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THE RAPID FUSION AFTER AN LBO COMPARATIVE TAX LAW

Theoretical
Article

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Abstract

Practitioners refer to "fast fusion" as the action, of acquisition of controlling interest with leverage effect, which results in the fusion of the acquired company with the mother company.

The aim of such a merger may be financial as the buyer captures not only the outcome of the takeover company but directly its liquidity, the repayment of the loan would be made not only by way of a dividend but by direct use of the entire cash flow of the target via the merged firm.

Moreover, such a transaction will enable the banker, as last lender to the holding, to directly take a guarantee over the assets of the target.

However, the fusion is essentially driven by a desire for tax optimization; it will impute the expenses of the holding on the taxable profits of the acquired company.

This process of rapid fusion is very interesting from a tax point of view, but its admission was controversial by the jurisprudence, which by hypothesis is important because this holding was indebted so as to obtain a maximum leverage.

This company was chosen in particular because of its ability to pay dividends to the holding regularly to enable it to meet the deadlines of the loan.

I. The tax effects of the rapid fusion

In the case of holdings, the leverage resulting from the simple interposition between the acquirer and the target company of a front company turns out to be an imperfect solution for tax purposes. Indeed, the holding company holds more than 10% stake in the target company, the dividends received are taxed as parent-subsidiary and consequently virtually exempt at the holding company.

As result, for tax purposes, the interest on loans generates a structural deficit that will be virtually impossible to charge.

To avoid this tax loss, several solutions have been proposed, among which the rapid fusion, which appears to be the most advantageous technique from a fiscal point of view.

The expected tax optimization by LBO

Practitioners of legal engineering have three main options available to them to avoid the loss of tax losses generated by mounting L.B.O:

- Firstly, the option of tax consolidation, this solution, which has the effect of establishing a fiscal consolidation within the group, allowing the imputing of the holding deficit on the profits resulted from the target company;

- Secondly, the holding company has, since the finance Act 1993, the right to avoid the application of this system for the dividends received from the target company, when the dividends have the nature of taxable products under ordinary conditions, it becomes then possible to impute the loan interests taken by the holding on dividends received from the target. This prevents the formation of a structural deficit that would become of no value after five years. However, the solution has the disadvantage of causing the loss of part of the tax credit provided by the target;

- Finally, the absorption of the target company by the holding company, the holding company may well decide the absorption of the target company; this absorption has the effect of permitting, after the grouping of assets, the allocation of interest expense incurred by the acquiring company on the profits generated by the acquired company¹.

The latter solution appears, because of this total imbrication between the holding company and the target, as a particularly effective tax optimization technique².

Tax optimization generated by the process of the rapid fusion

As it has been specified, the advantage of the rapid merger of the target company and the holding company is the direct use of cash of the target for repayment of the loan company; compared to a reimbursement by dividends, this advantage is essentially tax. In an LBO scheme before merger, the dividends paid by the target company to the holding company (which allows the

repayment of the loan) are subject to corporate tax in the target company.

However, after the merger, the repayment of the loan is done through direct drain on the treasury of the merged, so pre-tax society; the repayment part resulting from the loan interest will, in this case, constitute a reduction of the taxable income.

Thus, this technique will allow in a radical manner the implementation of a chronic fiscal consolidation. Indeed, the chronic tax deficit of the holding company will be imputed immediately on the profits of the merged company.

Moreover, the process of rapid merger will, subject to benefit from the favorable tax treatment of mergers, allow a revaluation of assets and generate new depreciation bases (particularly in the context of a merger from below); this will improve the available cash flow to service the loan debt.

The technique of rapid fusion also offers the ability to use the reserves of the target company, regardless of their age and consequently the tax.

Finally, as an alternative, it is a way to avoid the rigid and prohibitive laws governing the practice of tax consolidation.

Thus, the operation of rapid fusion, which appears particularly attractive from a tax perspective, should provide a maximum legal security to taxpayers and engineering practitioners. Indeed; they should be able to guard against any legal dispute as regard to tax law abuse. Yet the poverty of the jurisprudence in this area is very unfortunate and encircles the rapid fusion technique in a highly uncertain legal limbo³.

II. The rapid fusion in the test of private law branches

To date, the judicial uncertainty about the admission of rapid mergers under the tax law is at its highest point, only a decision of the Administrative Court of Lyon dated May 26, 1992 exists as a reference.

Nevertheless, the Court of Cassation in France has had to rule on the validity of the rapid fusion in respect to other legal branches other than tax law.

The validity of the fast fusion under tax law

In its judgment of May 26th, 1992, the Court of Appeal of Lyon explicitly rejected the existence of an abuse of law in connection with a rapid merger transaction through a LBO⁴.

The facts of the case are as follows:

July 29th, 1977, the SA Property Management has created 1,000 shares in the capital and they are mainly held by ML and his wife, MMD and O. each holding 5 shares.

On December 28th, 1977, ML yields 495 shares to MB, and his family.

On February 14th 1978 the SA Property Management acquired 648 of the 1000 shares in the

capital of SA Property management Villeurbanne (RIV), shares that were held by MM. D. and O.

March 28, 1978, the same operation is repeated, this time with 252 shares of the company RIV; after this operation, financed by a loan of 900,000 francs contracted by the SA Property Management, Property Management SA holds 900 of the 1,000 shares of the SA MIR.

To optimize the operation, on March 31st, 1978, the extraordinary general meeting of the SA Property Management decided to merge by absorption with RIV Company whose name it also takes. In practical terms, and logically, the merger results in fusion-waiver up to the 90% stake held by the acquiring company in the capital of the acquired company.

As for the remaining 100 shares in the capital of the company being acquired, they are exchanged against 1000 shares of the acquiring company MM. DO, which holds 85 of the 100 shares then receives 850 shares of the Company Property Management, shares given then to MM.L and B.

In late March 1978, at the end of the operations, Mr. L. and B. hold 1800 shares from 2000 shares that make the capital of the Property Management Company SA which became SA RIV. During the first accounts auditing, the Authority considered that this operation, fixed in nine months, results in an abuse of law and proceeded to the reinstatement of financial expenses deducted by the SA Property Management.

Receiving the case, the County Commission of direct taxes and taxes on turnover estimated that the operation was rather an abnormal act of management.

This qualification seemed to be inspired by the fact that the operation had been designed for the exclusive benefit of both buyers' partners', it is, in the same case that the Administration, in a second audit in 1985, will reject the deductibility of the interest expense. Having suffered the rejection of consecutive claims to the two verification procedures, the SA Property management Villeurbanne carried twice the proceedings before the administrative court.

The Administrative Tribunal of Lyon, joining the two requests, the operation was considered as an abnormal act of management. However, evidence of an abuse of law was not reported. The Administrative Court of Appeal overturned that decision and concluded that there was, in this case, neither sign of abnormal act of management nor an abuse of law.

Although its scope should be minimized, the decision of the Administrative Court of Appeal of Lyon is of significant importance; it raises questions about the influence that can now have the theory of abuse of law on LBO operations when they find their denouement in the rapid absorption of the target company. Indeed, if the tax judge

clearly recognized the existence of a tax benefit in the rapid absorption of the target company, he clearly refuses to qualify it as abusive transactions; nevertheless, it is only a judgment of court of a second appeal whose scope should be treated with caution. The doctrine also remains very skeptical about this resounding judgment, "we must not misunderstand this shift in law of the jurisprudence and conclude that the existing legal arrangements in the case of a restructuring benefit from immunity⁵".

The Court of Cassation in France, meanwhile, delivered three judgments about the rapid fusion but they shed no light on how the appreciation should be under the tax law.

The rapid fusion in the light of other branches of law.

The Court of Cassation in France is the only Supreme Court that has rendered judgments on the process of rapid fusion. However, its decisions do not bring anything to the validity of this fusion under tax law. They refer only to commercial law and criminal law.

The rapid fusion and commercial law

The Moroccan legislator has set up a protective device that protects creditors following the merger, the rights of creditors of the company being acquired, those bondholders, holders of investment certificates, etc ...⁶

It must be mentioned that the Moroccan jurisprudence suffers from a deficit in these cases.

In France, and to assess the validity of the rapid fusion under commercial law, the Court of Cassation could validate this fusion under Article 217-9 of the Act of July 24, 1966 which prohibits the purchase by a company of its own shares⁷.

The court adopted the same attitude in its judgment on the 19th of December⁸, the facts being as following:

SODERO agreed to EURODIS for the acquisition by the latter of 97% of the shares of SA Sepco France. As a guarantee for its loan, SODERO Company had three guarantees: a joint guarantee repayment of the loan, a lien on the shares of the company Sepco France, being acquired, and a lien on the business assets of the company Sepco Saumur, a subsidiary of Sepco France.

Subsequently, the company EURODIS was subject to liquidation, the company SODERO sued the surety for reimbursement; sentenced on appeal for the payment of a sum of 2,419,151 euros, it has been granted no appeal. The company made two complaints to the Court of Appeal:

- The court made this judgment in that way while additional guarantees to the financial company had been granted contrary to the provisions of Article 217-9 of the Act of 24 July 1966;

- The court also failed to respond to its conclusions in which the company argued essentially that the operation stemmed from an attempt to divert the law.

The Court of Cassation in France rejected the appeal for the reason that "the loan granted by the company SODERO to the company EURODIS was guaranteed by shares in the company Sepco France, it was clear then that the property involved is not the property of Speco France, the constitution of this guarantee lies outside the scope of the prohibition of the Article 217-9 of the Act of 24th July 1966. »

The Court of Cassation in France only confirmed a decision it made on the matter on Nov. 15, 1994 ⁹ Indeed, the high court had already admitted at that time the compliance with the Article 217-9 of a guarantee accepted by the acquisition holding as a guarantee on the shares of the target for the purpose of the establishment of credit lender, and secondly, the repayment of the loan agreed by the acquisition holding company through dividends and non-statutory reserves.

Thus, the Court of Cassation in France believes that the creation of a guarantee on the shares acquired through a loan, as a guarantee for the repayment of this loan, is an operation entirely conventional and legitimate and that it does not constitute the vampirisation of the sold company.

The favorable opinion that the trade room has about the rapid fusion is not shared by the Criminal Division, which considered that the merger would be a misappropriation of assets and / or an abuse of authority criminally punished.

The rapid fusion and the criminal law

To better understand the importance and implications of the judgment, we must remember the attractive mechanism of an L.B.O, there are legal, tax and financial reasons that lead the buyer to buy most or all of the shares of a target company by a holding company. The latter, established and controlled by the buyer, will borrow from financial institutions some of the funds needed to purchase the shares of the target.

Financially, the transaction is interesting in that the repayment of financial institutions can be done with funds from the target.

It is also attractive from a fiscal point of view because loan interest can be deducted from taxable products on the holding companies and the dividends used to repay financial institutions are paid by the target to the holding as tax-free.

These operations are dangerous because they put on the target company the burden of financing the purchase of its own shares by means which may constitute criminal offenses. Indeed, the advances made from the fund of the target to the holding, while it will not have the ability to repay, and the extinction of the debt of the holding

company to the target by making a merger of the holding by the target are criminal offenses¹⁰.

Such was the situation in the case-Delattre Levivier¹¹ where the Criminal Division has sanctioned, as an abuse of power, the manager and shareholder of the holding company who aimed at the absorption of the latter by the subsidiary to achieve two objectives:

- Firstly, compensate retroactively and at the right time, as a result of the merger, the debt of the holding company born from a cash management agreement granted by the subsidiary to the holding company to finance the acquisition of its shares, with the debt of the holding company under a service agreement;

- Secondly, to become a shareholder of the target. This operation, which was based on a particular assembly represented, according to the Court, a lesionaire character, it was foreign to the social interest, unbalanced and lacking any economic justification for the absorber.

The review of the jurisprudence related to the rapid fusion requires much more interest on the various risks created by this restructuring operation. Indeed, these dangers that are at the same time criminal, commercial and taxed extremely threaten the validity of the mechanism L.B.O followed by rapid fusion.

Conclusion and propositions

The quasi-absence of case law in the matter and its piecemeal aspect have helped fuel the doctrinal controversy and to create an uncertainty on the regularity of the mounts L.B.O when they are followed by a rapid fusion; in effect, the many risks incurred by those who put in place such constructions, are an impediment to the assumption of the rapid fusion in the ranks of the recognized techniques of occasions of businesses.

The validity of such restructuring operations may be questionable because of the dangers they pose both on the tax plan, that on a legal level, the fact of the opposition that it implies between the logic policyholder and the logic of the repurchase operation.

The merger between the holding company for the acquisition and the target company can take away the benefits in tax matters which can be summarized as follows:

- 1- The automatic consolidation of tax results of the holding company for the acquisition and the target, this effect is also obtained in the case of tax integration in countries such as France;
- 2- The absence of reintegration of the share of costs and expenses in the event of distribution of dividends of the target company, reintegration also silenced in case of creation of tax integration;
- 3- The absence of cost of withholding tax related to a distribution of reserves pre accounting of the target company.

Nevertheless, as any restructuring operation generating benefits on the tax plan, the fast fusion has been the subject of particular attention from the part of the administration, which has a range of resources for the call in question.

Due to its subsidiary nature, we stray from the outset the risk linked to the change of activity based on the article 221-5 of the general French tax code¹², this article would have been able to apply in the present case, when the holding company absorbs the target company and if this holding has no activity similar to that of the target, and terminal to hold the titles of the latter (holding pure) ; in this hypothesis, the transferee company, at the origin inactive, resumes by force of circumstance, the industrial or commercial activity of the absorbed, this will be perceived by the tax administration as a cessation of business; this cessation of business has as consequence the immediate taxation of operating profits, the reintegration of regulated provisions and particularly the deletion of the Right to the postponement of deficits incurred up to the date of change of activity.

However, it should be noted that the rapid nature of the fusion mitigated or even eliminated this consequence because the transferee company will not have had the time to generate profits or of the most-significant gains; in addition, the absence of having closed its first exercise, it will have been able to manufacture of fiscal deficits.

The main tax risk, in the case of fusion rapidly following a L.B.O, resides in the discount in question by the tax administration of the assembly itself, near in its whole and not to each operation of the building taken in isolation.

The fitting L.B.O followed by a rapid fusion is composed of several operation phases, namely, the establishment of the holding company, the subscription by the latter to a loan, the merger between it and the target; they all have a legal existence indisputable and can in no case be qualified as fictitious.

The creation of the holding company cannot be fictitious or even, without significant resources, it operates legally and criminally and promotes the pooling of resources for the purpose of realizing a taking control.¹³

These criteria were those retained by the administrative court of appeal in Lyon in its judgment of 1992, to move aside the fictional nature of the holding company, the latter had in effect been regularly constituted and had known a regular activity to the acquisition and management of shareholdings; in its conclusions, the government commissioner refers elsewhere to the actual operation of the mount on a six-month period of activity during which the holding company has cashed the rents and fees.¹⁴

As well as the establishment of the holding company, the subscription to a borrowing and debt

of resultant acquisition shows no artificial nature and can only be the base of the existence of an abuse of law by fictitious; in effect, with regard to the sums made available to the holding company acquisition by third party lenders, it seems problematic to challenge the reality of when the sums have well advanced.

As stated by Pr. ALLARD DE WAAL, it is possible "to understand the problem from a different angle and see the quality of the legal relationship created, based on the loan (etc.), who led the third party lenders to take the risks that are those of a shareholder "¹⁵; such an argument seems, in the light of the grievance of fictitious, inoperative because the links established contractual and the provision of funds have a reality that cannot be challenged and this regardless of the quality of Silas.

Pr. ALLARD DE WAAL differs on this subject the hypothesis to consider as the fictitious contractual relations established between the company and its shareholders and which led to the establishment of current accounts of associated elements; in effect, the simple fact that the amounts are lent by people having the quality of associates, it is not of itself sufficient to justify the grievance of fictitious, it is perfectly permissible to associates to lend, even that it is frequent to see, conversely, of Silas take a participation in the capital of the borrower company ; as indicated by the author, "the qualities of shareholder and lender will accumulate perfectly, each referring to a legal special relationship. "¹⁶

Finally, the merger of the holding company and of the target, which is "the culmination" of the mount L. B. O, cannot be more fictitious, in effect; it allows you to achieve the recovery operation of business in the fiscal and optimal financial conditions.¹⁷

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