5 January 2016

VAT Recovery and Grouping

EU Court Rules That Active Holding Companies May Be Entitled to Full VAT Recovery and Partnerships May Join VAT Groups

SUMMARY

In a welcome development for taxpayers, the Court of Justice of the European Union has ruled that a fully taxable holding company that is actively involved in the management of all its subsidiaries should be able to recover in full any input tax incurred in connection with acquiring, managing, and holding those subsidiaries. Holding companies that actively manage only some of their subsidiaries should be entitled to partial recovery of input tax, based on the proportion of input tax that is attributable to their management activities (or other "economic activity").

The Court also held that EU member states should not restrict membership of a VAT group to entities with legal personality linked to the controlling body of a group by a "relationship of subordination", except to prevent abusive practices, tax evasion or avoidance. Taxpayers, however, cannot rely directly on the relevant provisions of EU law, so Member States will have to legislate for entities that do not have legal personality (such as partnerships) to join VAT groups.

BACKGROUND

In order to recover amounts of input tax (VAT that a taxable person pays on goods or services received), a holding company has to show:

- that it is a taxable person carrying on (or intending to carry on) an "economic activity", for which it receives the supplies carrying VAT; and
- a "direct and immediate link" between those inbound supplies and outbound supplies giving rise to the right to deduct (primarily taxable supplies).

So far as the second point is concerned, if the inbound supplies are not linked to specific outbound supplies they may nonetheless have a sufficiently direct and immediate link with the overall economic activities of the business as a whole, where the costs are "part of the [business's] general costs and

are, as such, components of the price of [its] products".[1] The question is then whether the business's supplies taken as a whole give rise to a full or partial right to deduct.

In the *BAA* case the English Court of Appeal denied recovery of input tax incurred on deal fees in connection with the acquisition of new subsidiaries because the acquisition vehicle failed to show that it satisfied these tests.[2]

For a holding company the primary issue is typically the extent to which it is engaged in "economic activity" or can demonstrate an intention to carry on economic activity: merely holding and managing investments in subsidiaries for the purpose of receiving dividends, like a private investor, does not constitute "economic activity". By contrast, managing its subsidiaries actively and providing administrative or management services to them for consideration is an "economic activity". The Court of Justice of the European Union has acknowledged that some companies may carry on both economic and non-economic activities and, where this is the case, deduction of input tax is allowed only to the extent that the input tax is attributable to the economic activity.

A second relevant issue for holding companies is how they intend to recoup their expenditure. HMRC's current guidance suggests that VAT costs incurred by a holding company are recoverable only to the extent that the company intends to recoup the expenditure from income resulting from taxable supplies.

Two recent judgments of the Court have clarified the correct approach.

LARENTIA + MINERVA AND *MARENAVE*

FACTS

The first of the two judgments is in joined cases referred by the German courts.[3] The two cases had slightly different fact patterns:

- Beteiligungsgesellschaft Larentia + Minerva mbH & Co. KG was a 98% limited partner in two limited partnerships. It provided them with administrative and business consultancy services in return for payment, and also received dividends from them. Larentia + Minerva sought to deduct in full the input tax it incurred on the costs of raising capital from a third party to fund the acquisition of its limited partnership interests.
- Marenave Schiffahrts AG was a holding company that acquired interests in four limited partnerships and was involved in their management following the acquisition, for which it charged fees. Marenave had increased its capital to cover the costs of acquiring the interests in the limited partnerships, and sought to deduct in full the input tax it incurred in relation to that increase of capital.

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1 *Commissioner of Customs & Excise* v. *Midland Bank plc* (c-98/98), paragraph 31 of the judgment.

2 *BAA Ltd* v. *HMRC* [2013] EWCA Civ 112. For more detail on the decision, see our client publication of 18 April 2013, available at: https://sullcrom.com/siteFiles/Publications/SC_Publication_VAT_Cases_On_Deal_Fees_and_Grouping.pdf.

3 *Beteiligungsgesellschaft Larentia + Minerva mbH & Co. KG* v. *Finanzamt Nordenham* (C‑108/14) and *Finanzamt Hamburg-Mitte* v. *Marenave Schiffahrts AG* (C‑109/14).

QUESTIONS FOR THE COURT

The German tax authorities denied the claims by Larentia + Minerva and Marenave for full recovery of input tax, and the German Federal Finance Court referred 3 questions to the Court:

1. If the holding companies provide taxable services to their subsidiaries post-acquisition (in circumstances where they also receive dividend income from those subsidiaries), how should the German tax authorities determine the deductions of input tax in respect of supplies connected with the purchase of shares in those subsidiaries?
2. Are national rules contrary to EU law if they restrict VAT group membership to entities with legal personality that are in a "relationship of control and subordination" with the controlling company of the group?
3. If the national rules in question 2 are contrary to EU law, is the correct EU position directly enforceable by a taxable person?

DECISION OF THE COURT

VAT Recovery by Active Holding Companies

The Court held that where a holding company actively manages all of its subsidiaries, it should be able to deduct in full any input tax incurred in respect of the acquisition of shares in those subsidiaries (save to the extent the holding company is making exempt supplies, against which input tax would not be recoverable on general principles). Dividends received by the holding company are not taken into account and do not prevent full deduction of input tax.

A taxable person can deduct input tax to the extent it is incurred as part of its general costs and is a "cost component" of the price of the outbound services that it supplies. This "cost component" concept has given rise to confusion, hence HMRC's guidance that the company must expect to recover its costs out of management fees. The Court has reiterated that the costs of services related to an acquisition are part of the taxable person's "general costs and are, as such, components of the cost of output transactions".

Even where the holding company incurs input tax before it is charging its subsidiaries for active management (most likely for expenses before acquiring them), the input tax should be deductible by a holding company if it intends to charge them for management services in the future: for the purposes of the "direct and immediate link" test, it is enough that the inbound supply on which the company incurs input tax has a direct and immediate link with its economic activity as a whole.

If a holding company looks to rely on its intention to engage in active management, it should put itself in a position to prove that intention (as the BAA case showed). It makes sense to document the proposed provision of services in board minutes and engagement letters, and register the holding company for VAT (and apply to join an existing VAT group, if appropriate) as soon as possible.

"Mixed" Holding Companies

Where a holding company actively manages some subsidiaries, and is a passive shareholder in others, its costs will not have a "direct and immediate link" with the company's economic activity as a whole to the extent that those costs relate to subsidiaries in which it is a passive shareholder. The

Court held that a "mixed" holding company may only recover input tax to the extent it is attributable to the proportion of that holding company's activity that constitutes economic activity.

The relevant Member State must decide the method for determining the pro rata recovery of input tax.

VAT Grouping

Each Member State has a margin of discretion when applying the VAT grouping principle, but Member States must justify any restrictions in accordance with the aim, set out in the relevant EU law, of "[preventing] tax evasion or avoidance". The Court confirmed that national legislation must allow persons that do not have legal personality (e.g. partnerships) to be part of a VAT group, unless the grounds above justify a contrary restriction.

The current UK rules only allow for partnerships to join VAT groups in limited circumstances. Partnerships are registered in the names of the general partner(s). Two different situations can flow from this depending on whether the partnership has one general partner or more than one:

- If the partnership only has one general partner (as will usually be the case for a limited partnership), the partnership is registered in the name of that general partner. If that general partner is part of a VAT group, the partnership also forms part of the VAT group and should be accounted for under the existing group registration.
- If, however, the partnership has two or more general partners, the partnership must be accounted for under a new VAT registration and it cannot join the VAT group of any of its general partners. If the same general partners are general partners together in more than one partnership, those partnerships are all included in the same VAT registration. This is not technically the same as forming part of a single VAT group, although there is unlikely to be much difference in practice.

The Court also made clear that there is no need for a relationship of subordination and control between companies in a VAT group, since the relevant EU law merely requires that group members are "closely bound to one another by financial, economic and organisational links". Member States should therefore permit horizontal VAT grouping (for example, between sister companies), unless the countering of tax evasion or avoidance necessitates a condition of subordination and control.

Direct Effect

The Court decided that taxpayers could not directly enforce its decision in respect of VAT grouping, since the relevant provision of the directive requires Member States to specify the financial, economic and organisational links needed to qualify. Each Member State, therefore, must interpret its national legislation as far as possible in accordance with the decision of the Court. If no compatible interpretation of the legislation is possible, Member States must amend national laws to comply with EU law.

SVEDA

FACTS

The second of the two judgments is in *Sveda UAB*,[4] a case referred by the Lithuanian court. Sveda UAB undertook to construct and run a "Baltic mythology recreational discovery path" and to offer the public access free of charge by agreement with a Lithuanian government agency. Sveda was to be reimbursed 90% of the set-up costs through a grant. Sveda intended to sell food, drink and souvenirs to users of the path. Sveda claimed input tax deductions for the path's construction costs.

QUESTION FOR THE COURT

The State Tax Inspectorate denied this deduction on the ground that Sveda did not establish that the capital goods acquired were intended to be used for the purposes of an activity subject to VAT. The Supreme Administrative Court, therefore, referred the following question:

Does the VAT Directive grant a taxable person the right to deduct input tax paid in producing or acquiring assets for business purposes which are intended for use free of charge, but may be used as a means of attracting visitors to a location where the taxable person plans to supply goods and/or services?

DECISION OF THE COURT

The Court agreed with Sveda that, although use of the path was free to the public, Sveda was carrying out an economic activity. Member States must allow taxpayers to collect output tax and deduct input tax where the inbound transactions are linked to outbound transactions that fall within the scope of VAT and are not exempt. They need not recoup their input costs entirely out of income from taxable supplies. The Advocate General's opinion explained that there is no need for the taxable person to reflect the full cost of an input transaction in the pricing of the relevant taxable output transactions – the United Kingdom was wrong to think this was required. The Court referred to the input costs coming "partly" within the prices of the outbound transactions. Any restriction of the kind advanced by the UK is therefore unlikely to be compatible with EU law.

IMPLICATIONS OF THE DECISION

The decisions have a number of implications.

- Member States must permit a holding company involved in the management of all its subsidiaries to recover input tax in full. Input tax recovery should only be disallowed to the extent the holding company is supplying exempt services.
- Member States must permit a holding company involved in the management of only some of its subsidiaries to claim partial recovery of input tax based on a method of apportionment which each Member State determines.
- The Court is yet to give guidance on how the principle is to be applied in more complex structures – must management services be provided to each subsidiary? To each direct subsidiary? Or is it enough to provide them to an indirect subsidiary?

[4] *Sveda UAB* v. *Valstybinė mokesčių inspekcija prie Lietuvos Respublikos finansų ministerijos* (C-126/14).

- HMRC's current guidance allows for recovery of input tax on acquisition costs only to the extent that the taxpayer intends to recoup those costs out of income from taxable supplies. In the decisions of *Larentia + Minerva* and *Sveda*, the Court has made clear that that is a misunderstanding of the idea of a "cost component". HMRC should, therefore, update its guidance to reflect the Court's decisions and to ensure that UK practice is compatible with EU law.
- The current UK VAT grouping rules restrict membership of VAT groups to bodies corporate. Unless the UK can demonstrate that this restriction is necessary and appropriate to combat tax evasion or avoidance, it should amend its rules to allow entities that do not have legal personality to join VAT groups.

We are yet to see a response from HMRC to *Larentia + Minerva* and *Sveda* to explain how the decisions affect its guidance on the VAT recovery position of holding companies. As its current guidance notes that the decision in *Larentia + Minerva* is likely to affect HMRC's determinations on VAT recovery, some response is clearly needed.

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