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Bank branches: the French VAT experience

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Any enterprise intending to conduct operations abroad and having a measure of permanency may select to form a subsidiary or a branch. Many reasons may lead any such enterprise to choose one of these solutions.

Everybody knows that the branch is not a body corporate separate from the head office, while a subsidiary has a genuine legal entity. The main merits of the branch are to be found in the fact that it is formed easily and that it may negotiate business with third parties which know that a legal relationship will be established directly with the head office and therefore do not need to contact such head office located in a foreign country, as the branch is an extension thereof.

But this is also the reason why, in certain cases, the formation of a subsidiary, in the form of a company limited by shares, may prove useful, in order to limit the members' liability to their sole contributions. However, the drawback is that operating rules shall be determined by domestic law.

Also, tax considerations weigh on the decision. Even though VAT is only one of the factors that will determine the final decision, VAT mechanisms may create material distortions, in particular when, as in the case of banking operations, the operators are partial taxpayers which are not entitled to recover all of the VAT levied on their expenditures.

Are the services that a head office and its branch may render to one another subject to VAT under standard rules?

Before courts had the opportunity to adjudicate on this issue, tax authorities had indicated, in a response given on 21 October 1979 to Member of Parliament Lauriol, that "*because a foreign enterprise and its French branch are one same legal entity, the services that they render to each other do not fall within the scope of VAT and are therefore not subject to VAT, provided that the French branch does not act in fact as an establishment that is independent of the foreign enterprise.*"

However, in a Timex Corporation decision dated 9 January 1981, No. 10145, the Conseil d'Etat found that the French branch of a US company that received a balancing transaction was not liable for VAT, "*because the amounts concerned were not paid by a third party in consideration for services rendered to it, because the head office does not have a specific interest in the continued operation of the establishment, in respect of which it is, in any event, liable vis-à-vis third parties, and because finally (…) no provision sets forth that tax is due in respect of services rendered to each other by economic entities, that are not separate legal persons and are run directly by the same company (…). Such transfers may only constitute contributions or withdrawals.*"

When interpreting the above decision, tax authorities indicated (answer dated 23 November 1987 to Member of Parliament Guéna) that "*an enterprise and its branch form the same legal entity. The transactions that they are conducting between each other are internal transactions that fall outside the scope of VAT as defined in Article 256 A of the French Tax Code. Such transactions therefore do not give a right to a deduction under Article 271 of such Code. Therefore, in the event of a loan granted by a French branch to its head office located outside the EEC, the interest paid may not be included in the numerator of the fraction serving to determine this French branch's deduction percentage when such branch also renders services to third parties. Such rules do not create any distortion, because they apply to branches of foreign companies as well as to branches of French companies.*"

This position was recently confirmed as follows by the Conseil d'Etat in a decision dated 29 June 2001: *"the interest paid by branches of a bank having no separate legal personality, in order to remunerate loans granted by the head office, do not constitute amounts paid by a third party in remuneration of a service. As the tax event is lacking, the interest charged by the head office does not amount to revenues falling within the scope of VAT and may therefore not form part of the numerator or denominator of the deduction percentage referred to under Article 212 of Schedule II to the General Tax Code (VAT prorata). Of no relevance are the facts that the branches are acting in an autonomous manner and that, in connection with the corporate income tax audits, tax authorities check the price of the services that the head office charges to its branches and that they add back, where applicable, the amount of any unclaimed interest."* (CE 29 June 2001, No. 176105, 9th and 10th s-s, SA Banque Sudameris: RJF 10/01 No. 1217)

How should the head office's right to a deduction be determined?

It is necessary to examine whether, in order to calculate its VAT deduction percentage (the numerator of which includes transactions giving a right to a deduction and the denominator corresponds to the total amount of revenues), the head office must take into account transactions made with its branches or use only the amount of transactions made by the branches with third parties.

What are the possible interpretations?

— It first seems excluded for the head office to calculate its deduction percentage by taking into account both the interest charged to its branch and the interest charged by its branch to its own clients, because either (i) the branch is autonomous and, in such event, its revenues are not to be taken into account for the calculation of the head office's deduction percentage; or (ii) the branch is considered as a mere extension of the head office located abroad, in which case, internal transactions have no impact on the deduction percentage;

— A minimalist approach would consist in taking into account only the revenues achieved by the head office with third parties, by excluding any transaction made by branches or between the head office and its branches. However, this would only be logical if the branch were to be considered as independent from the head office for VAT purposes.

— Another possibility would have consisted in taking into account transactions made between the head office and the branches for the reason that, even though branches are not independent for tax purposes, they are granted a certain autonomy for tax purposes as soon as they are permanent establishments. This reasoning requires a minimalist reading of the Timex decision, such reading assuming that the Conseil d'Etat merely intended to adjudicate on the tax rules applicable to subsidies (which, in any event, because of the Satam case law, are not services and therefore correspond to transactions falling outside the scope of VAT).

The above position had the merit of being in accordance with banking regulations applicable in most countries, under which any banking branch located in a country other than that of the head office must be approved and registered as a bank and must submit to all rules applicable to the host country's banks, including the obligation to be managed and led by an individual designated – and approved in that capacity – and having all required powers. In its accounts and financial statements submitted to the host country's central bank, the branch (or registered office) includes, albeit in certain cases in separate accounts, all accounts with the head office (or branch) among its "client" accounts.

Concretely, a banking branch is considered as an autonomous entity.

What is currently the case law of French administrative courts?

The inclusion of transactions between the registered office and the branch in the head office's deduction percentage was not admitted by the Conseil d'Etat which ruled against such a solution in the aforementioned Sudameris decision and found that the interest paid by a banking branch that is not a separate legal person in order to remunerate loans granted by the head office does not correspond to amounts paid by a third party in remuneration of a service. The Conseil d'Etat found that the interest paid by the head office does not correspond to revenues falling within the scope of VAT and may therefore not be included in the deduction percentage.

Sudameris was established in France and contended that, when branches have the nature of permanent establishments, the interest on loans granted to Latin American branches having no separate legal personality was to be included in the scope of VAT. The company relied in particular on rules applicable, as regards corporate income tax, to branches acting de facto as independent establishments and on the decision of the Monaco Revision Court according to which the deduction percentage of a foreign bank's Monaco branch was to be calculated on the basis of the Monaco establishment's sole revenues (Monaco Revision Court, 3 October 1995, No. 95/7, Chase Manhattan Bank, NA).

According to the *commissaire du government* (rapporteur before the Court), the only reason that may lead to a reversal of the Timex case law or at least to a referral to the Court of Justice of the European Communities in order to seek a preliminary ruling, consists in the fact that not all Member States of the European Community are applying the same rules in this area.

The application of this doctrine raises questions as to its validity in view of the provisions contained in the 6th and 8th Directives. However, the Conseil d'Etat has not found, in the Court of Justice's recent case law, any reason to think that the Court would include, within the scope of VAT, relationships internal to a company.

Another analysis might have prevailed, i.e. a global, worldwide, view of the deduction percentage. Such a solution would consist in including, in the head office's deduction percentage, the revenues earned by the branches (but not the revenues related to internal transactions between the head office and the branches). Such a theory has two major drawbacks:

— The first drawback, which is practical in nature, stems from the difficulty, for audit units, of checking the amount and nature of services rendered abroad, in particular in order to know whether such services grant a right to a deduction, because audit possibilities are reduced to nil for those countries that are not party, with France, to a treaty providing for assistance in tax matters;

— The second reason is linked to the fact that we may wonder whether, under general VAT rules, the percentage of VAT that may be deducted from expenditures made in France by the head office is to be influenced by transactions made outside of France by permanent establishments. However, in our opinion, such an aspect is not truly controlling in that, for instance, a loan may be made directly by the French head office to a client of its permanent establishment.

This being said, it seems to us that the global deduction percentage theory can find a solid basis in legal provisions as Article 19-1 of the Sixth Directive sets forth that the deduction percentage is the result of the relationship between the total annual amount of revenues related to transactions giving a right to a deduction and transactions that do not give a right to a deduction.

Also, Article 271-V-d of the French Tax Code sets forth that a right to a deduction results from "*those non-taxable transactions made in France by taxable persons, to the*

extent that they would grant a right to the deduction if their place of taxation were located in France."

This theory therefore seems to us to be that which is most in conformance with applicable provisions. It is also in line with economic logic, because indubitably the monitoring of branches generates costs at the head office's level, and this must be taken into account.

We must note that the "global deduction percentage" solution has not been submitted for review to the Conseil d'Etat which has therefore not adjudicated on its validity. In addition to the issue of the calculation of the head office's right to a deduction, it is also necessary to consider the exercise of the branch's rights to a deduction.

Deduction of expenditures incurred by the branch for the purposes of its head office

When a branch conducts transactions that are partly taxable, while rendering services to its registered office located in a foreign country, the determination of the rights to a deduction proves highly delicate. Indeed, the branch has two types of activities:

— on the one hand, the branch carries out transactions falling outside the scope of VAT by rendering services to the head office;

— on the other hand, the branch may have to engage in transactions falling within the scope of VAT when services are rendered to third parties.

If the branch only engages in transactions in favour of the head office, then it may exercise its rights to a deduction in respect of incurred expenses by applying the procedure provided for in the 8th Directive.

If the branch only engages in transactions intended for third parties, it is then subject to the general rules applicable to taxable persons and must deduct VAT on its VAT return by applying the same against VAT due in respect of transactions subject to VAT. Any credit arising as a result of this shall then be refundable under standard rules.

What happens when the branch engages in transactions in favour of its registered office and third parties?

In this respect, French tax authorities have devised an original solution. The branch must then create two separate sectors (Inst. 4 August 1983, 3 D-6-83), one of which covers "internal operations," while the other one is earmarked for "taxable transactions."

As regards the sector covering transactions falling within the scope of VAT (i.e. transactions made with third parties), the rights to a deduction are exercised in accordance with standard rules through the VAT return (C3 form) filed by the taxable person.

As regards internal transactions (transactions with the head office) which tax authorities consider as falling outside the scope of VAT, a refund under the 8th Directive procedure is only admitted as regards VAT related to movable property and services acquired by the establishment for the purposes of services rendered to its foreign head office and that such head office uses exclusively for the purposes of transactions granting a right to a refund in its home State.

The related tax should, in principle, be subject to the refund procedure organised by the 8th Directive (implemented under Articles 242-OM and 242-OT of Schedule II to the French Tax Code). However, tax authorities "admit" that such tax may be applied against the tax due in respect of VATable transactions or, in default, may be refunded under standard conditions, i.e. by being applied against VATable transactions made by the establishment.

However, such a possibility is subject to satisfaction of certain conditions:

— the branch must inform the local tax unit of its intent to rely on such measure;

— the branch must indicate the following on its purchasing invoices: “application of Articles 242-OM to 242-OT of Schedule II to the French Tax Code. Deduction made in connection with VATable transactions”;

— finally, a memorandum attached to the VAT return must include the following indications: nature of the goods and services acquired for the purposes of the foreign head office, name and address of the suppliers or service providers, invoices’ dates and numbers, amount of the related VAT that is deducted.

For goods and services common to the two sectors, tax authorities indicate that the deduction in respect of movable property and services is determined by applying the French establishment’s overall deduction percentage. However, for the determination of this percentage, tax authorities indicate that it is necessary to include in the denominator alone those internal transfers from the foreign head office that are related to movable property and services as well as to immovable property. Tax authorities admit that financial transfers from the head office may be included both in the numerator and denominator when they are made in exchange for movable property and services in respect of which VAT may be refunded.

The inclusion of internal transfers appears to be debatable, to say the least. We must indicate that this doctrine very much predates the publication of the SATAM-SOFITAM decisions providing for the exclusion of the revenues from the scope of VAT for the calculation of the pro rata percentage.

If the solution commented upon by tax authorities in their instruction seems disputable in several respects, such a position emphasises the contradictions existing between the solutions adopted in this area.

Indeed, while tax authorities and the Conseil d’Etat agree to negate the existence of transactions between the head office and the branch as regards the calculation of the right to a deduction held by the head office which may not include transactions made with its autonomous establishments, on the contrary, the existing doctrine recognises these establishments’ full autonomy when calculating the deduction rights of the branch, which must, in order to exercise such rights, calculate its own deduction percentage and include therein, where applicable, any internal transfers from the head office.

Only the solution of the global deduction percentage would provide a satisfactory answer, because the effects of globalisation are such in the banking and financial community that it would be an illusion to consider that expenditures incurred by a branch are only related to its own operations.

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