

# **New territorial rules for VAT banking and financial transactions: the French touch!**

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An article by the CMS VAT Group

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## New territorial rules for VAT banking and financial transactions: the French touch!

The French VAT rules applicable to banking and financial transactions are marked in France by a specific feature, which is also observed in certain other Member States: by making an election, as authorized by Council Directive 2006/112/EC of 28 November 2006 (Art. 135 and Art. 137 1 a and French Tax Code (CGI) Art. 260 B and 261 C), the taxpayer decides to subject certain exempted transactions to VAT.

This election has non-negligible merits for French bank or financial companies:

- improvement of their rights to deduct the input VAT incurred on expenditures borne by these banking and financial institutions for the purposes of their taxable transactions or for the purposes of the transactions that, although they are not taxable in France, would give a right to a deduction in France if their place of taxation were located in France (CGI, Art. 271 V d);
- limitation of the applicability to these operators of the tax on salaries, levied on all employers that are not subject to VAT on at least 90% of their turnover (CGI, Art. 231), in respect of the salaries paid to their employees. The salaries tax applicability ratio takes into account the revenues and proceeds that do not give a right to the deduction of VAT on all of the entities' revenues and proceeds.

It is necessary to pay special attention to the application of the new territoriality rules to services governed by Directive 2008/8 of 12 February 2008, combined with this special "French" VAT feature applicable to banking and financial institutions, principally as regards the impact related to the presence or operations in France of a permanent establishment of a foreign banking or financial institution.

### 1. French-style election scheme

The election for the application of VAT to these institutions may be made by credit institutions, investment service providers, and foreign exchange and discount operators (CGI, Annex III, Art. 70 sexies).

This election is comprehensive and thus causes the application of VAT to all relevant transactions carried out by the institution that made such election, i.e.:

- the granting, negotiation and management of loans, save for any interest or other remuneration likely to be assimilated with interest;
- transactions on commercial instruments, save for the discounting fees;
- transactions covering bank accounts and checks;
- transactions involving securities, except for the fees earned in connection with the issuance and placement of shares;
- remunerations earned by institutions authorized to collect funds in connection with peoples' savings schemes;
- issuance of restaurant vouchers; and
- factoring transactions.

However, other transactions are excluded from the scope of the election (CGI, Art. 260 C), i.e. primarily any insurance and reinsurance transactions.

The conditions applicable to the election were, in the past, very rigid, but have recently been relaxed by the French legislature: after being made, this election applies without any time limit, but may be terminated by the operator at any time effective from 1 January of the fifth year following the year in which the election was made.

## 2. Impact of territoriality rules

### 2.1. Prior to the coming into effect of Directive 2008/8

Banking and financial services were, as a matter of principle, it is the case for all services, taxable at the place where the service provider is established. However, as regards intangible services, which include banking and financial transactions, the place of taxation of the service was as follows:

- as regards B-to-B services: the place where the recipient is established, with payment of the VAT through the reverse charge procedure, if the recipient is established in a EU Member State;
- as regards B-to-C services: the place where the service provider is established, in the case where the recipient is established in a EU Member State.

Under these rules, tax authorities had indicated that the election for the application of VAT to banking and financial services could apply only to the services supplied by a service provider that had made the election in France and only as regards transactions whose place of taxation was located in France.

Accordingly, the election made by an operator established in France for the taxation of its banking and financial services could not have any impact:

- on the services supplied to clients established outside of France, where such services were not territorially taxable in France; or
- of course, on the treatment of the banking and financial services acquired by this French operator, from another operator established outside of France and in respect of which it had been appointed as the person liable for the payment of VAT through the taxpayer inversion mechanism (administrative documentation 3 L 52 No. 9 to 11).

In other words, the election for the application of VAT to banking and financial transactions could only concern those services supplied to French clients or to non-taxable clients established in other Member States.

When the same services were supplied to a taxable client established in another Member State or outside the European Union, such services were in principle VAT exempt.

But the corresponding turnover could be included in the numerator and the denominator of deduction prorata when such turnover corresponds to transactions that would have given a right to a deduction (because of the election), if they had been taxable in France (CGI, Art. 271 V d).

### 2.2. Since 1 January 2010

Taxation at the place where the recipient is established has become the general rule as regards B-to-B transactions, while B-to-C transactions remain, save for exceptions, taxable at the place where the service provider is established.

As was the case in the past, banking and financial services continue to be non-taxable in the Member State where the service provider is established when the client's place of establishment is located outside the European Union (ruling No. 2010/10 of 23 February 2010).

However, as regards the legal effect of the election and its impact on taxation rules, fresh issues have been raised in connection with the new rules, in particular because of the rules concerning the designation of the person liable for the payment of VAT.

### 3. Designation of the person liable for the payment of VAT: role of the head office and the permanent establishment

As regards relationships between taxable persons (B-to-B), the principle according to which the service is taxable at the place where the recipient is established is applied along with the inversion of the taxpayer.

Indeed, Article 196 of Directive 2006/112, as amended by Directive 2008/8, sets forth that VAT is due by the taxable person or by the legal person not taxable VAT but registered for VAT purposes, to which the services referred to in Article 44 are supplied, if such services are supplied by a taxable person which is not established in the said State.

Under Article 192 bis, a service provider subject to VAT, having a permanent establishment on the territory of the State in which the tax is due, is deemed not to be established in the said State (as regards the appointment of the taxpayer), if the said establishment does not participate in the supply of goods or services taxable in the said State.

In other words, when taxable person A, having its head office in the United Kingdom, supplies a service to client/taxable person C, established in France, where A has a permanent establishment B, the person liable for the payment of VAT in France is client C, if the permanent establishment B does not participate in the supply of the service, while the permanent establishment must pay VAT if such permanent establishment contributes to the supply of the service.

In principle, Member States have agreed that a permanent establishment participates to the supply of a service (or to the delivery of the goods) if its resources are used in order to carry out the transaction, whether before, during or after its performance, regardless of the importance of the means that have been actually deployed. There is no derogation to this rule, except where the establishment only carries out administrative tasks related to the service, such as the issuance of the corresponding invoice. France complies with this guideline.

It is necessary to note that rules are different when client C is established in the Member State in which the service provider's head office is also established (case where A is located in France and has a permanent establishment B in the United Kingdom): in such case, A is always the person liable for the payment of VAT, whether or not A participates in the performance of the service supplied to C (head office's attraction rule).

#### **What is the impact of an election for the taxation of services, such as the election applicable in France to banking and financial services?**

Insofar as head office A and its branch B constitute one single legal entity, it has been possible to consider that a banking or financial service taxable in France (because the taxable client is based in France) was to be taxed in France because of the election made in France by the service provider, whether such service provider is the head office or the permanent establishment.

However, such an analysis might have entailed a change in the VAT rules applicable to the services supplied from a foreign country to a client who is a French taxable person. Therefore, French tax authorities have defined a different approach: even where the supplier is established in France where the service is taxable, the election made in France has no impact on the rules applicable to transactions made from a structure established outside of France. These transactions are VAT exempted.

However, French tax authorities have indicated that a separate election would allow for the application of VAT to these services in France.

Let us go back to our examples:

- a financial service is supplied to French client C by the head office A of a UK bank having in France a permanent establishment B that has made an election for the application of VAT to banking and financial services. B participates marginally (e.g. placement of an order) in the production of the service. Nevertheless, if no election is made by A in France, then the service is VAT exempted. In practice, neither permanent establishment B (participant) nor client C owe any VAT in France in respect of this transaction (ruling No. 2010/03 of 26 January 2010); a financial service supplied to French client C by a permanent establishment B, located in the United Kingdom, of a bank (A) whose head office (attraction rule) is located in France, has made in France an election for the application of VAT to its services. If no election is made by B in France, then the service is VAT exempted. In principle, neither the French head office A (attraction principle), that made the election, nor the recipient/taxable person C are liable for the payment of VAT.

**Is the turnover earned from a foreign country transferred to the head office (attraction) or to the permanent establishment (participation)?**

This question is not trivial: we have recalled that the merit of the “French-style” election related to the application of VAT to banking and financial services has the following merits: (i) it allows for the deduction of VAT levied on input expenditures contributing to the carrying out of the relevant transactions; and (ii) it reduces or even eliminates the salaries tax applicable in France to all employers which are not subject to VAT on at least 90% of their turnover.

The turnover made from a foreign country must (when the client/taxable person is established in France) be deemed transferred to the head office or the French establishment because of the application of the head office attraction rule or the permanent establishment’s participation rule. Such transfer may also have an impact on the determination of the VAT prorata and the tax on salaries (calculation of the applicability ratio) due by the head office or establishment located in France.

Such is not the case: indeed, tax authorities have indicated that the turnover earned from a foreign country has no impact on the determination of the prorata calculated by the head office or the permanent establishment located in France or its position as regards the tax on salaries (ruling No. 2010/03 of 26 January 2003).

Such position of tax authorities is favorable in the case where the transactions carried out from a foreign country are VAT exempted.

## 4. New obligations

The obligations incumbent on banking and financial institutions should not be materially increased under the new rules. However, in all cases where these institutions have branches in various Member States of the EU, their accounting systems must distinguish the services according to whether they are supplied from the head office or from one of the permanent establishments.

The invoicing may be physically made from the head office or from the permanent establishment, regardless of the place of taxation of the service and the identity of the taxable person designated as the person liable for the payment of VAT.

On the contrary, when the person liable for the payment of VAT is the head office or the French permanent establishment (because of the head office’s attraction or the permanent establishment’s participation), tax authorities have indicated that the identification number that must be indicated on the invoice is the number of the person liable for the payment of VAT, i.e. the FR number of the head office or the French permanent establishment, even where the service is supplied from a foreign country (BOI 3 A-1-10, instruction of 4 January 2010, No. 212).

However, please note that taxable persons are not required to prepare an invoice as regards VAT exempted services supplied to taxable persons.

Finally, we must recall that taxable persons are required to file a recapitulative statement of services only as regards services supplied by them to a taxable person established in another Member State of the European Union in which the client is liable for the payment of VAT.

**For further information on this tax analysis and thought, please contact:**

Anne Grousset  
Partner – CMS Bureau Francis Lefebvre  
T +33 1 47 38 55  
E [anne.grousset@cms-bfl.com](mailto:anne.grousset@cms-bfl.com)

Elisabeth Ashworth  
Senior Associate – CMS Bureau Francis Lefebvre  
T +33 1 47 38 42 96  
E [elisabeth.ashworth@cms-bfl.com](mailto:elisabeth.ashworth@cms-bfl.com)

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