group loan). Another illustration of this type of pragmatic solution is given in Sheet No. 5.

On the other hand, if the company fails to demonstrate that the rate used was at most equal to the market rate or that the market rate was necessarily higher than the rate defined in Article 39-1-3° of the CGI, the non-deductible portion of interest is calculated in relation to the latter rate.

Application to the specific case

In this particular case, since loan no. 3 was not concluded in the interest of the company, the entire financial charges resulting from this loan are not deductible.

The analysis of the normality of the rate for loan 2 is carried out according to the principles described in Sheet 5 "Comparability - presence of multiple and substantial differences".

As regards loan No 4, the reference to a range of rates obtained by a panel of companies cannot constitute a conclusive reference if it is not demonstrated, firstly, that the rates used correspond to loans whose characteristics are similar to those of the intra-group loan contracted by the company and, secondly, that each of the said companies on the panel is in a situation similar to that of the borrowing company⁴. In the particular case, as the company did not produce any analysis, it did not provide evidence that the interest rate for loan 4 was at most the same as the one it could have obtained from independent financial institutions or organisations under similar conditions. Nor did it show that the market rate was higher than that defined in Article 39-1-3° of the CGI. The administration can only challenge the deductibility of interest charges exceeding those calculated on the basis of the floor rate set by Article 39-1-3° of the CGI, unless it demonstrates that the charge was not deductible.

It is also recalled that other measures to limit financial charges may apply (see in particular BOI-IS-BASE-35-10).

⁴ For the analyses that could be conducted to demonstrate this, reference can be made to Fact Sheet No. 3 "Comparability - CRA methodological publications and credit risk" and No. 5 "Comparability - presence of multiple and substantial differences".

Methods of proof

Situation under review

Company A has taken out a loan from an affiliated company B. The loan is granted at a rate higher than that defined in Article 39-1-3° of the General Tax Code (CGI)¹.

Company A has not taken out any other loans.

The company intends to justify the interest rate of this loan by means of a certificate issued by a third party bank. It is mentioned that this certificate does not constitute an undertaking by the bank to lend at this rate.

Following the auditor's questions in the context of the tax audit of company A, the latter asked the head company of the group to which it belonged whether any of the companies in the group had taken out loans with an independent financial institution or body under conditions similar to its own. In this context, a loan made by a company whose credit risk² is similar to that of company A and whose characteristics are similar to those of the loan concluded between companies A and B was identified.

With regard to the system for limiting financial charges provided for in Article 212-I-a of the CGI, do the supporting documents produced by company A constitute admissible evidence?

Principle

When a loan is granted by an affiliated company, the interest recorded by the borrowing company is deductible within the limit of that calculated according to a rate defined in Article 39-1- 3° of the CGI.

However, the borrowing company benefits from a mechanism of proof to the contrary: it can deduct interest calculated on the basis of a higher rate if it demonstrates that the latter corresponds to the rate it could have obtained from independent financial institutions or organisations under similar conditions (Article 212-I-a of the CGI).

Application to the specific case

It is up to the company to justify the interest rate charged by comparison with the rate that independent financial institutions or organisations would have been likely to grant it for a loan with the same characteristics on an arm's length basis, taking into account its own characteristics and in particular its risk profile³.

Proof to the contrary may be provided by any means by the taxpayer, including by

1 Rate equal to the annual average of the average effective rates charged by banks for variable-rate business loans with an initial maturity of more than two years.

2 In particular, it may be useful to refer to the details provided in Sheet 3 on credit risk assessment.

3 Cf. CE ruling 18 March 2019 n° 411189, SNC Siblu and CE opinion 10 July 2019 n° 429426 and n° 429428, Wheelabrator Group SAS.

production of one or, in some cases, several comparables. These may be loans granted under similar conditions either to the taxpayer by independent financial institutions or organisations (internal comparables) or to another undertaking - with a similar risk profile to the taxpayer - by financial institutions or organisations independent of that undertaking (external comparables). The taxpayer may, if necessary, take into account the yield of realistic alternative transactions to the intra-group loan with comparable economic characteristics⁴. The justification of the intra-group interest rate can be based, if nothing else, on the application of economic models that attempt to approximate the arm's length interest rate by distinguishing different components (schematically, risk-free rate + credit risk premium + adjustments)⁵.

As a general rule, written opinions from banks should not be considered as evidence that the arm's length principle has been respected⁶. However, such opinions may be attached to the file presented by the taxpayer if they support an analysis that is sufficiently precise.

It is good practice for a company to seek comparables before setting up an intra-group loan, as this enables it to secure the interest rate chosen at the same time as the transaction is concluded.

However, comparables cannot be rejected by the tax authorities simply because they were not collected before the loan was concluded. If the borrowing company did not gather these comparables beforehand, it can always provide proof a posteriori of the validity of the interest rate chosen in light of the applicable legislative provisions. The onus is always on the borrower to demonstrate that the proposed comparables are transactions carried out under similar conditions, having regard to the borrower's own situation and the characteristics of the loan in an arm's length situation and, therefore, to the market conditions prevailing at the time of the intra-group loan⁷.

In this particular case, the justification provided by company A by means of the external comparison can be accepted as it was assessed in the light of the characteristics of the loan on the one hand and the borrowing company's own situation on the other.

4 For an example, see Fact Sheet No. 8 "Comparability - Bond Market".

5 The different components must be justified in principle and quantum. In this respect, it is often necessary to identify comparable transactions with regard to one or more components to justify the calibration of a given component.

6 See §10.107 and §10.108 of the Transfer Pricing Guidelines on Financial Transactions (BEPS Inclusive Framework: Actions 4; 8-10).

7 On this last point, see §10.32 of the Transfer Pricing Guidelines on Financial Transactions (BEPS Inclusive Framework: Actions 4; 8-10).

Comparability - CRA methodological publications and credit risk

Situation under review

Simplified joint stock company A has taken out a loan from an affiliated company B. The loan is granted at a rate higher than that defined in Article 39-1-3° of the General Tax Code (CGI)¹.

Company A has not taken out any other loans.

No credit rating has been assigned to company A or its loan with B.

The company intends to justify the interest rate of this loan on the basis of the rate of a loan taken out by a company C from a financial institution independent of C. Company C has a credit rating assigned to it by a rating agency.

In order to justify that the credit risk taken by the independent financial institution in its loan to C is similar to that taken by B in its loan agreement with A, the latter has tried to approach the rating that a rating agency might have given it.

To do so, it relied on the explanations provided by a rating agency in a methodological publication, which was distributed on the Internet for educational purposes and covered, among other things, Company A's business sector. In order to assess some of the rating criteria listed in this publication, the company used its consolidated accounts for the last two years.

With regard to the system for limiting financial charges provided for in Article 212-I-a of the CGI, can a company's credit risk be assessed on the basis of a rating determined on the basis of methodological publications by rating agencies?

Principle

When a loan is granted by an affiliated company, the interest is deductible within the limit of that calculated according to a rate defined in article 39-1-3° of the CGI.

However, the borrowing company benefits from a mechanism of proof to the contrary: it can deduct interest calculated on the basis of a higher rate if it demonstrates that the latter corresponds to the rate it could have obtained from independent financial institutions or organisations under similar conditions (Article 212-I-a of the CGI).

Application to the specific case

It is up to the company to justify that the interest rate charged corresponds to the rate that independent financial institutions or organisations would have been likely to grant it for a loan with the same characteristics on an arm's length basis, taking into account its own characteristics and in particular its risk profile².

1 Rate equal to the annual average of the average effective rates charged by banks for variable-rate business loans with an initial maturity of more than two years.

2 Cf. CE ruling 18 March 2019 n° 411189, SNC Siblu and CE opinion 10 July 2019 n° 429426 and n° 429428, Wheelabrator Group SAS.

The assessment of similarity is therefore made taking into account, on the one hand, the borrowing company's own situation and, on the other hand, the characteristics of the loans under arm's length conditions.

The comparison criteria to be taken into account are all those that can have a significant impact on the interest rate; the credit risk of the borrower is a **key** criterion that should be given particular attention.

The assessment of a borrower's credit risk, which is summarised in the periodic ratings³ that the rating agencies assign to the companies that request them, is the result of an analysis of changes in a multitude of economic variables, both internal and related to the borrower's environment.

Since Company A does not have a relevant internal comparable, it may seek to compare its credit risk to that of other companies in order to identify possible external comparables⁴. For example, it may seek the rating that it could have received from rating agencies if it had asked them to do so.

For educational purposes, the rating agencies publish on the Internet documents that present in a transparent manner the main criteria, both quantitative and qualitative, that they take into account when establishing ratings for companies in the sector to which they belong. The presentation is explicitly simplified: it does not claim to be exhaustive as to the criteria taken into account⁵ and the weightings of the criteria mentioned may differ substantially from those actually used. Moreover, while historical data make it possible to capture trends and make inter-company comparisons, the rating that an agency assigns to a company is based mainly on the consolidated forecasts that the agency makes independently.

The methodological publications of the rating agencies described above may, however, be regarded as useful tools for making a reasonably reliable assessment of a company's credit risk, provided in particular that the taxpayer, on whom the burden of proof rests :

- correctly apply the principles described in these publications;
- ensures that the prospects of the borrower company⁶, taking into account in particular its characteristics, strategy and sectoral developments, do not suggest a significant mismatch between its past and future situation, or takes account of such a mismatch in an appropriate and documented manner;
- ensures that no essential criteria have been omitted or particularly underestimated⁷;
- investigate whether its membership of a group has an impact on the rating that a rating agency might have given it⁸, and if so, take its impact into account in an appropriate manner (see Box 1 on the next page);

3 As an example, a rating scale from the rating agencies Standard & Poor's, Moody's and Fitch Rating is attached.

4 On the concepts of internal comparables and external comparables, see Fact Sheet No. 2 "Evidence".

5 In particular, the publications apply to quite broad sectors, which makes it possible to omit some specific but important factors.

6 Taking into account the assets it controls directly or indirectly, and therefore the prospects of any subsidiaries.

7 This analysis may be based on the explanations provided by the rating agencies in connection with the actual rating of companies belonging to the same group or sector, but also on the key elements identified in sectoral studies and the specific characteristics of the company's functions, assets and risks, assessed from a consolidated standpoint (see previous footnote). This analysis is intended to compensate for the very general nature of the publications, which cover fairly broad sectors.

8 Probability that a borrower will benefit from the support of a member of a group in the event of financial difficulties (see box on next page), other advantages linked to belonging to a group (use of a central purchasing unit of the group, use of a brand with an influence beyond the company and its subsidiaries, financial controls according to the standards of an international group, etc., which may, for example, greatly moderate the influence of a possible size criterion in the rating).

- investigate whether or not state support would be likely in the event of future financial difficulties, and if so, take into account the impact on the company's rating in an appropriate manner (quite rare cases);
- provide all the necessary justifications⁹ to the control services.

Finally, the mere fact that companies were likely to obtain the same credit rating is not sufficient to prove the comparability of the loans they concluded. It is indeed necessary to examine the characteristics of these loans. It has been noted that the characteristics of a loan (repayment priorities, guarantees, etc.) can have a substantial impact (positive or negative) on the rating that would have been specifically attributed to it by a rating agency. It is therefore necessary to look not only at the rating that the company might have been given by rating agencies but also at the rating that the agencies might have given to the intra-group loan.

In general, the taxpayer is expected to produce sufficiently rigorous work in relation to the key criterion of credit risk, i.e. to take into account the main criteria that an independent rating agency would use to assess credit risk and to provide sufficient justification. The taxpayer is not required to have the company or the intra-group transactions rated by an independent rating agency or agencies. In addition, the taxpayer does not have the expertise of an independent rating agency but only a simplified description of the methodology usually followed by such an agency and a good knowledge of its sector and its own specificities. Consequently, the taxpayer is not required to present an analysis as exhaustive and detailed as that which an independent rating agency could produce.

In this particular case, Company A's approach may be admissible if it completes its analysis and provides the necessary justifications to the administration.

PRECISIONS

~~9~~ Methodological publication of the rating agency, documents used to assess the qualitative and quantitative criteria affecting the rating, such as the company's management reports and consolidated accounts, the minutes of the management bodies, sectoral studies contemporary with the loan, an **Implicit group support and rating of a subsidiary** depending on the circumstances, group membership may be a variable in the assessment of a subsidiary in a situation of abnormal management. (Inclusive BEPS Framework Action 8-10)

16 Cf. *CE*, 19 July 2017, No. 392543, General Electric France, concerning adjustments motivated by the administration under the angle of the abnormal management act. Attention is drawn to the fact that in the application of the contrary proof mechanism provided for in a.o. of Article 212 of the CGI, the burden of proof rests on the taxpayer, whereas it rests on the administration in the case of an abnormal act of management.

17 See Subsection C.1.4.3. of the Transfer Pricing Guidelines for Financial Institutions. (Inclusive BEPS Framework Action 8-10)

The framework of group support in the event of financial difficulties depends, inter alia, on the relative importance of the subsidiary to the group, the links between the subsidiary and the rest of the group, and the impact that support or lack of support from the subsidiary would have on the rest of the group. These factors should be assessed from the point in time when the related party loan was entered into and taking into account the future strategy of the group.

Where the subsidiary is at least moderately strategic for the group, the rating agencies therefore take into account the implicit support of the group in establishing the final rating of the subsidiary.

On the contrary, in the presence of a subsidiary that is not strategic for the group, the probability of implicit group support is generally insufficient to impact the final rating of this subsidiary.

In this case, company A, which bears the burden of proof, must, if the group is in a better position than it is on its own, propose an analysis to assess whether or not there is implicit support from the group and, if so, establish the effect of this on the final rating that a rating agency might have chosen.

2 - Commercial tools for modelling credit risk

Subsidiaries of groups that also own rating agencies market credit risk modelling tools. These should be distinguished from the methodological publications of independent rating agencies, which are the subject of this sheet, and which are distributed free of charge on the Internet to enable everyone to understand the main rating criteria.

Commercial tools for modelling credit risk sometimes rely on methodologies that are significantly different in some respects from those used by independent rating agencies to establish official credit ratings, and attention should be paid to the impact of these possible differences¹².

¹² See also Subsection C.1.1.2.4. of the Transfer Pricing Guidelines for Financial Transactions (BEPS Inclusive Framework: Actions 4; 8-10).

Annex: Rating agency rating scale (long-term)

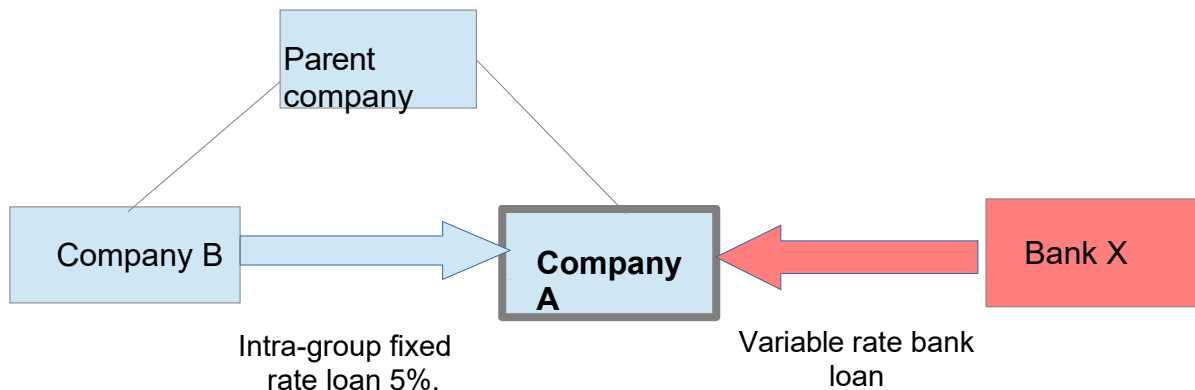
Agences			Signification des notes
Standard & Poor's	Moody's	Fitch Ratings	
Catégorie "investissement"			
AAA	Aaa	AAA	Valeurs de premier ordre
AA+	Aa1	AA+	Qualité haute
AA	Aa2	AA	
AA-	Aa3	AA-	
A+	A1	A+	Qualité moyenne supérieure
A	A2	A	
A-	A3	A-	
BBB+	Baa1	BBB+	Qualité moyenne
BBB	Baa2	BBB	
BBB-	Baa3	BBB-	
Catégorie spéculative			
BB+	Ba1	BB+	Éléments spéculatifs
BB	Ba2	BB	
BB-	Ba3	BB-	
B+	B1	B+	Hautement spéculatif
B	B2	B	
B-	B3	B-	
CCC+	Caa1	CCC+	Risques très élevés
CCC	Caa2	CCC	
CCC-	Caa3	CCC-	
CC	Ca	CC	Hautement vulnérable
C	C	C	Hautement vulnérable avec moins d'espoirs de recouvrement
SD et D	C	RD et D	En défaut

Comparability - the case of an adjustment improving the reliability of a comparable

Situation under review

Company A took out two loans at the same time, each financing half of a project:

- the first, with the related company B ;
- the second with a third party bank X.



The loan rate provided for in the contract signed between A and B exceeds the rate provided for in Article 39-1-3° of the CGI¹.

The company justifies the normality of the rate between A and B by producing the loan granted by Bank X as a comparison.

The two loans were taken out at the same time. They have similar characteristics with the exception of the nature of the interest rates provided:

- the intra-group agreement between A and B provides for a fixed interest rate of 5%;
- the bank loan bears interest at the variable rate of 3-month Euribor + 3.5%.

The company made a financial adjustment to convert the variable rate of the bank loan to a fixed rate.

With regard to the system for limiting financial charges provided for in Article 212-I-a of the CGI, is the bank loan taken out with Bank X an acceptable comparable?

¹ Rate equal to the annual average of the average effective rates charged by banks for variable-rate business loans with an initial maturity of more than two years.

Principle

When a loan is granted by an affiliated company, the interest recorded by the borrowing company is deductible within the limit of that calculated according to a rate defined in Article 39-1- 3° of the General Tax Code (CGI).

However, the borrowing company benefits from a mechanism of proof to the contrary: it can deduct interest calculated on the basis of a higher rate if it demonstrates that the latter corresponds to the rate it could have obtained from independent financial institutions or organisations under similar conditions (Article 212-I-a of the CGI).

Application to the specific case

It is up to the company to justify that the interest rate charged corresponds to the rate that independent financial institutions or organisations would have been likely to grant it for a loan with the same characteristics on an arm's length basis, taking into account its own characteristics and in particular its risk profile².

The assessment of similarity is therefore made taking into account, on the one hand, the borrowing company's own situation and, on the other hand, the characteristics of the loans under arm's length conditions.

The comparison criteria to be considered are all those that can have a significant impact on the interest rate³. These include date, credit risk of the borrower and the amount made available, duration, type of rate, currency, country risk of the borrower, repayment and interest payment terms, seniority and subordination considerations, collateral, sector of activity of the borrower (in particular financial/non-financial sector) and use of funds, and the presence of optional elements.

The OECD instructions of February 2020 made the following clarification:

*"The terms and conditions of a financial transaction between independent enterprises are usually formalised in a written agreement. However, contractual agreements between associated enterprises do not always provide sufficiently detailed information or are not always consistent with the actual conduct of the parties or with other facts and circumstances. It is therefore necessary to examine other documents, the actual conduct of the parties - notwithstanding the fact that this examination may lead to the conclusion that the contractual framework corresponds to the actual conduct - as well as the economic principles that usually govern the relationship between independent enterprises acting in comparable circumstances in order to accurately delineate the actual transaction, in accordance with Section D.1.1 of Chapter I."*⁴.

Where conditions are not perfectly comparable, it is accepted that the borrowing company should make some adjustments to improve comparability.

In this particular case, only the nature of the interest rate defined in the two loan contracts, fixed or variable, differs.

Furthermore, the adjustment proposed by Company A is reasonably reliable and the company has provided all the elements on which it based its proposal (detailed methodology, confirmation of variable/fixed rate swap).

The bank contract with X is an acceptable comparable if the proposed adjustment has sufficiently improved its reliability.

2 Cf. CE ruling 18 March 2019 n° 411189, SNC Siblu and CE opinion 10 July 2019 n° 429426 and n° 429428, Wheelabrator Group SAS.

3 See also section B. of the Transfer Pricing Guidelines for Financial Transactions (BEPS inclusive framework: actions 4;8-10).

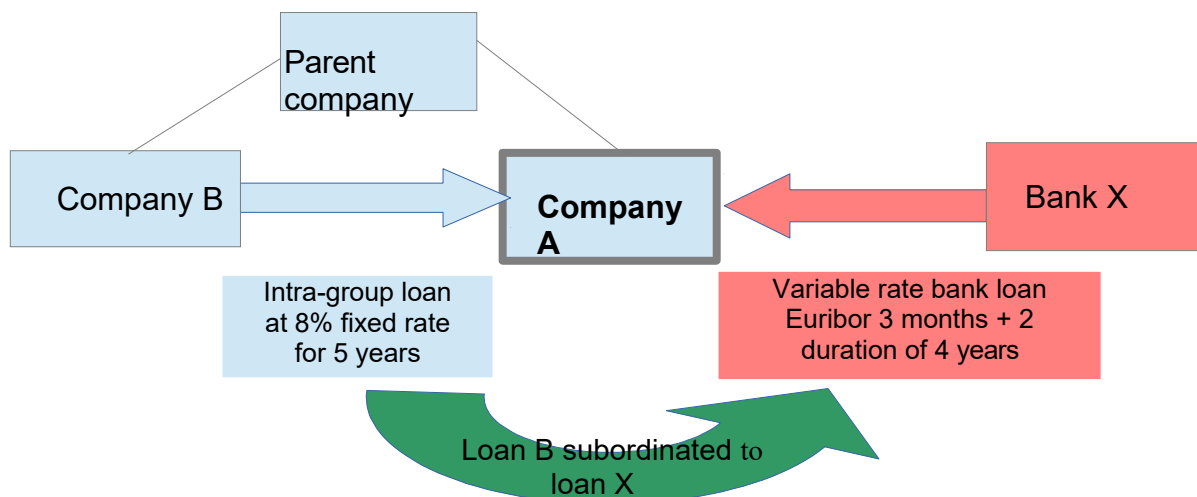
4 See §10.22 of the Transfer Pricing Guidelines on Financial Transactions (BEPS inclusive framework: actions 4;8-10). See also §10.56 for an illustration of a guarantee on the assets of a company that borrows from the parent entity.

Comparability - presence of multiple and substantial differences

Situation under review

Company A has taken out two loans at the same time, each financing half of a project:

- the first, with the related company B ;
- the second with a third party bank X.



The loan rate provided for in the contract signed between A and B exceeds the rate provided for in Article 39-1-3° of the General Tax Code (CGI)¹.

The company justifies the normality of the rate charged between A and B by producing the loan offer granted by Bank X as a comparison.

The two loans were taken out at the same time. They have similar characteristics with the exception of :

- the nature of the interest rate (fixed rate of 8% for the intra-group loan versus variable rate of 3-month Euribor + 2% for the loan from Bank X);
- the duration of the loan (4 years and 5 years respectively);
- the subordination² of the intra-group loan to the loan granted by Bank X, which subordination is provided for in the contract for the latter loan.

1 Rate equal to the annual average of the average effective rates charged by banks for variable-rate business loans with an initial maturity of more than two years.

2 A debt is said to be subordinated when its repayment is conditional on the prior repayment of other creditors.

Noting these differences, the company made two successive financial adjustments to correct the differences in the nature of the rate (fixed/variable) and the duration. Finally, it explains the difference between the rate applied (8%) and the rate of the bank loan thus adjusted (4.5% in total) by the subordination of the intra-group loan to the bank loan, without however justifying the quantum of the impact of this subordination.

With regard to the system for limiting financial charges provided for in Article 212-I-a of the CGI, is the bank loan taken out with Bank X an acceptable comparable?

Principle

When a loan is granted by an affiliated company, the interest is deductible within the limit of that calculated according to a rate defined in Article 39-1-3° of the CGI.

However, the borrowing company benefits from a mechanism of proof to the contrary: it can deduct interest calculated on the basis of a higher rate if it demonstrates that the latter corresponds to the rate it could have obtained from independent financial institutions or organisations under similar conditions (Article 212-I-a of the CGI).

Application to the specific case

It is up to the company to justify that the interest rate charged corresponds to the rate that independent financial institutions or organisations would have been likely to grant it for a loan with the same characteristics on an arm's length basis, taking into account its own characteristics and in particular its risk profile³.

The assessment of similarity is therefore made taking into account, on the one hand, the borrowing company's own situation and, on the other hand, the characteristics of the loans under arm's length conditions.

The comparison criteria to be taken into account are all those that can have a significant impact on the interest rate⁴.

Where the terms of the two loans are not perfectly comparable, it is accepted that the borrowing company makes adjustments to improve comparability.

This is the case for adjustments that are relatively simple to apply and lead to a reliable and very precise result⁵, which can therefore be cumulated.

Other, documented adjustments leading to somewhat less accurate results may be accepted⁶. Several of these somewhat less precise but documented adjustments may be made provided that their cumulative application leads to a result that remains reasonably reliable.

Furthermore, any adjustment that is not sufficiently reliable (e.g. undocumented adjustment, adjustment based on insufficiently reliable or accurate data, or adjustment based on an inaccurate assessment of key elements for the determination of interest rates, such as the risk profile of the company) cannot be accepted.

In this particular case, the company produced a contractually comparable loan with different characteristics in terms of the nature of the rate, duration and subordination, but which was a realistic alternative to the intra-group loan.

3 Cf. CE ruling 18 March 2019 n° 411189, SNC Siblu and CE opinion 10 July 2019 n° 429426 and n° 429428, Wheelabrator Group SAS.

4 See details provided in Fact Sheet No. 4. See also section B. of the Transfer Pricing Guidelines for Financial Transactions (BEPS inclusive framework: actions 4; 8-10).

5 For example, it is possible to make a reliable and very accurate adjustment to correct a difference of relatively short duration, or a difference relating to the variable or fixed nature of the interest rate or, except in a special context, a difference in currency.

6 For example, an adjustment for a greater difference in duration or for real and significant subordination of the intra-group loan under review to the reference loan may be retained if it is determined with sufficient reliability.

The actual⁷ and significant⁸ subordination of an intra-group loan to another loan is likely to have a substantial impact on the interest rate and may therefore, as a matter of principle, justify an adjustment of the interest rate.

The subordination resulting from the loan agreement that company A concluded with bank X alone can be taken into account. However, any adjustment must be sufficiently reliable. The subordination adjustment made by company A cannot therefore be taken into account, as it is not documented.

Consequently, the administration accepted the deduction of interest calculated on the basis of the bank loan rate to which only the first two adjustments described above, determined in a sufficiently reliable manner and leading to very precise results, were applied cumulatively (i.e. an overall rate of 4.5%, which is higher than the rate defined in Article 39-1-3° of the CGI for the period under review)

7 In this particular case, subordination can be presumed to be real when it arises from a loan agreement between Bank X and company A alone. Such a presumption cannot be accepted in certain other situations. In particular, in the case of several intra-group loans of different ranks, it is up to the borrowing company to demonstrate that an additional risk premium is justified. Indeed, contractual arrangements between associated enterprises are not always consistent with the facts and circumstances and it is therefore appropriate to refer to the economic principles that usually govern relations between independent enterprises acting in comparable circumstances. For a further illustration, see Fact Sheet No. 7 "Comparability - Mirror Loans".

8 The subordination of one loan to another may be considered significant when the granting of the subordinated loan changes the credit risk of the company in a substantial way.

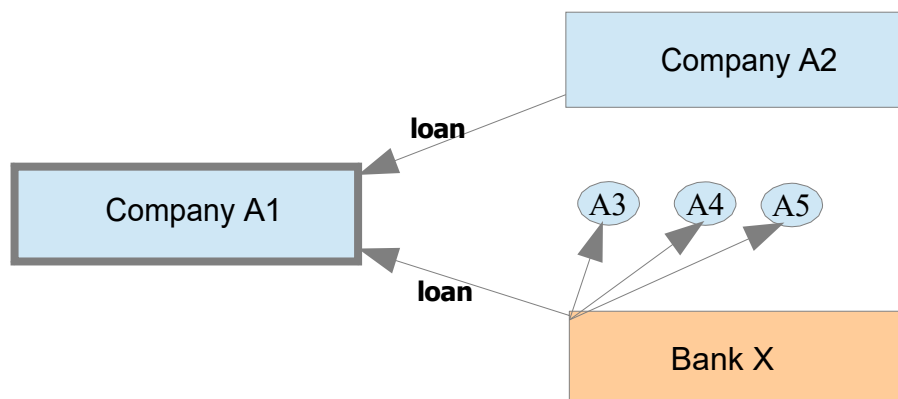
Comparability - multi-borrower bank loan contract

Situation under review

The simplified joint stock company A1 simultaneously takes out two loans, each financing half of a project:

- the first, with the related company A2 ;
- the second, with a third party bank X, under a joint contract involving three other borrowers, subsidiaries of the economic group to which company A1 belongs.

The two loans have similar characteristics, except for the guarantees.



The borrowing rates provided for in the two contracts are identical and exceed the rate defined in Article 39-1-3° of the General Tax Code (CGI)¹.

With regard to the system of limiting the deduction of interest provided for in Article 212-I-a of the CGI, is a loan resulting from a joint contract concluded between several companies of a group and an independent financial institution an acceptable comparable?

¹ Rate equal to the annual average of the average effective rates charged by banks for variable-rate business loans with an initial maturity of more than two years.

Applicable regulations

When a loan is granted by an affiliated company, the interest recorded by the borrowing company is deductible within the limit of that calculated according to a rate defined in Article 39-1- 3° of the CGI.

However, the borrowing company benefits from a mechanism of proof to the contrary: it can deduct interest calculated on the basis of a higher rate if it demonstrates that the latter corresponds to the rate it could have obtained from independent financial institutions or organisations under similar conditions (Article 212-I-a of the CGI).

Application to the specific case

It is up to the company to justify that the interest rate charged corresponds to the rate that independent financial institutions or organisations would have been likely to grant it for a loan with the same characteristics on an arm's length basis, taking into account its own characteristics and in particular its risk profile².

The assessment of similarity is therefore made taking into account, on the one hand, the borrowing company's own situation and, on the other hand, the characteristics of the loan under arm's length conditions.

Consequently, the loan contracted with Bank X is an admissible comparable provided that the borrowing company demonstrates by all means that the credit risk of the intra-group loan³ is similar to the credit risk of the loan granted by Bank X assessed in the light of the situation of the borrowing companies and the characteristics of this loan, and in particular the guarantees it provides⁴.

2 Cf. CE ruling 18 March 2019 n° 411189, SNC Siblu and CE opinion 10 July 2019 n° 429426 and n° 429428, Wheelabrator Group SAS.

3 For an assessment of a company's own situation, see in particular Sheet No. 3 "Comparability - Methodological publications by rating agencies and credit risk".

4 Particular attention should be paid to the safeguards provided in accordance with the Transfer Pricing Guidelines on Financial Transactions (BEPS). In addition, the difficulties associated with the presence of cross-guarantees are described in § 10.165 of the BEPS Guidelines.

Comparability - mirror loans

Situation under review

Companies A1, A2, A3, A4 and A5 are related companies within the meaning of Article 39-12 of the French General Tax Code (CGI). Companies A1, A2, A3 and A4 are foreign companies.

The French company A5 took out two loans at the same time, each financing half of the acquisition of an asset:

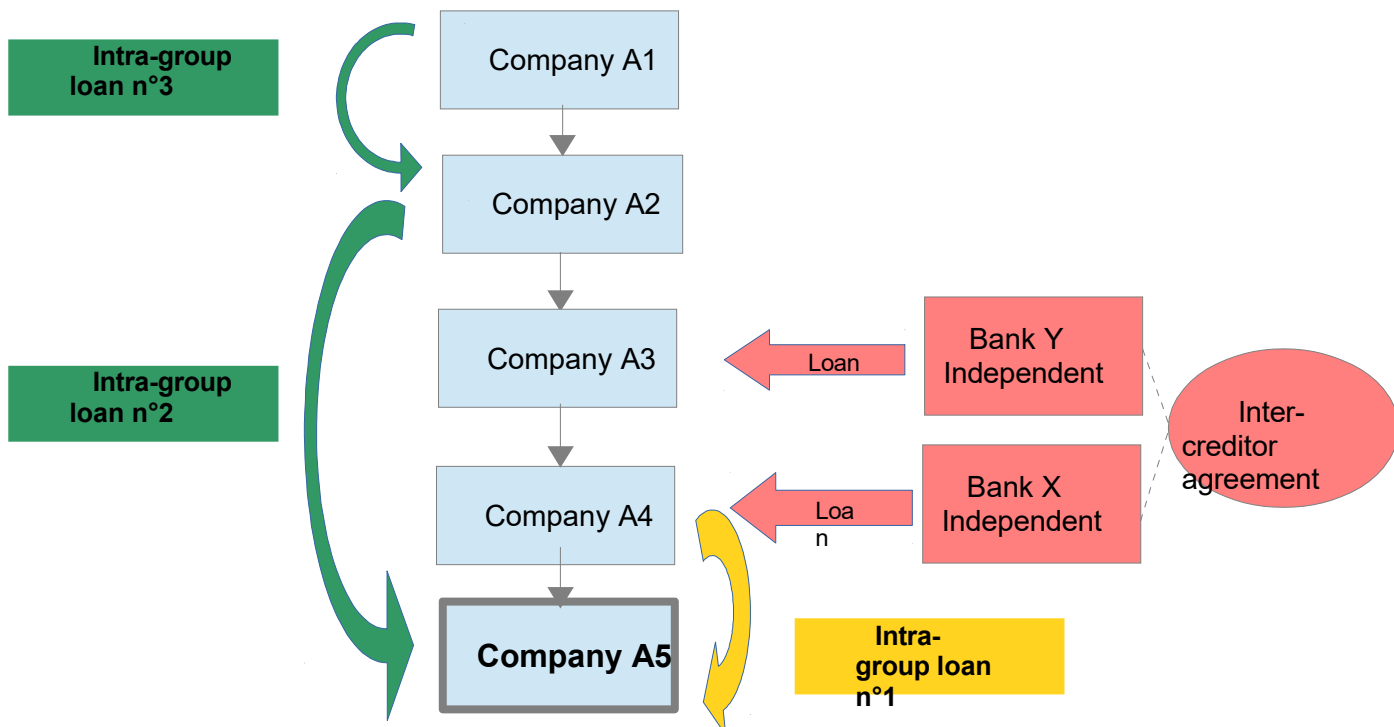
- the first, with the company A4 (loan no. 1);
- the second, with the company A2 (loan no. 2).

Companies A4 and A3 have respectively taken out a loan with banks X and Y. The latter have concluded an agreement providing for :

- that the repayment of the loan granted to A3 by Bank Y is subordinated to the repayment of the loan granted to A4 by Bank X;
- and that the repayment of any intra-group loan is conditional on the repayment of the bank loans granted by X and Y.

Part of the loan from Bank X to A4, which was intended to enable the group to finance asset acquisitions, enabled A4 to make loan 1 to A5. The rest of the funds borrowed by A4 and the funds borrowed by A3 enabled them to acquire subsidiaries and to grant loans to other group companies than A5.

Part of a loan granted by group leader A1 to A2 enabled the latter to finance loan No. 2 to A5.



The interest rates of the intra-group loans correspond to those of the "mirror" downgraded loans:

- the interest rate on loan 1 is similar to the interest rate on the loan that A4 took out with bank X beforehand;
- The interest rate of loan 2 is higher than that of loan 1 and similar to the interest rate of the loan that A2 took out upstream from the head of the group, company A1.

The rates of the two intra-group loans exceed the rate provided for in Article 39-1-3° of the CGI¹.

Company A5 intends to justify the normality of the rate charged between A5 and A4 (loan no. 1) by producing as a comparison the loan granted by bank X to A4.

Company A5 intends to justify the normality of the rate charged between A5 and A2 (loan no. 2) by producing the intra-group loan granted by company A1 to A2 as a comparison. Furthermore, it explains that because of the inter-creditor agreement, the repayment of loan no. 2 would be subordinated to the repayment of loan no. 1. It therefore intends to justify the difference between the rate of intra-group loan No. 2 and that of intra-group loan No. 1 by the need to make an adjustment linked to this subordination.

With regard to the system for limiting financial charges provided for in Article 212-I-a of the CGI, are the arguments presented to justify the rates of loans No. 1 and No. 2 admissible?

Principle

When a loan is granted by an affiliated company, the interest is deductible within the limit of that calculated according to a rate defined in Article 39-1-3° of the CGI.

However, the borrowing company benefits from a mechanism of proof to the contrary: it can deduct interest calculated on the basis of a higher rate if it demonstrates that the latter corresponds to the rate it could have obtained from independent financial institutions or organisations under similar conditions (Article 212-I-a of the CGI).

Application to the specific case

It is up to the company to justify that the interest rate charged corresponds to the rate that independent financial institutions or organisations would have been likely to grant it for a loan with the same characteristics on an arm's length basis, taking into account its own characteristics and in particular its risk profile².

The assessment of similarity is therefore made taking into account, on the one hand, the borrowing company's own situation and, on the other hand, the characteristics of the loans under arm's length conditions.

As regards loan No 1, the mirror loan agreement concluded by A4 with X can be accepted as comparable provided that the company demonstrates that it would have obtained identical interest rate conditions if it had borrowed directly from an independent financial institution or organisation the funds lent to it by A4, taking into account its own situation and the characteristics of the intra-group loan. For this purpose, it is necessary for the company to compare the characteristics of the "mirror" loan between X and A4 and of loan No 1, as well as the respective own situations of A4 and A5.

Assuming that all the characteristics of the loans are identical except for their amounts (the amount of loan 1 is substantially lower than that of the "mirror" loan between X and A4), it is up to the company to show that this difference does not have a significant impact on the rate given the respective situations of A4 and A5, and in particular their debt capacities.

With regard to intra-group loan No. 2, the transaction between A1 and A2 referred to does not comply with

1 Rate equal to the annual average of the average effective rates charged by banks for variable-rate business loans with an initial maturity of more than two years.

2 Cf. CE ruling 18 March 2019 n° 411189, SNC Siblu and CE opinion 10 July 2019 n° 429426 and n° 429428, Wheelabrator Group SAS.

the independence criterion and therefore cannot be used as a comparable.

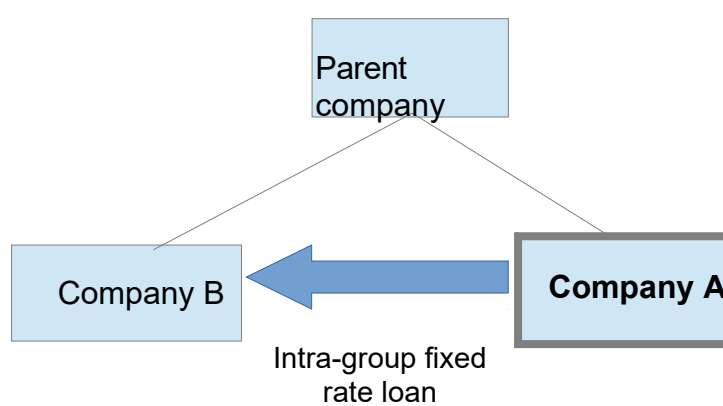
The subordination of any intra-group loan in relation to the bank loans granted to A4 and A3 respectively by X and Y, results from the agreement concluded by the group's creditors, i.e. from the structuring of the group's financing and the priorities that were defined when it was set up. The loan granted by Bank Y does not concern A5 and, moreover, the loan granted by Bank X only partially and indirectly concerns it. In order to justify applying a higher interest rate to loan No. 2 than to loan No. 1, the company must therefore demonstrate that if it had taken out its two loans with independent financial institutions or organisations, loan No. 2 would have substantially modified its risk profile to the extent that the rate required by an independent financial institution or organisation to make these additional funds available would have been substantially higher than the rate such an institution or organisation would have applied to loan No. 1.

In conclusion, the loan taken out by A4 with Bank X may be an acceptable comparable to justify the rates of the loans taken out by A5 with related companies, provided that the company completes its analysis.

Comparability - Bond Market

Situation under review

Company A took out a loan from related company B on 1^{er} March 2019 for a period of 5 years.



The loan rate provided for in the contract signed between A and B exceeds the rate provided for in Article 39-1-3° of the CGI¹.

The company justifies the normality of the rate charged between A and B by producing as comparables a panel of bonds issued on the financial market by other companies².

The company has selected bond issues:

- whose rating corresponds precisely to the one it determined for the operation (BBB+) by following all the recommendations in sheet 3;
- whose residual maturity at 1^{er} March 2019 is close to that of the intra-group loan³;
- whose currency is identical to that of the intra-group loan under review.

The company determined the yield to maturity⁴ for each bond issue as of 1^{er} March 2019. The company has made adjustments for small differences in maturity and has provided details of the calculations.

The rate it has chosen appears to be within the interquartile range determined from the panel of bonds thus constituted.

1 Rate equal to the annual average of the average effective rates charged by banks for variable-rate business loans with an initial maturity of more than two years.

2 The company has no better comparables.

3 For example, the company selected bonds issued on 1^{er} June 2017 with a maturity date of 1^{er} June 2024. As at 1^{er} March 2019, these bonds therefore had a remaining maturity of 5 years and 3 months.

4 The databases determine the yield to maturity of a bond at a given date from its price at that date. This rate is usually different from the bond's face rate, which is used to calculate interest.

Principle

When a loan is granted by an affiliated company, the interest recorded by the borrowing company is deductible within the limit of that calculated according to a rate defined in Article 39-1- 3° of the General Tax Code (CGI).

However, the borrowing company benefits from a mechanism of proof to the contrary: it can deduct interest calculated on the basis of a higher rate if it demonstrates that the latter corresponds to the rate it could have obtained from independent financial institutions or organisations under similar conditions (Article 212-I-a of the CGI).

Application to the specific case

The onus is on the company to justify that the interest rate charged corresponds to the rate that independent financial institutions or organisations would have been likely to grant it taking into account its own characteristics, in particular its risk profile, for a loan with the same characteristics under arm's length conditions⁵.

In an opinion of 10 July 2019 no.^s 429426 and 429428, the Council of State clarified under which conditions the taxpayer may refer to the rates charged on the bond market.

Thus, the rate sought cannot, in view of the difference in nature between a loan from a financial institution or body and financing by bond issue, be the rate that this company would itself have been likely to serve to subscribers if it had chosen, in order to finance itself, to issue bonds rather than to take out a loan.

However, the borrowing company, which has the burden of proving the rate it could have obtained from independent financial institutions or organisations for a loan granted under similar conditions, may provide such proof by any means.

In assessing this rate, the borrowing undertaking may thus, where appropriate, take into account the yield on bonds issued by undertakings in comparable economic conditions, where such bonds are, in the circumstances, a realistic alternative to an intra-group loan.

Furthermore, paragraphs 10.69 and 10.70 of the Transfer Pricing Guidelines on Financial Transactions issued in February 2020 (BEPS Inclusive Framework: Actions 4; 8-10) recall that the credit rating of a company may be different from the credit rating assigned to a securities issue to the extent that the credit risk associated with a financial instrument is not only related to the risk profile of the borrowing company but also to the characteristics of the securities (e.g. priorities for repayment, collateral). Depending on the facts and circumstances, and provided that a comparison can be made between the debt issue and the related party advance, where credit ratings exist for both the issuer and the issue, the related party advance is the most appropriate for determining the interest rate of the related party advance.

Finally, in order to check compliance with the mechanism of proof to the contrary provided for in the provisions of Article 212(a) of the CGI, sufficient information must be made available to the administration to allow a rigorous examination of comparability.

In this particular case, Company A's approach may be acceptable if the above conditions are met.

The following clarifications are also provided:

- It is usually possible to broaden the panel to include companies that are not engaged in the same activity as the borrowing company or in sectors other than that of the borrowing company (although companies in the financial sector can be eliminated if the borrowing company belongs to a different sector).

⁵ Cf. CE ruling 18 March 2019 n° 411189, SNC Siblu and CE opinion 10 July 2019 n° 429426 and n° 429428, Wheelabrator Group SAS.

This is particularly true in situations where a more restrictive search criterion would lead to a very small panel, as long as the rating criterion is precisely met by the panel selected.

- The fact that an issue is not for an amount comparable to that of the intra-group loan does not lead to its exclusion from the panel on this ground alone. The fact that an issuer is not of the same size as the borrowing company does not lead to its exclusion from the panel for this reason alone.