# IMPACTS OF THE COVID-19 SANITARY CRISIS ON THE FINANCING METHODS: FOCUS ON THE DEBT WRITE-OFFS

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*In the current context of the Covid-19 crisis, companies facing difficulty are looking for efficient solutions to limit the financial consequences arising from this crisis. If they can already benefit from payment facilities and other fiscal measures urgently adopted by the French Government, existing mechanisms improving their cash flow can also be put in place.*

*The financing of a company in poor financial health can be achieved through a variety of instruments with distinct aims: injection of cash into the treasury or debt relief.*

*When the goal is to reduce a company's debt, debt waivers may be appropriate. This operation may take the form of a subsidy, an interest-free loan and, in most cases, a debt write-off.*

*These days, where many activities have partially, or even totally, shutdown, debt waivers may be an interesting option for companies in order to maintain sales relationships and ensure the continuity of their activity as much as possible. However, before implementing such a mechanism, in order to prevent from any reconsideration by the tax authorities in the event of future tax audits, two main issues should / must be analyzed: (ii) the justification of the commercial nature of the waiver and (iii) its consequence, the partial or even total exclusion of this debt waiver from the charges of the supporting company.*

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*I- Overview of the debt write-off notion and its tax treatment*

The debt waiver is defined by the French Tax Authorities (« FTA ») as «*the renouncement by an enterprise to exercise its rights granted by an existing receivable*» [1].

From a tax perspective, two types of debt write-offs should be distinguished:

- The debt waiver **with commercial nature** originating in commercial relationships between companies and granted, notably, to maintain market opportunities or preserve sources of supply.
- The debt waiver **with financial qualification** granted with the aim of financially supporting an entity and no commercial purpose.

The characterization of the commercial or financial nature of the debt write-off is essential as it has an impact on its tax treatment.

In that respect, as regards **the waiving company**, where the debt waiver is of a **financial nature**, the corresponding charge will **not be deductible for tax purposes** unless the company benefiting from the waiver is subject to collective proceedings, or up to the negative net worth of this entity (see point III below).

As regards **the waiver benefiting company**, « *the debt waiver necessarily leads to a reduction in the liabilities of the debtor and, correspondingly, to an equivalent increase in its net assets* »[2]. Consequently, the amount of the waiver constitutes **a taxable revenue** at the standard corporate **income** tax rate.

*II- Difficulties arising from the justification of the debt write-off's commercial nature between affiliated entities: disregardment of the notion of « group interest »*

As a tax principle to any deduction of charges, the company granting the debt waiver must demonstrate that it constitutes a **normal act of management**.

Generally speaking, case law deems to be abnormal any act of management which consists in booking an expense or loss, or depriving a company of a revenue, without any justified commercial interest.

However, the **principle of non-interference** of the FTA in the management of a company enters into direct confrontation with the above point. As a result, the burden of proof of the abnormality of a management act lies on the tax authorities. Nevertheless, the proof is deemed

[1] BOI-BIC-BASE-50-10,1.
[2] BOI-BIC-BASE-50-20-20, 1.

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to be provided when the taxpayer is unable to justify the expense arising from the waiver in its principle and in its amount.

1 – Thus, before any substantive discussion, **it is necessary for the write-off to be recorded in the accounts** as an « *expense* » in the P&L of the waiving company and as an « *income* » in the books of the benefiting entity. Otherwise, the **tax risk** would be the **requalification of the waiver as a liberality** so that the corresponding expense would have to be integrated in the taxable result of the waiving company. In this context, it is critical for the taxpayer to correctly account the waiver.

2 – Meanwhile, to support the normal nature of the write-off, a detailed documentation will have to be kept in order to **justify the self-interest of the waiving company**.

This self-interest is assessed on a case-by-case basis. To this end, the FTA and case law focus on several criteria such as the nature and amount of the debt waived, the effective motivations for the waiver and « the existence of tangible and sufficient consideration »[3].

In this context, is considered as relying on normal management, the waiver of rent granted by a lessor to its lessee, whose financial situation is temporarily deteriorated[4], the write-off allowing the preservation of an asset such as a brand[5] or to avoid the judicial liquidation of the benefiting company[6].

Taking into account the above, the commercial character of the write-off is therefore based on (i) the **existence of commercial relationships** between the granting and benefiting companies and (ii) the **write-off motivation** enabling the benefiting company to proceed with its **economic activity**.

3 – Such a debt waiver may also be carried out between affiliated companies (sister companies or between a subsidiary and its parent company). However, this circumstance does not alter the assessment of the normal nature of the waiver.

Consequently, like debt write-offs granted between legally independent companies, **only the self-interest of the waiving company justifies the deduction of the debt waiver**. Case law considers that the **general interest of the group is not in itself sufficient** to justify the normal nature of the write-off.

Hence, a subsidiary has no interest of its own in waiving a claim on its parent company so that the latter can itself waive a claim on another of its subsidiaries without any commercial or

[3] BOI-BIC-BASE-50-10, 80.
[4] French Administrative Supreme Court « Conseil d'Etat », 16 June 2004, n°235647.
[5] Conseil d'Etat, 10 February 2016, n°371258.
[6] Conseil d'Etat, 26 June 1992, n°68646.

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financial links between these sister companies[7]. Similarly, the existence of a longstanding business relationship between two companies having a common shareholder does not, in the absence of any other consideration, constitute sufficient justification for granting a no-interest loan[8].

Practically speaking, in relationships between related companies, the line between the financial and commercial nature of the waiver is very tight. In this context, the FTA rigorously examine whether the write-off is, in fact, intended to be financial rather than commercial. Consequently, there is only few case laws accepting the interest of the waiving company as a justification for the commercial purpose of the aid[9].

No communication or measure taken by the French Government suggest that such criteria would be eased in the context of the current health crisis. Thus, taking into account the uncertainty in which we are living, we can only recommend that companies, related or not, wishing to carry out such waivers, draft a robust and detailed documentation to justify the normal nature of the write-off and highlight the self-interest of the waiving company.

In addition, particular attention should also be paid to waivers in the event of modification of the transfer pricing policy implemented in the context of the health crisis (on this subject, you can read a detailed article on the necessary adaptation of transfer pricing policy in the current crisis context, on LightHouse LHLF website).

This justification is even more important as, since 1 January 2019, there is no longer any tax neutrality for such waivers granted within a tax consolidation group.

However, it could be observed a glimmer of hope following the promulgation, on 26 April 2020, of the 2020 Amending Finance Lax for[10] providing for a new derogatory case of deductibility of rent waivers. Article 39 of the French Tax Code (« FTC ») adds the possibility for lessors to fully deduct rent waivers granted between April 15 and December 31, 2020, relating to buildings leased to a company. At the same time, such waivers are not taxable for the beneficiary company. However, this measure does not apply when the waiver is granted between related entities within the meaning of Article 39, 12[11] of the FTC.

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[7] Conseil d'Etat, 19 December 1988, n°55655.

[8] Conseil d'Etat, 4 February 1974, n°92009.

[9] See notably, Conseil d'Etat, 7 February 2018, n° 398676: « *waivers granted by a parent company to its subsidiaries where the parent company's turnover was almost exclusively provided by services invoiced to companies it controls, characterizing a commercial relationship ».*

[10] 2020 Amending Finance Law, n° 2020-473, 25 April 2020.

[11] « *A non-arm's length relationship shall be deemed to exist between two companies (i) where one of them holds, directly or through an intermediary, a majority of the capital stock of the other, or in fact exercises decision-making power in the other, or (ii) where they are both, under the control of the same third company* ».

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*III- The necessary softening of financial waivers in the context of the Covid-19 crisis*

1 – While a commercial waiver is fully deductible, **a financial waiver is excluded**, **for its full amount, from the deductible expenses** of the waiving entity.

However, it must be kept in mind that the deductibility of a non-commercial waiver may be subject to a tax deduction **limited in its amount** up to the negative net worth position of the benefiting company assessed after the waiver.
2 – It should also be reminded that **a waiver may be deductible when it is granted to a company which is subject to collective proceedings** (i.e. backup procedure, judicial statement, compulsory liquidation or insolvency proceedings) and when it is justified by the financial interest of the assisting company[12].

Therefore, the deduction of financial waivers is allowed only when it is **generally too late,** as the benefiting company is probably not in a position to meet its financial obligations. In the future, and especially in the current economic context, this may have **negative financial impacts** on the safeguarding of the activity of the waiving company itself.

3 – Finally, as regards the benefiting company, **the write-off may not be included in its taxable income** if (i) the waiver is granted by a **parent company** (holding at least 5% of the subsidiary's capital) and (ii) the subsidiary undertakes to **increase its capital to the benefit of the waiving company** by an equivalent amount **before the close of the second following financial year**[13] (in practice, for a waiver granted during April 2019, the capital increase must be completed no later than the close of the 2021 fiscal year).

Conclusion

Even though **the debt waiver mechanism** could be seen as an **opportunity** for companies wishing to provide financial support to related companies or commercial partners, **particular attention** must be paid to ensure compliance with the tax conditions regarding the deductibility of such write-off.

This scrutiny must be formalized through a **solid accounting and tax documentation** which will justify the normal management of the waiving company in any future tax audits

In any case, taking into the current period, limiting the tax deductibility of waivers to situations involving collective proceedings appears very harmful. In this context, and **in the lack of any easing measures regarding write-off's tax rules**, we would only be able to note the **increasing of the companies' financial difficulties.**

[12] BOI-BIC-BASE-50-20-10, 63.
[13] Article 216, A of the French Tax Code.

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However, it is hoped that the FTA, during post-crisis tax audits, will look with indulgent eyes debt waivers granted during the crisis.

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