NEW DEVELOPMENTS ON THE E.U. V.A.T. REGIME OF HOLDING COMPANIES

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INTRODUCTION

It may come as a surprise to some that the European value added tax ("V.A.T.") regime applicable to holding companies is not supported by dedicated provisions in Directive 2006/112/EC (the "V.A.T. Directive"), which rules the European V.A.T. system. Instead, the V.A.T. regime for holding companies is ruled by numerous decisions issued by the Court of Justice of the European Union ("C.J.E.U.").

Through its interpretation of the V.A.T. Directive provisions, the C.J.E.U. has outlined the main features of the regime for holding companies in an attempt to harmonize treatment within the E.U.

Despite the abundant jurisprudence, debate continues to surround the V.A.T. recovery rights of holding companies, as evidenced by three recent C.J.E.U.'s decisions issued in 2018.

In this evolving context, it is worthwhile to recall the main features of the V.A.T. regime laid out in the V.A.T. Directive and their application to holding companies in light of new case law – with the caveat that the following does not constitute an exhaustive list of all C.J.E.U. decisions but addresses the main ones relating to V.A.T. recovery rights.

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DISTINCTION BETWEEN PASSIVE AND ACTIVE HOLDING COMPANIES

An important feature of the V.A.T. regime is the distinction between "passive" and "active" holding companies. This distinction is based on the notion of economic activity for V.A.T. purposes.

The scope of the E.U. V.A.T. rules depends on whether a person is engaged in an economic activity, which is defined under Article 9, §1 of the V.A.T. Directive in the following terms:

> Any activity of producers, traders or persons supplying services, including mining and agricultural activities and activities of the professions, shall be regarded as 'economic activity.' The exploitation of tangible or intangible property for the purposes of obtaining income therefrom on a continuing basis shall in particular be regarded as an economic activity.

In line with this criterion, the C.J.E.U. has specified that the mere holding of shares without any involvement in the management of the subsidiaries cannot be assimi-

lated to the exploitation of intangible property, and as such, any resulting dividends are merely the product of passive ownership.[1]

Such holdings do not amount to economic activity, and therefore, passive holding companies do not qualify as taxable persons for V.A.T. purposes. This qualification has multiple consequences:

- The receipt of dividends does not fall within the scope of V.A.T.
- Passive holding companies lack the right to recover input V.A.T.
- Passive holding companies are exempt from any V.A.T. compliance obligations, such as V.A.T. registration and V.A.T. returns, subject to exceptions.

The same cannot be said for active holding companies. Indeed, the C.J.E.U. takes a distinct approach when the holding company is directly or indirectly involved in the management of its subsidiaries, for example, by supplying administrative, accounting, or I.T. services to subsidiaries.

From a general perspective and based on consistent C.J.E.U. case law,[2] once a holding company provides a taxable service to its subsidiary in exchange for consideration, it is deemed to perform a taxable economic activity and therefore qualifies as a taxable person for V.A.T. purposes.

This qualification opens the right to recover input V.A.T. Indeed, since it performs taxable activities for V.A.T. purposes, an active holding company may deduct the input V.A.T. incurred on its costs, a cornerstone of the V.A.T. system.

"Since it performs taxable activities for V.A.T. purposes, an active holding company may deduct the input V.A.T. incurred on its costs."

The resulting question is whether the V.A.T. deduction right is full or only partial and, subsequently, under which conditions the right should be exercised. During the last ten years, these complex questions have been largely unanswered and regularly put on the table of the C.J.E.U.

EXERCISING THE V.A.T. DEDUCTION RIGHT

General Provisions on the V.A.T. Deduction Right

As a general principle, any person engaged in taxable activities is entitled to deduct input V.A.T. paid for costs incurred in relation to this activity per Article 168 of the V.A.T. Directive.

As laid out in the V.A.T. Directive and frequently reiterated in C.J.E.U. decisions,[3] this recovery right is meant to relieve the trader entirely from the burden of V.A.T. in the course of its economic activities. Only the end-consumer should bear such charge. This constitutes an integral part of the V.A.T. scheme.

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1. C.J.E.U., 06/20/1991, *Polysar* Investments *Netherlands BV v Inspecteur der Invoerrechten en Accijnzen*, C-60/90; C.J.E.U., 06/22/1993, *Sofitam S.A.*, C-333/91.
2. C.J.E.U., 11/14/2000, *Floridienne S.A. and Berginvest S.V. v Belgian State*, C-142/99; C.J.E.U., 07/12/2001, *Welthgrove BV v Staatssecretaris van Financien*, C-102/00.
3. For instance, C.J.E.U., 02/14/1985, *Rompelman*, C-268/83.

While this principle appears relatively simple to implement with respect to commercial companies engaged in economic activities, the application of the V.A.T. deduction right in the context of active holding companies is more difficult to assess.

Since active holding companies qualify as taxable persons as a result of their involvement in their subsidiaries, they might be engaged in three types of activities from a V.A.T. perspective:

- Activities falling outside the scope of V.A.T.
- Activities falling within the scope of V.A.T. but that are V.A.T.-exempt
- Activities falling within the scope of V.A.T. that are fully taxable

In this context, the regular rules for exercising the V.A.T. deduction right[4] do not quite seem appropriate. While, in principle, the above-mentioned V.A.T. provisions only consider the performance of economic activities when assessing the right to deduct V.A.T., the role of the shareholding activity can hardly be ignored for active holding companies.

The other resulting question is to what extent this non-economic activity should be taken into account, bearing in mind that dividends might constitute significant income without necessarily being cost-consuming. On the other hand, the costs subject to the V.A.T. recovery claim could constitute a significant amount compared to the income generated from the taxable activity.

This mismatch has been notably addressed by Mrs. Juliane Kokott, Advocate General ("A.G."), in an opinion delivered on May 3, 2018, in the *Ryanair* case:

> A simple comparison of the values of the turnover from management services and from dividends neglects the fact that the holding of shares does not give rise to recurrent costs. Furthermore, the input tax surplus described above also exists only in the taxation period in which the acquisition of shares of a company occurs. If the management services are supplied for remuneration over a number of years, the situation is different.[5]

Consequently, this calls the determination of the input V.A.T. recovery right into question with respect to the allocation of costs incurred per activity performed.

C.J.E.U. General Principles for Determining V.A.T. Recovery Rights

The abundant C.J.E.U. jurisprudence establishes general guidelines for the allocation of costs to activities of the holding company:

- **Direct Allocation:** V.A.T. recovery is available for input transactions that are subject to V.A.T. and that have a direct and immediate link with one or more output transactions giving rise to the right to deduct. This condition is fulfilled when the expenditure is a component of the price of the output transaction that gives rise to the right to deduct.

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[4] Article 167 et seq. of the V.A.T. Directive.

[5] C.J.E.U., 10/17/2018, *Ryanair Ltd v. The Revenue Commissioners*, C-249/17, §30.

- **Overhead Costs:** Where the expenditure cannot be directly allocated to a specific output transaction, the treatment depends on whether the costs incurred were part of the general expenses linked to the taxable person's overall economic activities. In this situation, the expenditure will have, in principle, a direct and immediate link with the taxable person's business as a whole. Depending on the nature of the business, the related V.A.T. deduction will be (i) full (in the case of a fully taxable business), (ii) zero (in the case of a fully V.A.T.-exempt business), or (iii) partial (in the case of a combination of both taxable and V.A.T.-exempt activities).

In theory, these guidelines easily outline the V.A.T. recovery rights of active holding companies. However, their practical application raises many questions about the integration of the non-economic activity (*i.e.*, shareholding activity) in the calculation of deductible input V.A.T., leading to discrepancies among Member States and, consequently, to questions of prejudice being placed before the C.J.E.U.

DETERMINING V.A.T. RECOVERY RIGHTS IN SPECIFIC SITUATIONS

V.A.T. Deduction for Expenditures Incurred in a Shareholding Acquisition

V.A.T. Deduction for Expenditures for the Acquisition of a Shareholding (C.J.E.U., 09/27/2001, Cibo Participations, C-16/00)

Cibo Participations placed the first question before the C.J.E.U. concerning the deduction right for general expenditures incurred in the context of an acquisition of shares in an entity to which the holding company will supply taxable services.

According to the C.J.E.U., it is clear that the direct allocation method cannot be used in such context since no direct and immediate link can be drawn between the various costs incurred in the acquisition and a specific output transaction.[6] However, such costs can be considered general expenditures, which have a direct and immediate link with the overall activity of the taxable person.

Where the overall activity includes output transactions entitled and also not entitled to a V.A.T. recovery right (*i.e.*, a mix of taxable and V.A.T.-exempt activities), costs should be apportioned between these two activities, and only the portion related to output transactions entitled to a V.A.T. recovery right should benefit.

In other words, when costs qualify as general expenditures, they are linked to the overall activities of the taxable person and, in the case of mixed activities, an apportionment should be made to determine the *pro rata* deduction.

In this respect, the C.J.E.U. enunciated the following rule:

> Expenditure incurred by a holding company in respect of the various services which it purchases in connection with the acquisition of a shareholding in a subsidiary forms part of its general costs and therefore has, in principle, a direct and immediate link with its business as

[6] C.J.E.U., 09/27/2001, *Cibo Participations*, C-16/00.

> a whole. Thus, if the holding company carries out both transactions in respect of which value added tax is deductible and transactions in respect of which it is not, it follows . . . that it may deduct only that proportion of the value added tax which is attributable to the former.

Apportionment of Expenditures Based on Involvement in the Management of Subsidiaries (C.J.E.U., 07/16/2015, Larentia + Minerva, C-108/14 and C-109/14)

In *Larentia + Minerva*, the C.J.E.U. distinguished the situation in which a holding company manages all subsidiaries from a fact pattern in which only certain subsidiaries were managed by the holding company:

> The expenditure connected with the acquisition of shareholdings in subsidiaries incurred by a holding company which involves itself in their management and which, on that basis, carries out an economic activity must be regarded as belonging to its general expenditure[,] and the VAT paid on that expenditure must, in principle, be deducted in full, unless certain output economic transactions are exempt from VAT.
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> The expenditure connected with the acquisition of shareholdings in subsidiaries incurred by a holding company which involves itself in the management only of some of those subsidiaries and which, with regard to the others, does not, by contrast, carry out an economic activity must be regarded as only partially belonging to its general expenditure, so that the VAT paid on that expenditure may be deducted only in proportion to that which is inherent to the economic activity, according to the criteria for apportioning defined by the Member States, which when exercising that power, must . . . provide for a method of calculation which objectively reflects the part of the input expenditure actually to be attributed, respectively, to economic and to non-economic activity.

Broad Definition of Involvement in the Management of Subsidiaries (C.J.E.U., 07/05/2018, Marle Participations, C-320/17)

In a recent C.J.E.U. case, *Marle Participations*, the court clarified the concept of involvement in the management of subsidiaries and the conditions for exercising the right to claim input V.A.T. deduction for holding companies.

As previously stated, involvement in the management of subsidiaries is crucial for holding companies to claim input V.A.T. deductions because it qualifies the entity as active and therefore as a taxable person for V.A.T. purposes. If a holding company provides taxable services to its subsidiary, it automatically qualifies as a taxable person, irrespective of the nature of the services supplied. Traditionally, this referred to the supply of administrative, financial, commercial, and technical services and was therefore understood to be restrictive.

However, the C.J.E.U. ruling in *Marle Participations* broadened the scope to include the mere lease of a building to its subsidiary, provided the rent is subject to V.A.T. and the premises are regularly supplied to the subsidiary. Occasional supplies are

excluded from favorable treatment. Following this ruling, involvement is defined broadly as covering any service supplied to a subsidiary provided it is subject to V.A.T.

In regard to the input V.A.T. recovery right, the C.J.E.U. considers a cost to be linked to a shareholding acquisition even if the cost does not have a direct and immediate link to an output transaction. Indirect and deferred output transactions are considered linked to the overall economic activities of the active holding, *i.e.*, excluding the shareholding activity. The apportionment of costs linked to the shareholding activity applies only when the holding company is not involved in the management of all its subsidiaries. In *Marle Participations*, the C.J.E.U. ruled that the V.A.T. Directive would no longer be used to determine the scope of the input V.A.T. recovery right, such as mandating a *pro rata* deduction of costs. Instead, Member States may determine an appropriate allocation key in accordance with the general principles of the V.A.T. system.

"Member States may determine an appropriate allocation key in accordance with the general principles of the V.A.T. system."

Considering these three decisions, the position of the C.J.E.U. seems quite favorable regarding the recovery right for input V.A.T. for general expenditures incurred by an active holding company in the context of a shareholding acquisition, subject to the conditions mentioned.

V.A.T. Deduction for Abort Costs (C.J.E.U., 10/17/2018, Ryanair Ltd, C-249/17)

The C.J.E.U. issued another welcome decision for active holding companies regarding abort costs (*e.g.*, legal or due diligence costs) linked to an unsuccessful bid to take over shares of a competitor.

In regard to the qualification as a taxable person, the C.J.E.U. considers that the mere intention to supply management services to the intended target company constitutes preparatory acts for a taxable activity and therefore is sufficient to qualify the holding company as a taxable person at the time of incurring the abort costs. In addition, abort costs incurred in this context qualify as overhead costs linked to the economic activities of the holding company. Accordingly, the related input V.A.T. will be fully deductible in light of the intended taxable activity, even if not realized in the end.

This decision is in line with previous E.C.J. decisions and seems to confirm a favorable trend of access to the V.A.T. recovery right in the context of shareholding acquisition (even unsuccessful).

Limitation of the V.A.T. Deduction for General Expenditures for the Issuance of Shares (C.J.E.U., 03/13/2008, Securenta, C-437/06)

In regard to costs incurred in the context of the issuance of shares, the C.J.E.U. took a different approach while relying on the principles outlined above.

Although their qualification as overhead costs was not questioned, the C.J.E.U. ruled that the issuance of shares is linked to non-economic activity, *i.e.*, shareholding. In line with prior rulings, overhead costs must be linked with general activities of the active holding company*, i.e.,* economic and non-economic. Consequently, the input V.A.T. deduction right should be apportioned to the economic and non-economic activities. However, the C.J.E.U. left the determination of apportionment between these two activities to the discretion of the Member States.

V.A.T. Deduction for Expenditures Incurred in a Share Disposal

V.A.T. Recovery for Expenditures Incurred in a Share Disposal (C.J.E.U., 04/06/1995, BLP, C-4/94)

In *BLP*, the C.J.E.U. adopted a restrictive approach with regard to the input V.A.T. recovery right for expenditures linked to a share disposal. The company in question incurred various legal, accounting, and banking costs in relation to a sale of shares carried out to meet liquidity needs – funds from the disposal of one subsidiary were to be used to finance the provision of management services to other subsidiaries.

The C.J.E.U. held that the transaction carried out by the holding company was the sale of shares of a subsidiary. That activity was exempt from V.A.T. Consequently, there was no cost incurred to carry out a trade in whole or in part and no input V.A.T. was incurred. In addition, the costs incurred contained no direct and immediate link to a taxable output transaction. Hence, no input V.A.T. deduction right could be granted.

As is apparent, the approach of the C.J.E.U. in *BLP* was far more restrictive with respect to share purchase transactions.

V.A.T. Recovery for General Expenditures Incurred in a Share Disposal (C.J.E.U., 10/29/2009, AB SKF, C-29/08)

In *AB SKF*, the C.J.E.U. later took a less restrictive approach in a similar context.

Following *AB SKF*, the C.J.E.U. makes a distinction between costs directly allocated to an output transaction, *i.e.*, the sale of shares, and general costs not allocated to a particular output transaction. Costs incurred to sell shares are components of the price of the shares to be sold. Where they are not incorporated in the price, they constitute overhead costs and therefore have a direct and immediate link with the taxable person's economic activity as a whole.

Costs not allocated to a particular output transaction do not require apportionment between economic and non-economic activities. As to these costs, the C.J.E.U. adopted a taxpayer-friendly approach:

> The costs of the services in question are part of his general costs and are, as such, components of the price of the goods or services which he supplies. Such costs do have a direct and immediate link with the taxable person's economic activity as a whole.[7]

This applies regardless of the V.A.T. treatment applicable to the disposal of shares, where the transaction is V.A.T.-exempt or falling outside the scope of V.A.T. For these costs, the input V.A.T. deduction right is largely available to active holding companies.

V.A.T. Recovery for Expenditures Incurred in a Share Disposal of a Managed Subsidiary (C.J.E.U., 11/08/2018, C&D Foods Acquisition, C-502/17)

The decision in *C&D Foods Acquisition* claws back the scope of the decision in *AB SKF*. In *C&D Foods Acquisition*, the C.J.E.U. ruled that a sale of shares, in itself, does not constitute an economic activity, implying that no deduction of input V.A.T.

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[7] C.J.E.U., 04/06/1995, *BLP*, C-4/94, para. 58.

on related costs can be granted. Thus, it seems to adopt the holding in *BLP*. However, the case goes on to say that, if the direct and exclusive reason for the share sale relates to the taxable activity of the parent company, or constitutes a direct, permanent, and necessary extension of the parent company's taxable activity, a V.A.T. deduction right may be recognized. This would be the case if a sale of shares is carried out with the purpose of allocating the proceeds directly to the taxable activity of the parent company or to the economic activity carried out by the group of which it is the parent company. In substance, this suggests that the favorable ruling in *SKF* should be an exception to the general rule of *BLP*.

In sum, a deduction on share disposal costs is now possible in specific circumstances demonstrating that the underlying purpose of the transaction causes the share disposal to be directly and exclusively linked to a taxable activity. If so, an active holding company may be entitled to a V.A.T. recovery right on share disposal costs. While it may be easy to state the rule, the application may not be clear at all. What facts must exist to demonstrate that the purpose of the transaction meets the test of *C&D Foods Acquisition*? Certainly, detailed legal documentation relating to the objective of the divestment of shares might serve to support V.A.T. recovery on the connected costs. However, if no business records kept in the ordinary course of business by operating personnel address a business goal of the transaction, mere legal documents prepared by savvy lawyers may not suffice to justify V.A.T. recovery.

CONCLUSION

These numerous developments highlight the difficulty of establishing clear guidelines for determining the V.A.T. recovery right of active holding companies, particularly the apportionment between economic and non-economic activities.

Despite the guidance provided by the C.J.E.U., room for interpretation still exists and different approaches can be found among the Member States. In this context, it can be expected that questions will continue to be referred to the C.J.E.U. where the final decision may be based on the quality of the advocacy rather than well thought through policy.

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