To sell or not to sell?

Selling a unit of your company so it may carry on business independently may cost you an arm and a leg. But new ways of looking at the VAT on such transactions may prevail soon

The transfer of an organized part of an enterprise is common practice in companies undergoing restructuring processes. It is also an attractive option for company owners wishing to capitalize on their business achievements. It usually takes the form of selling some part of their assets or the acquisition of a stake in a larger business by way of a contribution-in-kind in return for shares. The tax treatment of such transactions is the source of much controversy with the Polish tax authorities. The biggest problems are connected with VAT on such transactions. Recently, the District Administrative Court in Warsaw passed judgment in a case involving such an issue which undermines the practice of the tax authorities to date.

Literal interpretations

Under the Polish VAT Act, transactions involving the disposal of an enterprise or plant (branch) which draws up its own balance sheet are out of scope of VAT regulations. But the tax authorities treat these provisions very literarily, which frequently leads to disputes with taxpayers. The tax authorities usually take the view that this exclusion from VAT does not apply to the disposal of an organized part of the enterprise, if it does not draw up its own balance sheet. They argue that in such cases, transactions are subject to VAT regulations and should be treated the same way as the sale of particular goods which are transferred item by item. Following their argumentation, in such a transaction, each item should be categorized and analyzed individually from the VAT application angle — whether it is exempt from or subject to VAT and what VAT rate applies to it. In the case of a contribution-in-kind, further to the Polish regulations, all such transfers of goods and assets are exempt from VAT (although the exemption introduced by Polish

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legislation is controversial from the standpoint of its consistency with EU regulations). When the transaction is exempt, negative consequences arise for the sellers, since they are unable to deduct the input VAT connected with the assets in the transaction.

The point at issue is that transfers of whole enterprises or branches drawing up their own balance sheets are quite rare. Typically, a transfer will relate to some part of a business, which is sufficiently distinctive to independently carry on some business projects, rather than to everything that the transferring entity owns.

The European way

The negative interpretation of the tax authorities with respect to the VAT consequences of the transfer of an organized part of an enterprise results from a misapplication of the regulations. It is important to note that the provisions of the Polish VAT Act directly follow on from the EU law, namely, Directive 2006/112/EC, which replaced VI VAT Directive in 2007. These directives gave EU member states the possibility to exclude from VAT such transactions that involve a transfer to another company (for consideration, free-of-charge or by contribution-in-kind) the whole or part of its assets. The aim was to ensure that VAT remained a neutral taxation in transactions involving company asset transfers where the acquirer intends to continue the activity so far carried on by the disposing company.

The above EU provisions were also interpreted by the European Court of Justice (ECJ). In 2003, the ECJ made a ruling (case Zita Modes no. C-497/01) that this rule should be applied to any transfer of an enterprise or its independent part containing movables and intangibles, which taken together, make a whole entity or part of the entity capable of carrying on independent business activities. The only condition is the intention of the acquirer to continue the activity of the transferred enterprise.

Looking for clues

Currently, while analyzing the VAT consequences of the disposal of an organized part of an enterprise, the Polish tax authorities stick to the literal meaning of the Polish provisions and thereby misinterpret them because they do not take into account the business purpose of the transaction. The consequence is that if you hive off the whole enterprise (everything the company possesses) or its branch drawing an independent balance sheet — the transaction is not subject to VAT, but if it is just part of the enterprise, even if capable of doing business independently — the consequences are different. So where is the clue to solving the problem?

To find the right solution, the tax authorities should rather look at the business background of the transaction. If the disposed part of an enterprise is capable of running independent business activities and will be actually used by the acquirer for this purpose, the transfer should be treated as a disposal of the enterprise itself and hence should fall outside of the scope of VAT regulations regardless of whether or not it has drawn up its own balance sheet so far.

Fortunately, the correct interpretation of these provisions is beginning to prevail in District Administrative Court judgments. Recently, the court in Warsaw issued a verdict rejecting the argument of the tax authorities as regards taxation of the disposal of an organized part of a business (III SA/Wa 540/08). The court ruled that there are no reasons for which the enterprise should be understood as the totality of assets of the entity. Within the company, there might be several enterprises each of which is capable of performing independent business activities. If a part of the enterprise is useful for performing defined business activities, it is an enterprise no matter whether it prepares its own balance sheet or not. The ruling is a positive step in the struggle for a true interpretation of the Polish VAT provisions. It follows some previous judgments (III SA/Wa 934/07, III SA/Wa 82/08). This might give taxpayers a chance to defend the standpoint that the disposal of organized part of enterprise is not subject to VAT regulations.

Devil in details

Apart from the obvious positive outcome of the ruling, there is one risk which may harm the companies which performed such transactions. If the tax authorities finally agreed that the disposal of an organized part of an enterprise is outside the scope of VAT while the taxpayers applied different solution before (i.e. taxed the transfer with VAT), any deduction by the acquirer of input VAT included in the transaction would be denied. This is due to amendments to VAT Act introduced in January 2008 according to which an invoice documenting a transaction being outside the scope of VAT or exempt from VAT does not give the taxpayer the right to deduct the input VAT shown in the invoice.