VAT Groups

Potential VAT Costs for Financial Groups as ECJ Recognises Intra-Entity Supplies between US Head Office and VAT-Grouped Branch

SUMMARY

The European Court of Justice has decided that IT services provided by Skandia America Corporation to its Swedish branch should be recognised for VAT purposes because the Swedish branch was part of a VAT group.

It is not clear how widely the principle underlying the decision extends and how EU member states will implement it. On the widest interpretation, it would apply to situations involving:

- non-EU companies with EU branches,
- EU companies with non-EU branches and
- companies in one EU member state with branches in another,

and apply irrespective of the grouping rules of the member state or states concerned.

Where it applies, it will affect international groups that do not fully recover VAT on their costs, most obviously banks and insurers.

Some of the effects of the decision may be mitigated by altering VAT group membership or restructuring the group’s operations.
THE SKANDIA CASE
STRUCTURE AND SKANDIA'S INTENDED ANALYSIS

Skandia America Corporation bought IT services from external providers in the United States (1 in the diagram). It distributed these services to various companies in the group, in particular its Swedish branch (2). The Swedish branch processed these services and supplied the result to various group companies, including others within the same VAT group (3). A 5% markup over cost was applied at each stage. Skandia America Corporation issued internal invoices to its Swedish branch.

Skandia’s intended analysis appears to have been as follows:

1. The external providers supplied IT services to Skandia in the United States: no VAT.

2. The provision of IT services from head office to Swedish branch was within the same company, so not a supply for VAT purposes: no VAT.

3. The supply of IT services from the Swedish branch to other VAT group members was disregarded because it happened within a VAT group: no VAT.

Why go to all this trouble? Why not buy the services into the Swedish entities directly from the external providers? It isn’t clear from the judgment how much value was added by Skandia America Corporation in its head office, or its Swedish branch. There may have been commercial reasons other than tax for setting up the supply chain this way. But there certainly was a tax reason: it would (at least on Skandia’s analysis) have reduced Skandia’s VAT charge. As an insurer, Skandia will not have been able to reclaim

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1 A position which had been confirmed by the Court of Justice in Ministero dell’Economia e delle Finanze v. FCE Bank plc (Case C-210/04); but in that case the Court had not been asked to consider whether VAT grouping affected the analysis.
all the VAT suffered on its expenses. A supply direct from the external providers to any of the Swedish entities would have been subject to VAT in Sweden: this would have been a real cost for the group. Structuring this way would have eliminated that cost – or so Skandia hoped.

**TAX AUTHORITY RESPONSE**

If the branch and VAT group had been in the UK, the intra-group supply (3) would not have been ignored: the UK brought in a special anti-avoidance rule aimed at this type of structure. The article in the Principal VAT Directive allowing EU member states to legislate for VAT grouping goes on to allow them to adopt any measures needed to prevent tax evasion or avoidance.2

The Swedish tax authority (Skatteverket) took a different approach. It argued that VAT grouping not only meant that the Swedish operations of the group companies should be treated as one: it also meant that their non-Swedish operations should be treated as separate entities for VAT purposes. Accordingly, the intra-entity provision of services to a branch that is part of a VAT group (as at 2 here), should be recognised as a supply.

Skandia appealed. The Swedish court referred the case to the European Court of Justice.3

**COURT DECISION**

The European Commission, Germany and the UK (two of the countries operating grouping regimes) all intervened in the case. The Commission had said in 2009 that joining a VAT group meant that cross-border intra-company supplies would no longer be ignored for VAT purposes: it therefore supported Sweden. The UK took a more expansive approach to grouping and supported Skandia; Germany's position was in between.

The Advocate General gave his opinion in favour of Skandia. In most cases the Court follows the Advocate General. Not this time, though: the Court agreed with Sweden that, because the Swedish branch was part of a VAT group in Sweden, it should now be treated as separate from its head office in the United States. It concluded that supplies by a head office outside the EU to a branch inside the EU must be recognised where the branch is part of a VAT group.

As a secondary point, the Court then held that it was the VAT group that had to account for the VAT, not the Swedish branch as such.

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3 Skandia America Corp. (USA), filial Sverige v. Skatteverket (Case C-7/13)
IMPLICATIONS
SUPPLIES AFFECTED

The Court’s decision to recognise intra-entity supplies has far-reaching implications. The problem is not so much its application to situations like Skandia’s, where member states may already have implemented anti-avoidance measures – or can readily do so – but its application to groups where the value of the intra-entity supply has been generated internally:

In the example above, the head office has not bought in services from outside. Nonetheless, it follows from the judgment that the services it provides to its branch are recognised for VAT purposes. In other words, central services provided by the head office of a bank or an insurer to its branches are to be recognised for VAT purposes and (if taxable) will give rise to an irrecoverable VAT cost where those branches have joined a VAT group.

SCOPE OF JUDGMENT

The member states have discretion over whether to allow VAT grouping: most, but not all, have done so. It is therefore unfortunate that the judgment is not clearer. The Court has provided minimal explanation for its conclusion and, since the Court disagreed with the Advocate General’s view, his opinion sheds no light on its reasoning. This leaves several questions on the scope of the judgment –

- The Court refers to supplies of services from head offices outside the EU to branches inside – but is there any reason why the same rule would not apply in other circumstances?
- From a branch outside the EU to a head office inside?
- From a head office in the EU to a branch elsewhere in the EU?
- From a branch in the EU to a head office elsewhere in the EU?
The Court’s analysis does not suggest that there is any reason to limit the rule, so long as the recipient of the services belongs to a VAT group.

- Does how the rules apply depend on the way the VAT grouping provisions are structured in each member state? In particular, does it make a difference that the UK’s regime:
  - sees the whole company, including UK and non-UK establishments, as part of the VAT group; and
  - does not see the VAT group as a separate entity from all its members, but identifies one member as the representative member and effectively treats the others as part of the representative member?

On the face of it the Court’s judgment applies irrespective of the national regime, without leaving any margin of discretion, but it is not clear that its rationale for the decision would hold in all cases for the UK regime. (And, on the face of it, the Court’s judgment in FCE Bank contained no exception where services were provided to a foreign branch forming part of a VAT group.)

- Would the position be different where the head office does not issue internal invoices to its branch?

The Court refers in its judgment to the supplies by Skandia America Corporation head office to its branch being made “for consideration”. This suggests that the Court might not have recognised a supply if the head office had not issued internal invoices. Taking the opposite view and recognising undocumented supplies within a company would certainly cause problems: would any benefit a branch received from something done by the head office have to be analysed for VAT purposes?

Simply not invoicing for intra-entity supplies might therefore solve the problem. That said, it may not be available as a solution: businesses may need to have formal intra-company arrangements in place to allocate costs for internal management, remuneration and corporate income tax purposes. And member states may use their discretion to implement anti-avoidance rules, or the Court or member state courts may apply existing anti-avoidance doctrines to impose tax.

**WIDER IMPLICATIONS**

The *Skandia* case should be seen in the context of the *Crédit Lyonnais* case\(^4\) decided by the Court last year. There the question was whether the bank’s ability to deduct input tax in France should be calculated by reference to the supplies made by its French head office or by reference to the supplies made by all the bank’s branches worldwide. The Court decided that Crédit Lyonnais was able to take into account only the supplies made by its French head office. It emphasised the nature of the EU VAT system as made up of harmonised national regimes, rather than a single EU-wide regime. Furthermore, it denied the existence of any principle requiring a company making supplies outside the EU through a branch to be treated in the same way as one making supplies directly from within the EU. The *Skandia* judgment, although it does not refer to *Crédit Lyonnais*, seems to be informed by the same conception of the VAT system as fragmented rather than universal, and sets a similar limit on the effect of using a

\(^4\) *Le Crédit Lyonnais v. Ministre du Budget (Case C-388/11)*

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single company to do business across borders. This appears to be a developing strand in the Court’s jurisprudence.

**NEXT STEPS**

It now falls to the EU’s member states to ensure that their national legislation correctly implements the EU legislative provisions on grouping as interpreted by the Court – whatever that means. This is a particular issue for the UK, as the City of London hosts branches of many international banks and insurers. We understand that HM Revenue and Customs is considering the implications for the UK’s regime.

Depending on how the different member states respond to the judgment, international financial groups may need to review the position they have taken on VAT accounting for past intra-entity supplies. Where member states treat VAT-grouped branches as separate from their head offices going forward, financial groups may be able to mitigate the effects by:

- altering the membership of VAT groups (effectively deciding between making VAT-free same-state supplies within the VAT group and making VAT-free cross-border supplies within the company), possibly facilitating this by reducing the number of separate subsidiaries that they have;
- restructuring internal supply chains; or
- restructuring to make use of the cost-sharing exemption for inputs provided by the Principal VAT Directive\(^5\).

At a time when the regulatory impulse is to make financial groups easier to split up – with subsidiarisation one of the tools for achieving that – it is ironic that the Court has come out with a judgment that may make subsidiarisation less attractive from a VAT perspective.

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\(^5\) Article 132(1)(f), implemented in the UK in 2012 in Group 16 to Schedule 9 of the VAT Act 1994.
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CONTACTS

<table>
<thead>
<tr>
<th>London</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Michael McGowan</td>
<td>+44-20-7959-8444</td>
<td><a href="mailto:mcgowanm@sullcrom.com">mcgowanm@sullcrom.com</a></td>
</tr>
<tr>
<td>Andrew Thomson</td>
<td>+44-20-7959-8501</td>
<td><a href="mailto:thomsona@sullcrom.com">thomsona@sullcrom.com</a></td>
</tr>
<tr>
<td>Emma Hardwick</td>
<td>+44-20-7959-8401</td>
<td><a href="mailto:hardwicke@sullcrom.com">hardwicke@sullcrom.com</a></td>
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