MAYER • BROWN

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Dividends paid to Luxembourg SICARs

Does the application of a withholding tax in France on dividends paid by French companies to Luxembourg SICARs constitute a discriminatory measure as regards European Community law?

According to French domestic law, dividend distributions paid by French companies to Luxembourg investment companies in risk capital (SICARs) are subject to the 25% withholding tax set forth under article 119 bis of the FTC, with no possibility to benefit from the exemption set forth under article 119 ter of the FTC (indeed, the application of the favourable provisions of this article requires that the legal entity located in the other European Community (EC) member state and receiving the dividends be subject to corporate income tax in that state without being tax-exempted, which is not the case of SICARs since these are tax-exempted in Luxembourg on passive income received).

From a tax perspective, dividend distributions made by French companies to Luxembourg SICARs are thus treated in a less favourable manner compared with dividend distributions made to comparable French vehicles such as French investment companies with variable capital (SICAV) or mutual funds (FCP), since these distributions are tax-exempted.

In this respect, and more generally, the European Commission has announced, in a communication dated March 18, 2010 (IP/10/300), that it has officially asked the French government to modify the rules regarding the treatment of dividends paid to investment funds located in other European Union (EU) and European Economic Area (EEA) member states, since these rules constitute obstacles to the free movement of capital set forth in the treaty on the functioning of the EU and the EEA.

In this context, with respect to the specific situation of dividends distributed to SICARs, the only way for France not to be considered as being in breach of the EC law would be to demonstrate that compliance with EC law is guaranteed by the double tax treaty between France and Luxembourg dated April 1st, 1958 (application of EC case law: ECJ December 14, 2006, case 170/05 Denkavit; ECJ November 8, 2007, case 379/05 Amurta), which implies, beforehand, that SICARs could benefit from this treaty (i.e., that they can qualify as "resident" within the meaning of the treaty).

In this respect, the French government considers that SICARs cannot benefit from the reduced withholding tax rates on passive income laid down in the double tax treaty, since SICARs cannot establish that the income they generate is actually subject to corporate income tax in Luxembourg (Rép. Dassault: AN July 4, 2006, n°92093). This position is in line with the approach by the French tax authorities regarding the French-Algerian double tax treaty, according to which a person exempted from tax in a country is not considered as being subject to tax in that country and cannot therefore qualify as a resident which may benefit from double tax treaties (administrative guidelines May 22, 2003, 14 B-3-03 n°5).

This position can however be questioned in several respects:

- Firstly, comments relating to article 4 of the OECD model tax treaty regarding the definition of "resident" do not seem to adopt such a strict interpretation of this concept, notably acknowledging that, according to domestic laws of various countries, a person is considered as being subject to tax even if the country does not *de facto* apply tax to this person, most of these countries moreover considering these persons as residents for the purposes of double tax treaties (see comments dated July 22, 2010 regarding the OECD tax treaty model, §8.6 et §8.7).
- Secondly, with respect to the double tax treaty between France and Germany which contains a definition of the concept of tax residency which is in line with the OECD tax treaty model, a judgment rendered by the Montreuil tribunal on January 14, 2010 indicate that the quality of resident is not subject to a condition of effective payment of tax in the state of residency.

- Thirdly, the definition of tax residency laid down in the double tax treaty between France and Luxembourg is different from the definition laid down in the OECD tax treaty model, since it is not necessary to be subject to tax so as to be considered as a "resident" (only article 8-3 indicates that in order to benefit from the "*avoir fiscal*" – tax credit on dividends – transfer, the beneficiary of the "*avoir fiscal*" transfer should also justify that he is taxed in Luxembourg on these dividends).

Thus, serious arguments exist in our view to conclude that, contrary to the position of the French tax authorities, SICARs should be qualified as "resident" within the meaning the double tax treaty between France and Luxembourg, and, consequently, benefit from the provisions of that double tax treaty.

The application of the French-Luxembourg double tax treaty provisions relating to dividends (even if it was admitted) should however not allow the circumvention of all discrimination as compared to the regime applicable to distributions paid to French investment funds. Indeed, the double tax treaty only sets forth a reduced withholding tax rate on dividends (vs. withholding tax exemption) which could not in be practice "neutralized" by the tax credit mechanism since this tax credit could only be used on the tax due in Luxembourg in respect of these dividends by the entity receiving dividends (dividends received by a SICAR are tax-exempted in Luxembourg).

Based on the above, the application in any case (i.e., with or without application of the French-Luxembourg double tax treaty) of a withholding tax on dividends paid by French companies to SICARs seems to constitute a discriminatory measure according to EC law to which the French authorities, without a doubt, will have no choice but to put an end to in due course. Meanwhile, the question remains as to whether the French distributing companies must continue to withhold taxes upon distribution, as well as the question of a potential claim for repayment of withholding taxes "wrongfully" paid in the past.

Tax (r)evolution in Luxembourg conduit financing

Administrative circulars LIR no. 164/2 dated 28 January 2011 and LIR 164/2bis dated 8 April 2011

In an administrative circular dated 28 January 2011, the Luxembourg tax authorities target the tax treatment of Luxembourg intra-group financing companies. Luxembourg is a popular location for conduit financing mechanisms. The circular deals with intra group lending activities financed by financial instruments in public or private offerings/financing or bank credit facilities. The circular confirms that financing companies are required to be compensated with an arm's length price that should be based on third-party transactions provided by credit institutions in comparable situations. All ruling requests will have to enclose a detailed and sound transfer pricing analysis.

The circular states that no ruling will be issued should a taxpayer fail to meet defined substance requirements. Beside the classical majority of Luxembourgish directors with the necessary professional qualifications and the fact that decisions of the company should be taken in Luxembourg, the circular requires the applicant to demonstrate that its capital is commensurate with the functions exercised, risks assumed and assets used. The circular states that, in principle, intra-group financing companies should be deemed to have an appropriate capital when it represents at least 1% of the nominal value of granted loans or EUR 2,000,000.

By formalizing and strengthening the substance requirement in Luxembourg, and by publicly disclosing conditions which until now resulted from a private discussion with the competent tax inspector, the circular was potentially affecting existing structures. The circular 164/2bis issued on 8 April confirms this point by stating that rulings issued prior to the circular 164/2 will elapse on 31 December 2011. After this date, the tax authorities will only be bound provided a new ruling, meeting the conditions set forth by the circular 164/2, is obtained. Taxpayers are urged to analyze existing structures.

VAT: expenses related to the sale of shares

Is the VAT on the expenses incurred for a sale of shares recoverable? (update of the Tax Newsletter of 4th quarter 2010)

Only a few months after having accepted the possibility, in certain specific cases, of deducting the VAT related to the costs incurred for a sale of shares, the *Conseil d'Etat* (French Supreme Administrative Court), in two leading cases rendered on December 23, 2010, provided actual instructions that should make it possible, at least in theory, to determine whether the VAT on a given expense related to the sale of shares is deductible. [*CE, 8e and 3e s.-s., December 23, 2010, Société Pfizer Holding et SA Michel Thierry, No. 307698 and No. 324181*].

In substance, the *Conseil d'Etat* now distinguishes between the 'expenses incurred in order to prepare the sale' and the 'expenses inherent to the transaction itself'.

Expenses incurred in order to prepare the sale (e.g., attorney's fees for services rendered in connection with vendor due diligence) are considered in any event as forming part of the company's overhead costs, and consequently the related VAT is deductible under ordinary conditions when the sale does not occur. When the sale occurs, these expenses remain, in principle, treated as overhead costs but the French tax authorities are entitled to challenge VAT deductibility if they establish that the sale has a patrimonial nature, which will be the case if the proceeds of disposal have been distributed, or if the expenses incurred have been included in the share sale price.

Expenses inherent to the transaction (e.g., brokerage fees or, more generally, any intermediation expense enabling the effective performance of the transaction) are regarded in principle as presenting a direct and immediate link with the share sale (transaction not subject to VAT). The VAT on such expenses is thus not deductible unless the taxpayer proves that these expenses have not been included in the share sale price.

The *Conseil d'Etat* further specified that expenses paid to the same intermediary in charge of both preparing and performing the transaction follow the VAT treatment applicable to expenses inherent to the transaction.

Attractive in principle, this new instructions manual is still questionable in certain respects and raises a number of practical uncertainties.

It is certain that the vendors of shares will *as a minimum*, and regardless of the type of expenses, have to prove the non-incorporation of the expenses in the sale price. This proof should in particular be supported by the cost accounting system of the selling company, or more generally, by express clauses of share sale contracts specifying that the vendor will bear the expenses it incurred for the sale of shares.

This being said, bringing this proof could be insufficient to justify the deductibility of the VAT on such expenses. Indeed, the *Conseil d'Etat* now provides, as pointed out above, and at least for the expenses incurred prior to the sale, that the VAT deductibility could be challenged by the tax authorities if the transaction has a '*patrimonial nature if the proceeds of disposal have been distributed, regardless of the modalities of the distribution*'.

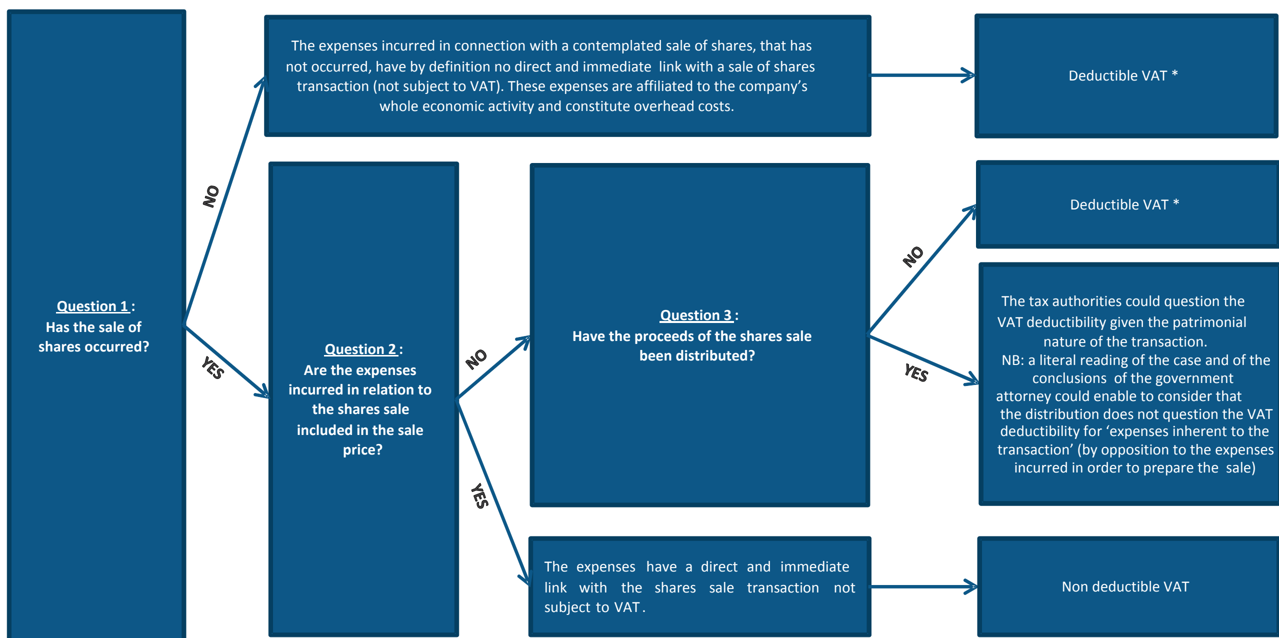
This requirement of non-distribution of the proceeds of disposal, constituting one of the main new developments of the cases, seems, in itself, questionable since its effect is to make the VAT treatment depend on the use the selling company makes of the proceeds, which does not seem to be in line with the European Community case-law (see, in particular, the BLP Group case of April 6, 1995). It is further questionable as the *Conseil d'Etat* seems to make it a condition of VAT deductibility solely for the expenses incurred in order to prepare the sale.

Certain questions are thus still unresolved by the two decisions of the *Conseil d'Etat*:

- Could the VAT related to expenses inherent to the transaction (considered, by definition, to be strongly related to a sale which is not subject to VAT) thus be deductible under the sole condition that the taxpayer demonstrate the non-incorporation of the expenses in the sale price, whereas VAT on expenses incurred in order to prepare the sale (considered as being more related to the company's whole economic activity) would only be so if the taxpayer further demonstrates the non- distribution of the proceeds of disposal?

- What is the impact of a partial distribution of the sale price on the VAT treatment of the expenses related to such sale (in his conclusions, the government attorney provides that in such an event 'pro-rata will be have to be done')?
- Is there a time-limit from which a distribution will no longer characterize a patrimonial transaction likely to result in a challenge of VAT deductibility?

We provide below a practical guide summarizing the questions to be analyzed by a taxpayer incurring expenses related to a sale of shares.



(*) the VAT related to the sale of shares is in all events only deductible if justificatory documents are produced (e.g. invo ices, cost -accounting, …).

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