FUSIONS & ACQUISITIONS

Fusions & Acquisitions

La première revue des rapprochements d'entreprises

DEPUIS 1987

DOSSIER : LE CAPITAL-INVESTISSEMENT ET L'ESG

N°306 NOVEMBRE-DÉCEMBRE 2019

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SMEC IN M&A AND PE DEALS

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A new tax "tool" is now available to buyers: reduced penalties are offered by a dedicated tax office in return for spontaneous regularization of the target's tax situation, in the hands of "new owners and buyers of an enterprise". What are the practical interest and impact of SMEC in M&A transactions?

In the narrow corridor separating the right to make mistakes from the incentive to regularize taxes, the sibylline instruction of 28 January 2019 on companies tax compliance (the "**Instruction**") is already emerging as a paving stone in the pond of acquisition transactions.

A. WHAT IS SMEC ?

Following the ESSOC law[1], it is through regulations that the "*Service de Mise en Conformité des entreprises*" (SMEC) is interfering in the French tax landscape. As a regularization office, SMEC is under the responsibility of the tax service in charge of MNEs, though remains open to any company, whatever the size. It appears as a "compliance" body for the tax situation, particularly in the event of an acquisition.

Beyond certain issues listed exhaustively[2], away from M&A and private equity transactions, the Instruction specifies that SMEC is open to "*all tax anomalies discovered by new owners and buyers of an enterprise*".

The scope of regularizable anomalies therefore seems infinite as to the very nature of the anomalies targeted, but defined temporally to those prior to the acquisition.

Penalty rebates at harmonized and non-negotiable rates

The stated advantage of regularization is the reduction of (i) the surcharges incurred (depending on the nature of the rectified anomaly), and (ii) the interest for late payment, as compared to the rates usually incurred in case of tax inspection:

[1] Law n°2018-727 dated 10 August 2018 for a State for a trusted relationship with society

[2] Relating to international tax issues (permanent establishment, financing taxation, abusive schemes), to the taxation of executives (impatriation, Dutreil agreements, capital gain on disposal of shares, management package), and more generally to any transaction likely to attract a heavy tax penalty (hidden activity, abuse of law, and fraudulent behavior)

Standard rates	SMEC rates	Interest for late payment
80%	30%	1.44% instead of 2.4%
40%	15%	(40% reduction)
10%	0%	1.2% instead of 2.4% (50% reduction)

Regularization must be spontaneous. The doors of SMEC will therefore remain closed if the acquired company is undergoing a tax audit, including if the inspection did not actually started but is officially announced to happen.

In addition, the rates are intended to be fixed and non-negotiable. The actual cost of regularisation hence depends, in practice, on the basis to be regularized, not on rates to be suffered.

A lot of unsolved questions

Despite the lack of precisions of the Instruction, it appears from its "direct" reading that only the buyer is in a position to bring into conformity the anomalies discovered during the takeover of a company. It is even the target company which, as the taxpayer, appears to be the only one entitled to file a compliance file with SMEC.

Case n°1	***« Full tax warranty »*** The tax consequences of regularization are borne in full by the seller	*The SMEC penalty rates do not apply*
Case n°2	***« Partial tax warranty »*** The tax consequences of regularization are partly borne by the seller	SMEC penalty rates apply pro rata to the liabilities remaining to be borne by the buyer under the tax warranty agreement
Case n°3	**No tax warranty** The tax consequences weigh exclusively on the buyer	SMEC tax penalty rates are fully applicable

Regularization process shall be launched within eighteen months of the acquisition, distinguishing between three cases, depending on whether or not the tax consequences of the adjustment weigh on the seller:

B. NEW REFLEXES OR NOT?

It is therefore the buyer who decides, at least on the surface, to correct the anomalies detected during the audit phase of the target (or detected after, but borne before, the acquisition).

Given that the consequences of regularization depend on the tax coverage (see table above), it is clearly the very dialectics of the tax warranty during the negotiation phase of the contractual documentation between buyer and seller that is shaken by the prospect of filing a file with SMEC.

To the old reflexes of a relatively standardized dialogue on the assumption of tax risks by the parties, which in practice depends quite largely on the balance of power between buyer and seller, new arbitrations are emerging, to the extreme since it is indeed the very principle of tax risk coverage that is being questioned.

In other words, penalty discounts shall only apply should the buyer remains liable to tax over regularized items, i.e. if the adjusted tax risk is excluded from the scope of the tax warranty.

Some may see it as a welcome alternative to discussions on the scope of such a guarantee, the exonerating nature of audits, questions of thresholds, capping, etc., or even the light at the end of the tunnel of a transaction whose tax audit has revealed a deal breaker tax risk. The interest of Vendor due diligence also appears, in this respect, revived.

However, this would mean putting aside a little quickly the new difficulties emerging from this "third way". It is never easy to deliberately and voluntarily renounce to tax hazard, which itself arises here under a twofold aspect: first of all, apart from specific cases, a tax audit never occurs for sure. Moreover, if it does, it is almost impossible to predict with absolute certainty that it could generate a penalty of 40%, or 80%, or even any reassessment at all.

The impact of a regularization (concerted between the parties, or not) on the acquisition price of a company, is therefore far from an exact science.

C. WHAT ABOUT CRIMINAL EXPOSURE ?

But another argument could in practice lead some economic actors towards regularization, given that times are changing: the new possibilities for regularizing "tax gaps" are in fact part of an increasingly repressive tax framework in France. For example, the "tax fraud" law of 23 October 2018, which has "unlocked" cases of referrals to the national financial prosecutor's office.

However, it seems to be a given that the tax risks regularized before the SMEC prevent, *de facto* and *de jure*, any automatic transmission of the file to the public prosecutor's office: whatever the amount of the regularized items, the penalties incurred never exceed the threshold for automatic transmission set by law.

However, the tax administration can always take the initiative to file a complaint. Above all, the Instruction itself specifies that in the event of disagreement with the company on the conditions for regularization, the French Tax Authorities may initiate a tax audit. This may, eventually, lead to a situation of automatic transmission to the public prosecutor's office.

Here again, the question of the possible criminalization of a case proposed to the SMEC remains open.

CONCLUSION

It therefore seems very difficult, at this stage, to accurately assess the impact of SMEC in M&A transactions and PE deals. "*God created the Good, then withdrew*"...let us remain aware, now that SMEC has been created, to the way in which economic actors and practitioners will understand it and appropriate it (or not...).