MAYER • BROWN

Tax Newsletter

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VAT: expenses related to the sale of shares

Is the VAT on the expenses incurred for a sale of shares recoverable? (update of the article in the Tax Letter of October 2008 – November 2008)

The issue of the deductibility of the VAT relating to the expenses incurred by a taxpayer for a sale of shares (e.g., counsels' fees, brokerage costs) has for several years resulted in abundant national and European case law which has generally moderated the strict position of the French tax authorities.

Indeed, the French tax authorities consider that *"the VAT related to expenses incurred for a sale of shares [...] is not recoverable since these expenses have a direct and immediate link with an operation that does not give rise to VAT deduction"* (Guidelines 3 A-1-06 of January 10, 2006, No. 9).

For several years, first level jurisdictions have found that providing these expenses have a direct and immediate link with the whole economic activity, the expenses incurred by an entity for a sale of its shareholding in a subsidiary may form part of its overhead costs, which in practice permits a total or partial input VAT deduction relating to such expenses (see in particular Administrative Court of Appeal of Paris May 21, 2007, No. 05PA03817, SCA Pfizer Holding France).

The European Court of Justice, in the AB SKF case dated October 29, 2009, confirms such analysis and specifies that the jurisdiction has to determine, taking into account all the circumstances in which the transactions in question occur, if the expenses incurred are likely to be incorporated in the price of the shares sold (in which case the deduction of VAT is not permitted) or if they form part of the costs of the transactions that are directly related to the economic activities of the taxpayer (in which case VAT deduction is permitted).

A recent decision of the Paris Administrative Court of December 9, 2009 seemed contrary to the recent trend of case law and in certain aspects, represents a movement towards the administrative position.

However, the Conseil d'Etat (French Supreme Administrative Court), seized for the first time on this issue, has recently ruled in a decision of June 10, 2010 that the expenses (in this case the brokerage costs charged by a bank) borne by a company for a sale of marketable securities, an action which is outside the scope of application of VAT, constituted overhead costs that were related to the taxable economic activity of the company and are consequently, deductable, since the company in question was experiencing financial difficulties and such a sale was necessary to enable the company to continue operating.

This decision has the double effect of condemning the 'extreme' position adopted by the French tax authorities and harmonizing national and European case law.

Nevertheless, it is difficult to infer a general application to this decision in future as it is based purely on the circumstances of that particular case.

If, as seems to be the case, it is now established that VAT deductibility on expenses related to the sale of shares cannot be refused in theory, the circumstances in which such expenses will be considered overhead costs that can be related to the economic activity of the company should be rare in practice.

As an example, the circumstances quoted by the aforementioned decision of the Paris Administrative Court of May 21, 2007 include forced sale, merger, demerger, direct or indirect share contribution, continuation of the activity of the taxpayer in difficulty (situation of the decision of the Conseil d'Etat).

In future cases, the Courts will take a subjective approach and analyze each case based on its individual circumstances.

Declarative obligations (IFU)

Must the interest capitalized annually on convertible bonds issued by a company be declared in its imprimé fiscal unique ('IFU') filing?

The provisions of article 242 ter of the French General Tax Code ('GTC') require that each year and in respect of each taxpayer, entities that have made payments of capital income (in particular, dividends and interest) must make a declaration (called the imprimé fiscal unique or 'IFU') detailing the sums that were paid in the preceding year. In theory, any failure to complete an IFU is punishable by a fine representing 50% of the undeclared sums.

Complying with these provisions presents practical difficulties, in particular in connection with LBO transactions, in which part of the acquisition finance is often made up of convertible bonds. It is not clear whether the interest capitalized annually in relation with such bonds must be declared in the IFU filed by the debtor company.

The terms and conditions of convertible bonds obligations typically provide that:

(i) interest will be automatically capitalized, in accordance with the provisions of article 1154 of the French Civil Code, on each anniversary-date of the issuance of the convertible bonds, and

(ii) interest capitalized and accrued interest will only be paid to convertible bond holders on the date of conversion or repayment of those convertible bonds.

On that basis, it is reasonable to assume that interest capitalized on convertible bonds did not have to be declared each year in a company's IFU, since the cumulated interest claim on each anniversary-date is neither effectively paid to the convertible bond holder, nor registered in an individual current account in his name. The interest would only be paid at the time of conversion or repayment of the convertible bonds.

However, this approach has not been expressly confirmed by the French tax code or the administrative doctrine and consequently uncertainty remains, and is reinforced by the generally accepted rule that transfer into an account is equivalent to a payment.

The debtor company, which at the time of issuance of the convertible bonds recorded a debt for an amount equal to the convertible bonds' nominal value, for example 1,000 euros, must automatically increase (i.e., without the convertible bonds holder having to take any decision in this sense) the amount of his debt so as to integrate the accrued interest for the period on each anniversary-date of the issuance of the convertible bonds

For example on the first anniversary-date of the issuance of the convertible bonds, the amount of the recorded debt is equal to 1,000 + (1,000 x 10%) = 1,100 euros. On the second anniversary-date of the issuance of the convertible bonds, the amount of the recorded debt is equal to 1,100 + (1,100 x 10%) = 1.210 euros. And so on.

As a matter of practice, it has been recommended that the interest capitalized should be declared in the IFU, to avoid any risk of the 50% penalty being applied.

However, the tax authorities, in a letter recently sent to our firm regarding this issue, have expressly confirmed to us that (i) only the effective payment of the interest to the convertible bond holder for the first year would result in the establishment of an IFU on the income collected in the first year, and that (ii) it is not necessary to declare annually capitalized interest on the IFU.

This position is justified according to the French tax authorities both by the drafting of articles of the French tax code relating to the IFU (article 242 ter refers to the 'individuals paying the capital income' and article 49 E of the Annex III to the GTC refers to 'the individual collecting the income') and by the link that must be made between the date on which the interest that must be declared in the IFU arises and the taxation date of such interest received by a convertible bond holder liable to pay income tax (such holder would not be liable to pay income tax under the fiscal year of capitalization as long as the interest is not 'available' to him within the meaning of article 156 of the French General Tax Code; he would then only be liable to tax either at the time of conversion or repayment of the convertible bonds).

Ideally, the position taken by the French tax authorities should be formalized in order to put an end to the confusion arising from this issue during acquisition tax due diligences

Transfer of a foreign company's registered office to France

What are the tax consequences in France arising from the transfer of the registered office of a company incorporated in an EU Member State to France?

In a ministerial response "Buffet" of August 26, 2010, the French tax authorities have accepted that the transfer of the registered office of a company incorporated in another Member State of the European Union to France, along with the compliance of the company's articles of association with French legislation, does not result in the tax consequences ordinarily associated with termination of a business (notably the immediate taxation of the untaxed profits).

Subject to the tax consequences, if any, in the country the company was formerly resident in (in this case, Luxembourg), the French tax authorities have advised that the tax neutrality of such a transfer concerns the transferring company and its French shareholders.

This approach mirrors the approach taken, in the opposite situation, as set out in article 221-2 of the French tax code ('*The transfer of a registered office in another EU Member State, whether with or without a loss of the legal personality in France, does not have the consequences of a termination of business*').

Any contrary approach would have constituted a restriction to the freedom of establishment prohibited by article 43 EC.

Transfer pricing

Italian transfer pricing implementing rules: something to monitor

Italy recently introduced a transfer pricing documentation requirement (Law Decree No. 78 dated 31 may 2010). Implementing provisions were expected and have now been introduced by an administrative circular dated 29 September 2010 (reference 2010/137654).

The administrative circular covers both material and formal aspects of transfer pricing documentation.

Interestingly, specific rules are issued for given categories of taxpayers such as sub-holdings; Italian subsidiaries of foreign multinational groups; permanent establishments of non-resident companies, etc.

The administrative circular confirms the endorsement by Italy of the EU Transfer Pricing documentation principles; the documentation is composed of a Master file (that may be drafted in English) and of a country file (in Italian). It should be noted that the Italian rules go far beyond European or even recent OECD developments.

For example, the administrative circular states that taxpayers will have to build an argument when they are not relying on a CUP or another traditional method. The documentation set should also include precise and detailed disclosures on business restructuring and management services.

The administrative circular confirms the opportunity for taxpayers to communicate transfer pricing documentation relating to prior taxable years. Taxpayers willing to use this opportunity will have to notify the Italian tax authorities that they maintain proper documentation for those prior years, not later than 90 days following the publication of the administrative circular.

Maintaining appropriate transfer pricing documentation should enable taxpayers to avoid fines and criminal actions against directors in the case of any tax adjustments.

Clarification is still expected on the availability of such an option in relation to existing tax audits. Something to closely monitor.

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MAYER BROWN PARIS

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In Paris, the tax group is made of 16 lawyers who have acquired a strong reputation for the tax structuring of acquisitions (including due diligence) and LBO transactions, as well as the formation of private investment funds. The practice assists French corporate groups on all tax matters and tax litigations. Our breadth of expertise also covers patrimonial and personal tax advice, management and transfer of family groups and tax assistance to managers.

The Paris team also deals with transfer pricing issues and in doing so works with the European Transfer Pricing Centre in Brussels.

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