

**UNIVERSITÉ DE MONTPELLIER**  
**FACULTÉ DE DROIT**

**MASTER II DROIT DU COMMERCE INTERNATIONAL**

**Dissertation**

**TAXATION OF WARRANTY SERVICES IN SHARE PURCHASE AGREEMENTS :  
A PURCHASER'S PERSPECTIVE ON A PRACTICAL INNOVATION**

Under the supervision of Pierre MOUSSERON, Professor at the University of Montpellier



Léa CRUCIANI

*2024-2025*

*I would like to express my sincere gratitude to Maître Henri Bitar and Maître Christian Guichard for their expert guidance and invaluable perspectives on tax law, which significantly deepened the intellectual framework of this work.*

*I also wish to thank Professor Pierre Mousseron for his continued support and implication throughout the supervision of this dissertation and for the foundational concept that initiated this research.*

*Furthermore, I would like to acknowledge the dedication of Professor Mousseron and Mrs Aurélie Brès to the Master II students throughout the year, demonstrating a profound commitment to the dissemination of knowledge and the cultivation of highly skilled legal practitioners.*

*Finally, I am grateful to each of my classmates for their friendship and the supportive environment we fostered over the past two years, hoping our paths continue to cross in the future.*

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## List of Abbreviations

Abbreviation

Definition

|       |                                          |
|-------|------------------------------------------|
| BOFIP | Bulletin Officiel des Finances Publiques |
| ECJ   | European Court of Justice                |
| GTC   | General Tax Code                         |
| M&A   | Mergers and Acquisitions                 |
| VAT   | Valued Added Tax                         |

## INTRODUCTION

*Scope of study.* This dissertation aims to analyze the tax implications of the purchase of a warranty in the context of a share purchase agreement, from the point of view of the buyer.

### A. Representations and Warranties clauses

*Contractual warranties as a substitute for the law.* When acquiring all or part of a company's equity interests, the dissatisfied purchaser has access to legal and contractual mechanisms to challenge the transaction. But as businesses operate in a "society of risk,"<sup>1</sup> which justifies the implementation of strategies to prevent the occurrence of damage, the law proves largely insufficient to fully protect the acquirer of equity interests or shares. Beyond a simple transfer of shares, it is an entire complex economic structure, resulting from the intertwining of assets, liabilities, and obligations, that passes into the hands of the purchaser.

This inadequacy of the law and general sale mechanisms has led to the emergence of the practice of inserting protective clauses or guarantee agreements for the benefit of this acquirer.

*Terminology and function of warranties.* These contractual mechanisms are commonly referred to as Representations and Warranties in English written contracts. They enable the purchaser to invoke the warranty in cases where a company's liabilities increase, or its assets decrease due to events with a cause predating the transaction but discovered only afterward. Representations are statement of fact; they are what the seller declares is existing at the time of the contract. These declarations serve to clarify the content of the parties' consent to the deed<sup>2</sup>. Warranties correspond to the guaranty that will be provided in the case of misrepresentation.

*Forms and typology.* These warranties are generally included in the sale agreement in the form of clauses declaring the content of the assets or liabilities of the transferred company; however, they can also take the form of liability warranties (Representations and Warranty clauses), within which a distinction can be made between value guarantees (price reduction) and indemnity warranties (compensation).

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<sup>1</sup> U. BECK, *La société du risque. Sur la voie d'une autre modernité*, trad. L. BERNARDI, (1986), 2004, Champ, Flammarion

<sup>2</sup> P. MOUSSERON, *Les Conventions sociétaires*, LGDJ 2e édition

To simplify the scheme, those warranties can benefit the company whose shares are being transferred through a stipulation for the benefit of a third party, the latter being external to the transfer agreement. In this case it would have to be an indemnity warranty. However, the warranties can also directly benefit the acquirer, in that case they are most of the time price reduction warranties.

When the warranty directly indemnifies the acquirer, it effectively leads to a price revision clause within the share transfer agreement. The warranty mechanism thus remains intrinsically linked to the transfer agreement itself, a point emphasized by Mr. Germain: “We are then in an original hypothesis where the guarantee is not externalized in an external guarantee, but is an integral part of the fundamental element of the contract, which is the price”<sup>3</sup>.

***Voluntary externalization of the warranty.*** The warranty can, however, be voluntarily externalized into a legal act distinct from the transfer agreement, expressly referring back to the main transfer agreement. It is precisely this specific hypothesis that we will focus on in this study<sup>4</sup>. Consequently, two main options arise when structuring the transaction:

- Either stipulate that the share transfer agreement is concluded under the condition precedent of the signing of the warranty, which is attached as an appendix to the transfer agreement.
- Or integrate the warranty directly into the transfer agreement upon signing. In this case only formal ratification will be required on the closing date.

## **B. Definition of a Warranty Service**

***Focus on a specific new form of warranty.*** Our study will focus on the hypothesis of contractualizing a warranty that differs from those typically encountered. Indeed, it is appropriate to consider here a warranty that comes in addition to the transfer of equity interests and would be considered a genuine service in its own right, akin to a warranty in insurance matters.

***Contractual isolation of the warranty.*** It is therefore necessary to imagine a warranty that the

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<sup>3</sup> M. GERMAIN, Conclusion, Gazette du Palais, May 20, 2010, P. 97

<sup>4</sup> Those external warranties exist and can take different forms that we don't need to develop in our study, but might include: Extracontractual warranties (outside the share transfer agreement); Representations and Warranties given by a third party ; External Financial warranties ; or Warranty and Indemnity Insurance

parties intended to be completely *autonomous*<sup>5</sup> from the main transfer agreement, although it remains an undeniable economic accessory to it.

Specifically, in this hypothesis, the transfer of equity interests is stipulated with a determined price without incorporating a warranty mechanism, and the warranty as a service will be the subject of a separate contract, with its own price that the purchaser will pay specifically for this additional protection. This constitutes an innovation and gives a different perspective compared to classic and standard warranties, where the transfer price is negotiated between the parties, more or less taking into account the risk associated with the target company's liabilities.

Therefore, at the point of the transfer, the purchaser would make two distinct payments, each reflecting a separate contractual agreement: one payment for the share transfer price and another, supported by its own invoice, specifically for this newly conceived, independent Warranty Service. Those two payments have different objects, the first one being the sale of shares and the second one being the warranty.

***Illustration of the Warranty Service.*** For example, the parties may, in the exercise of their contractual freedom, stipulate a share purchase price of one million euros and conclude this transfer agreement. In parallel and simultaneously, the purchaser will have the option to acquire the guarantee by signing another complementary contract for a certain price like fifty thousands euros, whereby the seller (or a third party) undertakes to indemnify the purchaser or to reimburse the difference between the value of the shares as agreed and the actual value of these shares after the disclosure of a liability predating the transfer, or an overvaluation of assets. It should be specified that the price of the warranty will be negotiated between the parties according to the estimated extent of the risk and the duration of the warranty.

***No consequences in company law matters.*** Despite a separate act, the courts consider, out of concern for the protection of the buyer, that this act formed a whole with the transfer act itself<sup>6</sup>. The same would probably apply to the Warranty Services. Indeed, the fact that the warranty might be established in a separate document is unlikely to alter this qualification, as the essential consideration is its participation in the overall economic purpose of the transfer and its place within a framework of reciprocal obligations.

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<sup>5</sup> The word 'autonomous' is used for illustrative purposes only and should not be understood in the sense of Article 2321 of the French Civil Code, which presupposes an obligation undertaken by a third party.

<sup>6</sup> Cass. 1e civ. 20 September 2012 n° 11-13.144 (n° 931 F-D), *Abihssira c/ Sté Amidis et Cie*

### C. Tax implications

*Focus on taxation of the payment of the warranty.* However, the study of the taxation of this warranty remains pending. It will be appropriate to specifically consider the hypothesis of the purchase of shares by a holding company and not a natural person in order to simplify the study and allow for the accounting treatment of the payment of this warranty.

Therefore, for clarity and precision, our analysis will concentrate exclusively on the tax treatment of this guarantee at the time of agreement and payment, deliberately excluding its implementation. This complex area, which has not been explored in existing literature to our knowledge, necessitates a separate and comprehensive investigation.

It will therefore be appropriate to examine the tax implications that a warranty thus stipulated and potentially qualified as a “service” has in terms of direct taxes (Corporate Income Tax) and indirect taxes (VAT, Registration Duties) for the buyer only.

*Objectives of the fiscal study.* It will notably be appropriate to study whether such a warranty can produce the expected effects in tax law and analyze whether such a conventional arrangement is potentially more or less fiscally advantageous for the purchaser of the shares who would also be the beneficiary of the warranty.

## **PART I: DIRECT TAXES: ADVANTAGEOUS TAX DEDUCTIBILITY AND INTEGRATION IN ACQUISITION COSTS**

In our scenario, since the purchaser spends separate money to obtain a Warranty Service in addition to the transfer of shares, it is necessarily an expense, which might have the advantage of being deductible from the taxable income (A) ; but in comparison with standard Representations and Warranties, it might also have an impact on the value of the purchased shares in the books of the purchaser (B).

### **A. Deductibility of the tax**

#### **1. Arguments in favor of the deductibility**

The warranty as a service bought by the purchaser, which we will consistently consider to be a holding company, constitutes a supplementary expense, which leads to the analysis of this expense as a deductible charge from the tax result.

***General conditions for tax deductibility.*** Article 39 of the General Tax Code essentially lays down five general conditions for the deductibility of taxes in the context of calculating the taxable profit of companies.

***Reduction of the net assets.*** Firstly, the expense must necessarily reduce the company's assets, thus reducing its net worth. In our hypothesis, the money spent to pay for the « subscription » to the warranty may come directly from the cash flow or will be added to the debt that the holding company may have incurred, as is usually the case, to acquire the shares of the target company. Thus, to return to the first example, the acquirer will have taken out a loan for the principal amount of the transfer (€1 million) to which is added the loan for the amount of the guarantee (€50,000, for example).

***The company's interest.*** Secondly and most importantly, the expense must be incurred in the company's interest. This means that they must relate to "normal management" (expenses that are neither excessive nor fictitious) of the company. In the present case, there is no doubt that the principle of purchasing a warranty is an expense incurred in the company's interest because it aims to protect against the decrease in assets that notably constitute the shares of the company.

***Recommendation.*** Nevertheless, the parties wishing to take advantage of this possibility should ensure not to stipulate an excessively high price for the warranty so as not to incur the wrath of the tax authorities who might see, at least in part, an excessive or fictitious expense, potentially re-integrating a portion of the warranty paid as non-deductible because it would have been artificially separated from the share acquisition price.

The other conditions for deductibility, such as justification and the fact that the expense must not be prohibited by tax law, do not pose a problem.

***Analogy with insurance premium expenses.*** By analogy with the payment of an insurance premium, in principle, the amount paid for the guarantee should be deductible, provided that this expense is incurred in the interest of the company, of the business operation, in other words, when they are intended to cover a risk, whose realization would create a certain loss or expense, as such capable of being deducted from profits.

This is the case when the premium guarantees the company against the loss of asset items.

***Application to the Warranty Service.*** In our case, this warranty does indeed prevent the risk of devaluation of the shares. These same shares being recorded as assets of our acquiring company, they constitute an asset whose value would decrease in the event of realization.

***Timing of the deduction.*** The tax year for the deduction of premiums is in principle the one during which they accrued. Thus, deductible premiums are related to the result of the current tax year at their due date.

However, when the period for which the risk is covered does not coincide with that of the tax year (case of premiums payable in advance), the rule of matching expenses to the correct accounting period leads to deducting the insurance premiums paid by a company according to the accrual rule and therefore to carrying to an "Accrued Income" (Régularisation Actif) account the amount of premiums corresponding to the coverage acquired for the following tax year.

***Application.*** In the present case, we believe that the deduction of this expense should not pose a problem as the warranty will be valid and will cover a real risk of the disclosure of a liability from the date of transfer of the shares.

## 2. The risk of requalification by tax authorities

***Risk of integration with the share acquisition cost.*** Despite the analogy with insurance premiums, tax authorities and judges are not bound by the qualification given by the parties. They might argue that the cost of this Warranty Service is not a deductible operating expense but rather an integral part of the overall cost of acquiring the shares. This would most likely be the case if the parties don't make it clear enough that the warranty is bought in addition to the transfer of shares that could have been performed without the warranty.

***Capital expenditure and non-deductibility principle.*** As established earlier, the purchase price of shares is generally considered a capital expenditure, which is not immediately deductible from taxable profit. Instead, it is added to the cost basis of the shares and only affects the taxable result upon their subsequent disposal.

***Argument for integration based on the warranty's purpose.*** Tax authorities could contend that the primary purpose of the warranty, even if contractually separated, is to protect the value of the acquired shares from pre-acquisition liabilities or diminution of assets. This protection is inherently linked to the acquisition itself and thus could be treated as an additional cost of acquiring the capital asset (the shares).

They might argue that the economic reality of the transaction is a single acquisition of shares with a built-in protection mechanism, regardless of the separate contractual documentation.

***Consequences.*** This would eliminate the immediate tax benefit that the acquiring holding company might have hoped for by treating it as a deductible expense. Instead, the cost would be integrated into the acquisition price of the shares, thus only potentially reducing any capital gains (or increasing capital losses) realized upon a future disposal of those same shares, aligning its tax treatment with the underlying capital asset.

***Importance of clear contractual justification.*** To mitigate the risk of requalification, it will be crucial for the acquiring holding company to clearly and convincingly demonstrate the distinct economic substance of the "Warranty Service" as a separate risk mitigation service, genuinely independent of the share purchase price negotiation. This would require robust contractual documentation and a clear articulation of the economic rationale for the separate pricing and the service provided by the warranty.

## **B. Impact on the tax basis of the acquired shares**

***Separate payment and potential impact on acquisition cost.*** The distinct contractual arrangement and allocated cost of the Warranty Service raise the question of whether this separate payment influences the tax basis of the shares acquired by the holding company for capital gains tax purposes.

***Taxable gain.*** Under French Tax law, the capital gain is calculated as the difference between the sale price and the acquisition cost (150-0 D, 1 of the GTC). This acquisition cost must in all cases be increased by the acquisition costs personally paid by the taxpayer, which is the seller, as the “transferor” of the shares (which is in our case, the previous purchaser of the shares and the Warranty Service).

The central point of the issue lies in whether the tax authorities will view the separately priced warranty premium as an integral acquisition cost. Economically, this warranty serves to secure the original acquisition, and would suggest its incorporation in the acquisition price. The fact that it has a distinct price from the transfer of shares could allow the purchaser to include it in as an acquisition cost, which would not be possible with a standard Representation and Warranties that doesn't have a distinct treatment and price.

***Risk of distinct treatment.*** However, there is still a risk that tax authorities exclude the integration of the warranty price from the acquisition cost. In that case the reseller would be compelled to fiscally record the shares at their “gross” acquisition price, the amount specifically paid for the equity interests themselves.

***Higher taxation on capital gains.*** This separate treatment could impact the calculation of future capital gains tax in the eyes of tax authorities. If the warranty premium is excluded from the acquisition cost, the difference between the acquisition cost and the sale cost would be higher.

This would be disadvantageous for the purchaser-resaler as it would result in an economically higher taxation on capital gain than if the warranty would have been taken into account, despite the specific payment that was originally done for the warranty.

Given the tax administration's current tendency to interpret rules in a way that maximizes tax revenue, there is a risk they might favor this separate treatment, even if it wouldn't align with the economic reality<sup>7</sup>.

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<sup>7</sup> While our hypothesis posits a distinct warranty service, its inherent economic contribution to securing the shares' acquisition value suggests it should, in our view, be integrated into the acquisition cost for tax purposes. This approach would not only be more advantageous for the original buyer of the warranty but also more accurately reflect the economic reality of the expense incurred directly for the share acquisition.

## PART II: INDIRECT TAXES: TAX EXEMPTION AND PREDICTIBILITY

This second part will now turn its attention to the potential indirect tax consequences. Specifically, it will analyze the Value Added Tax (VAT) treatment of this distinct Warranty Service (A) and its impact, if any, on registration duties applicable to the share transfer (B).

### A. Value Added Tax implications

**Definition of Valued Added Tax.** Value Added Tax (VAT) is a general tax on consumption and therefore applies to the use of individuals' income specifically, to consumer spending in France on goods or services, whether of domestic or foreign origin.

Although the total amount of VAT is, in principle, equivalent to what would result from a single tax levied at the final stage of consumption, it is in fact collected at every stage of the economic chain.

**A European tax.** Although originated in France in 1954, VAT is now governed at the European level. The current framework is established by the VAT Directive 2006/112, as amended in 2008, which superseded the well-known "Sixth Directive" of 1977. This European framework grants jurisdiction to the European Court of Justice to rule on VAT-related issues faced by businesses. In fact, the ECJ has significantly contributed to the development of the VAT system.

**Scope of application of the VAT.** VAT is applicable to the supply of goods and the provision of services carried out for consideration by a taxable person acting as such (General Tax Code art. 256). In other words, professionals must charge VAT on the sales they make, whether these involve goods or services.

**The taxable person.** VAT applies to sales of goods and services only when a taxable person (a VAT-registered business or individual acting in a business capacity) carries them out (General Tax Code, art. 256 A).

This rule excludes transactions made by regular individuals managing their private assets. However, the definition of a taxable person is broad. It includes anyone who independently carries out economic activities like production, trade, or providing services, regardless of their legal structure (e.g., sole trader, company).

**The onerosness.** According to both settled case law and administrative doctrine, for an indemnity to fall within the scope of VAT, it must meet the test of "onerousness", meaning that there must be a direct link between the payment and a service rendered for the benefit of the party making the payment<sup>8</sup>.

By contrast, where the indemnity solely aims to compensate for a commercial loss or damage, even if foreseeable or recurrent, the payment is deemed to be outside the scope of VAT. This principle is especially relevant in the context of warranties.

The European Court of Justice clarified the condition and notion of "onerous supply" in its Apple and Pear Development Council decision<sup>9</sup>, which was later incorporated by the Conseil d'Etat in its Codiac ruling<sup>10</sup>. Two conditions must be met for a supply of services to be deemed made for consideration:

- The service must be provided directly to a clearly identified beneficiary, and
- There must be a necessary link between the benefit received by the beneficiary and the payment made to the provider-in other words, a genuine quid pro quo.

## 1. The transfer of shares

### a. Absence of taxation of the transfer of shares

**Explicit legal exclusion.** Article 261 C of the General Tax Code specifically excludes certain banking and financial operations from the scope of VAT, including "operations other than those of custody and management relating to shares, interests in companies or associations, bonds and other securities [...]".

It follows that the transfer of shares, regardless of the parties' status and their economic activity, will always be VAT exempt. Thus, the price received for the securities can never be invoiced with VAT.

This rule is also found under Article 135(1)(f) of Directive 2006/112/EC. The European Court of Justice has consistently refused to categorize the mere acquisition and holding of shares as an

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<sup>8</sup> BOI-TVA-CHAMP-10-10-10, TVA - Champ d'application et territorialité - Opérations imposables en raison de leur nature - Condition de lien direct pour les opérations réalisées à titre onéreux, in Bulletin Officiel des Finances Publiques.

<sup>9</sup> European Court of Justice, 8 March 1988, case 102/86, Apple and Pear Development Council

<sup>10</sup> Conseil d'État, Section, 6 July 1990, 88224

economic activity, holding that companies engaging in such operations must be considered as merely managing an investment portfolio in the same way as a private investor.<sup>11</sup> The French administrative doctrine adopts a position consistent with the European Court of Justice's case law, excluding the transfer of shares from VAT.

***Non-taxation of Representations and Warranties.*** According to authors, the standard Representation and Warranties clause, being closely linked to this exempt transfer, logically follows the same tax treatment.<sup>12</sup>

***The absence of a direct and reciprocal link: the warranty is not the counterpart of a service.*** Moreover, standard Representations and Warranties clauses do not seem to fulfill any of the legal and pretorian criteria. At the moment of the payment of the price of the shares and when the warranty is triggered, there is habitually no service rendered and therefore no direct link between the payment and a benefit received.

b. The deductibility of the expenses related to the acquisition of the shares

At first glance, common sense would suggest that expenses incurred and subject to VAT from third parties, in order to carry out a VAT-exempt operation such as the acquisition of shares, would not be deductible. However, the European Court of Justice has developed a body of case law going against this interpretation.

***Deductibility.*** In its *Cibo* ruling dated 27 September 2001<sup>13</sup>, the Court of Justice ruled that expenses incurred by an actively managing holding company during the acquisition of control of target companies form part of its general overheads and have a direct and immediate link with its entire economic activity.

The Court thus ruled that the VAT relating to these expenses is fully deductible if the holding company and purchaser only carries out activities taxable for VAT, such as providing intra-group

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<sup>11</sup> European Court of Justice, 29 April 2004, case 77/01, EDM; European Court of Justice, 20 June 1996, case 155/94 Wellcome Trust

<sup>12</sup> L. CHATAIN Conventions de garantie et fiscalité, Bulletin Joly Sociétés n° 10, octobre 2009, dossier n° 184 p. 905 : “En d’autres termes, les indemnités sont hors champ d’application de la TVA et les opérations de cession de titres sont des opérations exonérées de la TVA.”

<sup>13</sup> European Court of Justice, 27 September 2001, case 16/00, *Cibo Participations*

management services (management fees). If not all of its activities are taxable, the VAT deduction would be subject to a pro-rata calculation.

The French tax authorities have acknowledged this case law and incorporated it into their official documentation<sup>14</sup>. The Conseil d'Etat also follows this precedent.

**Expenses.** These expenses can, for example and most commonly, be audit fees, legal and tax consultation fees, or any other expenses that will serve to finalize the sale. These expenses ensure the growth and sustainability of the company.

**Actively managing holding company.** At this stage, it is necessary to precise what the tax authorities consider an actively managing holding company and why this qualification is necessary to authorize the right to deduct VAT. Indeed, only a person subject to VAT (therefore charging VAT to third parties) is likely to be able to, in return, deduct the VAT on expenses incurred within the framework of their economic activity. This is the cornerstone. The holding company must be involved in the management of its subsidiaries, going beyond mere passive holding of shares, the involvement implying the realization of transactions subject to VAT<sup>15</sup>. This active involvement typically includes providing administrative, financial, commercial, or technical services to its subsidiaries that are subject to VAT.

The Société Lagardère SCA decision of the Conseil d'Etat of the 13<sup>th</sup> of December, 2017<sup>16</sup>, distinguishes:

- Mixed holdings (exercising a VAT-taxable economic activity in addition to managing participations) that occasionally invoice expenses to their subsidiaries are subject to VAT on this refactoring if it constitutes an "onerous" service for VAT purposes and the holding company's intervention is not artificial.
- Pure holdings that punctually invoice expenses to their subsidiaries are not considered taxable persons for this invoicing operation, even if it presents the characteristics of an "onerous" service.
- Holdings that invoice expenses to their subsidiaries on a permanent basis have the status of a taxable person in this respect, even if they do not carry out other permanent economic

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<sup>14</sup> BOI-TVA-DED-20-10-20, Droits à déduction - Détermination des droits à déduction - Coefficient de taxation, in Bulletin Officiel des Finances Publiques n°480 and 490

<sup>15</sup> European Court of Justice, 14 November 2000, case Floridienne S.A. – Berginvest S.A.

<sup>16</sup> Conseil d'État, 9<sup>ème</sup> - 10<sup>ème</sup> chambres réunies, 13 December 2018, 397580

activities, provided that the refinancing operations present the characteristics of an "onerous" service for VAT purposes.

Thus, whether mixed or not, a holding company that invoices VAT to its subsidiaries and is really implied in their managing, is subject to VAT, which allows it to deduct the VAT on acquisition expenses. This reasoning will be helpful when applying VAT rules to the payment of the Warranty Service.

## **2. Taxation of the Warranty Services**

*Premise.* It is important to recall that this study centers on the hypothesis that the seller provides the purchaser with a service distinct from the sale of shares, and this service is the provision of a warranty. This distinction arises from a specific contractual structuring of the warranty, whereby the parties have intentionally decided to treat the warranty as separate from the share sale. This means that in this case the seller will send a separate invoice for the warranty with its specific price.

Thus, here the parties explicitly chose to ensure that the warranty is not considered accessory or ancillary to the transfer of shares, thereby preventing it from automatically following the same VAT regime as the share transfer, namely being outside the scope of taxation.

This separate treatment has implications for VAT. However, it is important to note that tax authorities and courts are not bound by the parties' designation and could potentially, as in corporate tax matters, reclassify the guarantee as following the VAT regime of the share transfer. Realistically, though, the tax authorities might not have an interest in doing so, given their general inclination towards taxing a wider range of transactions. Therefore, a pragmatic view might be that if VAT is willingly collected on this guarantee, the tax authorities are unlikely to refund the amount paid to the Treasury.

Thus, it should be examined whether the parties can actually choose to distinguish the share price from the warranty price to apply VAT.

a. The Warranty Service as a guarantee

**Exemption for guarantees.** Article 261 C 1° b) of the French General Tax Code (CGI) also expressly exempts from VAT "the negotiation and assumption of commitments, suretyships and other securities and guarantees, as well as the management of credit guarantees carried out by the person who granted the credit."

This exemption constitutes an extension of the VAT exemption for financial operations in the preceding paragraph and has a very broad scope, covering all operations relating to the establishment of guarantees.

The status of the guarantor thus appears irrelevant to the qualification of a guarantee. The guarantor does not have to exclusively exercise an economic activity consisting of granting guarantees. The determining criterion is the nature of the operation itself, favoring a pragmatic approach in tax law.

**Examples.** Specifically exempted under this provision are guarantee fees, endorsements, *ducroire* commissions, and documentary credit confirmations<sup>17</sup>. However, the exemption is reserved for financial operations with a financial compensation.

The BOFIP (Official Administrative Tax Guidelines) does not provide further information to help in this qualification.

**Application.** Thus, the crucial question lies in the qualification of our Warranty Service as a "guarantee" in the sense of tax and financial law. *A priori*, given the broad scope of this exemption, it would seem that it does indeed constitute a guarantee within the meaning of the aforementioned article. This interpretation is supported by the irrelevance of the status of the party granting this guarantee or commitment.

It follows that in our case, the parties who distinguish the service from the transfer of shares should nevertheless not charge VAT on the price of the Warranty Service. One can indeed consider that this amount will be exempt from VAT, unless a contrary legal analysis of the guarantee's qualification prevails.

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<sup>17</sup> I. LARCHER, *Mémento TVA*, 24-25, Éditions Francis Lefebvre, n°76540

It also follows that even if the tax authorities were to consider this operation as accessory to the transfer of shares, the outcome would be the same and does not seem likely to generate excessive litigation. Indeed, if the warranty is reclassified as accessory to the transfer, it will be exempt from VAT, which will also be the case if it is distinct from the transfer.

Exemption will therefore be favored under the law in both scenarios, but on different grounds.

b. The Warranty Service as a “sui generis” service

(i) Chargeable VAT

***A potentially sui generis service.*** There's a possibility that both the tax authorities and the parties might consider the Warranty Service as a unique ("sui generis") service that doesn't qualify for the VAT exemption applicable to guarantees, thus making it taxable. This remains a possibility since the classification of the warranty as a "guarantee" under the General Tax Code is open to interpretation. Tax authorities could adopt a narrower view of which guarantees are exempt, reflecting their general tendency to encompass as many operations as possible within the scope of VAT.

In this scenario, the seller or a third party would be obligated to invoice VAT on the price of this service.

***The Seller's ability to charge VAT.*** At this point, it becomes relevant to determine whether the seller is actually entitled to collect VAT on their transactions.

***Legal Definition of Taxable Person.*** Article 256 of the General Tax Code subjects operations carried out by a taxable person acting as such to VAT. A taxable person is defined as anyone who independently carries out an economic activity, broadly defined as any activity of a producer, trader, or service provider, including the exploitation of tangible or intangible property for the purpose of generating income of a permanent nature (GTC art. 256 A). The status of a taxable person is independent of the legal form of persons, their situation with regard to other taxes, and the form or nature of their intervention. Thus VAT's application is linked to the materiality of the action or operation.

We have also already established that actively managing holding companies, involved in the management of their subsidiaries, are subject to VAT, which they must collect from these subsidiaries (*Cf supra*).

It follows that as long as the guarantor is a taxable person, either as a standard operating company or an actively managing holding company, they will be able to levy VAT and charge it to the buyer for this unique service provided. This remains subject to potential requalification by the tax authorities or the courts.

***The autonomy of the warranty.*** This distinction in price and *instrumentum* reinforces the autonomous nature of the warranty, mitigating the risk of it being qualified as part of the share price. By analogy, the same reasoning may apply to non-compete clauses, which, when independently remunerated, are also likely to be subject to VAT.

***The onerosness and direct link.*** Regarding the condition of the direct link, in this hypothesis the purchaser is explicitly paying a separate amount for the seller's commitment to indemnify them against specific risks. This premium is the direct consideration for the service of risk coverage provided by the seller. The seller, in exchange for this premium, undertakes a specific obligation, making the transaction "onerous" in the VAT sense. This direct and reciprocal relationship, where the premium is the price for the service, distinguishes it from the compensatory nature of indemnity payments under a standard warranty clause.

Even if the transfer of shares is exempt, a separately priced warranty could fall within the VAT scope, but this interpretation remains legally fragile due to the unprecedented nature of the service.

(ii) Deductible VAT

***General expenses.*** By analogy with the deductibility of expenses incurred for the purpose of acquiring the shares, this warranty could be considered an expense giving rise to VAT deduction by assimilation to general expenses. The argument here is that the warranty is an expense directly related to the acquisition of an asset (the shares) and aims to mitigate risks associated with that acquisition, similar to due diligence costs which can sometimes be VAT deductible.

Once again, this will not be possible if the purchaser is not considered a taxable person, that is to say if it is a pure holding company or if it is a bank for example.

Pure holding companies, whose sole purpose is to hold shares without direct involvement in the management of subsidiaries, are generally not considered taxable persons with the right to deduct VAT. Similarly, banks and other financial institutions often operate under specific VAT rules where their input VAT deduction rights are limited due to the nature of their exempt financial services.

Subject to these reservations, VAT could therefore be claimed and deductible.

c. The Warranty Service provided by a third party

***Insurance-like Warranty Service.*** The concept of a Warranty Service provided by a third party represents a specialized approach to risk mitigation in M&A. Some companies specialize in giving such warranties, often identifying themselves as "payment platforms for insurance" or being insurance companies themselves, a practice notably popular in the United Kingdom. This emergence of specialized third-party providers for warranties indicates a broader trend of market innovation and specialization within the M&A ecosystem. This move towards professionalizing risk transfer mechanisms reflects a sophisticated market demand for greater certainty and efficiency in deal execution.

Following a similar mechanism to what was discussed earlier, a buyer might prefer to establish a Warranty Service with one of these specialized organizations rather than directly with the seller in order to minimize the risk of loss.

***Warranty Indemnity insurances.*** As mentioned in the introduction, those types of warranties as services aren't completely new. They are called Warranty and Indemnity insurance (W&I). Warranty and Indemnity insurance has become a deeply integrated component of the mergers and acquisitions transaction process, fundamentally reshaping how risks are allocated and managed.

***The innovative concept of synthetic coverage.*** A significant evolution within this landscape is the emergence of synthetic W&I insurance. Unlike traditional W&I policies that directly mirror seller-provided warranties in a share purchase agreement, synthetic W&I policies feature a dedicated set of warranties directly attached to the insurance policy itself, with their terms primarily

negotiated between the buyer and the insurer. This innovative approach offers compelling advantages, particularly for sellers seeking a clean exit with minimal post-closing liability and for buyers aiming to enhance the attractiveness of their bids in competitive environments. This service is what resembles what we qualify as a Warranty Service the most.

The insurer, as a third party, will have less knowledge of the target business compared to the seller. This practical constraint means insurers will lean towards standard warranty language that applies broadly, rather than highly tailor-made clauses, which could impact the buyer's ability to tailor warranties to specific deal risks.

Considering their characteristics and the fact that these companies claim to provide insurance, it would likely be appropriate to classify the warranty as insurance in such cases for VAT purposes. This would consequently lead to the application of VAT on insurance premiums.

***VAT Exemption.*** Insurance operations, of any kind, are charges exempt from VAT. This exemption, from which they benefit, is specified in Article 261C 2° of the General Tax Code which states that insurance and reinsurance operations, as well as services relating to these operations carried out by insurance brokers and intermediaries are exempt from VAT.

An insurance operation is characterized by the fact that an insurer undertakes, in exchange for the prior payment of a premium, to provide an insured party, in the event of the occurrence of the covered risk, with the benefit agreed upon when the contract was concluded.

By nature, the existence of an insurance operation implies the existence of a contractual relationship between the provider of the insurance service and the person whose risks are covered by the insurance, namely the insured<sup>18</sup>. If the Warranty Service operates in all material respects like an insurance contract, tax authorities are likely to treat it as such, even if the provider is not a traditionally licensed insurer.

The primary rationale behind this exemption is to prevent double taxation. In France, insurance transactions are typically subject to a specific Insurance Premium Tax (IPT) rather than VAT. Applying VAT on top of IPT would create an undue tax burden, distorting competition and hindering the financial sector.

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<sup>18</sup> European Court of Justice, 8 March 2001 ; Case C-240/99, Försäkringsaktiebolaget Skandia (publ)

**Application.** Based on the characterization of these Warranty Services as insurance-like operations, Warranty and Indemnity insurances should fall squarely within the scope of the VAT exemption provided by Article 261C 2° CGI. There is also still a possibility that the exemption might apply on another legal basis, if the service fulfills the criteria of an insurance points to an alternative or complementary exemption under Article 261 C 1° CGI. As previously seen, this article covers various financial operations, specifically including “negotiation and assumption of commitments, guarantees, and other securities and guarantees”. A warranty, in essence, functions as a guarantee.

**Strict interpretation of VAT exemptions.** However, the interpretation of VAT exemption for insurance-related services has become increasingly strict over time. French tax authorities and courts, influenced by evolving ECJ judgments have shifted from a broad interpretation based on the regulatory status of the operator to a more objective analysis of the nature of the service provided<sup>19</sup>. This means that simply being “linked to the insurance sector” or provided by a non-traditional insurer is no longer sufficient for exemption. The service must be “characteristic of an insurance intermediary” and directly linked to the essence of insurance business, involving direct participation in the contract's conclusion<sup>20</sup>.

**The different treatment between the insurance premium and other taxable fees.** Conversely, services remain subject to VAT if they are not provided by an insurance broker or intermediary, or if they are not ancillary to core insurance transactions. This is where what we can call subscription fees often fall into the taxable category. These fees typically represent remuneration for services that, while facilitating the subscription of an insurance contract, do not constitute the direct assumption of risk or the essential, characteristic functions of an insurance intermediary<sup>21</sup>.

The insurance premium is the direct consideration paid for the transfer of risk from the insured to the insurer. It represents the price for the insurance operation itself, which is specifically exempted from VAT by Article 261 C, 2°.

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<sup>19</sup> See for instance : ECJ, 30 September 2021, Case C-299/20, *Icade Promotion SAS v Ministère de l'Action et des Comptes publics* ; ECJ, 17 March 2016, Case C-40/15, *Minister Finansów v Aspiro SA* (the principle of fiscal neutrality cannot extend the scope of an exemption in the absence of clear wording to that effect.)

<sup>20</sup> « VAT and insurance intermediation: a case law rendered by the Administrative Court of Appeal of Douai reiterates the tax risks for brokers », [consulté le 9 juin 2025]. <https://www.cyplo.com/en/blog/vat-and-insurance-intermediation-a-ruling-by-the-administrative-court-of-appeal-of-douai-reiterates-the-tax-risks-for-brokers>

<sup>21</sup> « Exemption from French VAT in the insurance sector: what you need to know », [consulté le 9 juin 2025]. <https://www.cyplo.com/en/blog/exemption-from-vat-in-the-insurance-sector-what-you-need-to-know>

It can however be noted that there is a lack of clarity on the applicable regime as there is a fine line between services that are genuinely ancillary to the main insurance operation (and thus exempt by attraction) and those that are distinct, taxable administrative or commercial services. This distinction is particularly challenging in modern business models involving extensive outsourcing and specialized service providers.

**General conclusion on VAT.** In conclusion, despite the parties' explicit separation and pricing of the Warranty Service we believe that VAT taxation should, in principle and for the core of it, not apply. While the distinct contractual nature might initially raise questions, the legal framework and the economic substance of the transaction point towards VAT exemption.

Indeed, the fundamental *ratio legis* of VAT is to tax consumption. While the Warranty Service is a service in form, its function is deeply intertwined with the underlying share transfer, acting as a specific mechanism for risk mitigation and financial protection for the buyer during this acquisition, a transaction mostly outside the scope of VAT.

To add a final argument, the exemptions under Article 261 C of the CGI concerning financial operations and guarantees, reflect a policy decision to avoid taxing activities closely tied to financial flows and risk management to prevent hindering these necessary sectors of the economy.

## **B. Registration duties implications**

**Definition.** Transfer taxes (referred to in French law as *droits de mutation*) are non-recurring levies triggered by specific legal events, namely the transfer of all or part of an individual's or entity's assets<sup>22</sup>.

Transfer taxes on onerous transactions are named registration duties. As we have just examined, economic transactions are, in principle, subject to VAT, which applies to all supplies of tangible goods and services rendered for consideration by a taxable person acting in that capacity (Article 256 of the GTC). However, as demonstrated in the context of implementing a warranty, certain transactions depart from what the law defines as an economic transaction and instead resemble private asset management. At that point, these patrimonial operations become subject to

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<sup>22</sup> A. PERIN-DUREAU, *Précis de droit fiscal international et de l'Union européenne*. 2e éd, LexisNexis, 2024.

registration duties. Consequently, in most cases they will be exempt from VAT, without this constituting a general principle of exclusion under tax law.

***The purchaser's burden.*** As a matter of principle, under article 726 of the General Tax Code, the purchaser bears the responsibility for paying these duties.

***The potential impact on taxation of the Warranty Service.*** After reviewing the conditions for taxation, it will be relevant to analyze whether the separately priced Warranty Service has any impact on the registration duties borne by the purchaser during the share transfer.

***The taxable base is the value of the shares.*** French tax law employs a traditional analytical approach when assessing these duties. The taxable base is determined by the value of the transferred assets and liabilities, without taking into account the market realities of operating costs or the broader context of distressed markets for financially troubled companies.

This approach directly stems from Article 666 of the GTC, which mandates that registration duties are assessed based on value. Consequently, irrespective of the price agreed upon by the parties for the shares, the tax authorities possess the right to substitute this transaction value with the fair market value (*valeur vénale réelle*) if the declared price is deemed insufficient. This position was officially affirmed by the Minister in response to a parliamentary question concerning the tax implications of a warranty clause<sup>23</sup>.

***Potential revaluation of the shares.*** In its answer, the Minister officially stated that under general principles of civil law, the sale price reflects the buyer's interest in completing the transaction. The acquisition of control over a company carries its own economic and strategic value, independent of the company's net asset value. It also stated that for registration duties, Article 666 of the Tax Code states that taxes are based on the fair market value, meaning the administration may apply this value even if the declared price is lower. While a price revision clause may allow for a refund of excess duties if the final price is lower than initially stated, the taxable base can never be reduced below the property's fair market value at the time of the transfer.

***Application.*** Based on the principle that registration duties are levied on the fair market value of the transferred property (in this case, the shares), the separate pricing of the Warranty Service

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<sup>23</sup> Rép. min. à QE n° 21982, JO AN Q. 5 févr. 1996, p. 625

should not directly influence the base for these duties. Unlike direct taxes where the contractual price is a primary factor, registration duties are attached to the intrinsic economic value of the shares themselves. The tax authorities will assess the duties based on this fair market value, irrespective of any separate consideration paid for an ancillary service like the warranty.

Therefore, the registration duties will be calculated solely on the fair market value of the shares transferred. The separate price paid for the Warranty Service, being consideration for a distinct contractual undertaking, does not alter this value assessment. Consequently, the Warranty Service itself is not subject to registration duties, as these duties apply to the transfer of the shares' ownership, not to related service agreements. The parties will still need to ensure the declared share price reflects the fair market value to avoid a tax reassessment on that basis.

## CONCLUSION

In conclusion, the exploration of Warranty Services in share purchase agreements reveals it to be not merely a contractual adjustment, but an innovation in M&A risk management. This approach offers compelling strategic and operational advantages for both buyers and sellers. For sellers, it facilitates a cleaner exit, minimizing post-closing liability and enhancing deal certainty. For buyers, it strengthens bid attractiveness in competitive environments and provides a robust, independent layer of risk protection. The “unbundling” and professionalization of risk transfer mechanisms inherent in this service rationalizes the transactional process, fostering greater efficiency and predictability in transactions.

From a tax perspective, while the landscape presents nuances, the outlook for this Warranty Service can be qualified as favorable. Regarding direct taxes, the separation and distinct pricing of the Warranty Service, unlike traditional R&W clauses, present a valuable opportunity: its cost could be integrated into the acquisition basis of the shares. This seemingly subtle distinction can significantly reduce future capital gains upon a subsequent sale of the acquired entity, providing a long-term fiscal benefit. Moreover, strong arguments exist for the immediate deductibility of the warranty cost as a business expense, particularly when structured as an insurance premium. By demonstrating that the expenditure is incurred in the company's interest to cover a well-defined risk, sophisticated structuring can pave the way for tax savings.

For VAT purposes, the core Warranty Service is highly likely to benefit from an exemption. By functionally operating as an insurance-like mechanism, transferring risk for a premium, it aligns with the principles of VAT exemption for insurance operations under Article 261C 2° of the General Tax Code. While the distinction between exempt premiums and potentially taxable subscription fees demands careful, the economic substance of the Warranty Service points towards an overall VAT-free treatment.

In essence, the Warranty Service represents a tool for optimizing share purchase agreements. While its tax implications require diligent structuring, (notably since there are always risks of requalification by the tax administration and the judges) the inherent flexibility allows for navigating complex tax regulations to unlock substantial advantages.

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