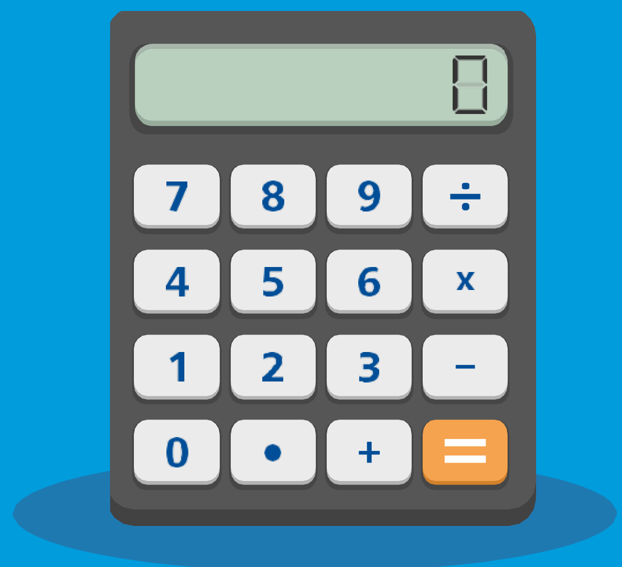
VAT implications arising from internal dealings between head-offices and branches

State of the art after the ECJ decision in Danske case (C-812/19)

Tax Alert



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VAT implications arising from internal dealings between head-offices and branches

The European Court of Justice ("ECJ") recently issued its decision on the Danske Bank A/S v. Skatteverket, case no. C-812/19 dated 11 March 2021 (the "Judgement"), clarifying some matters connected to its previous ruling on the Skandia case C-7/13. This decision, for sure, will have an impact in the VAT implications arising from transactions carried-out within the same legal entity.

Situation before the ECJ Danske case

Historically, even before the ECJ decision in the FCE Bank Case C-210/04, the Spanish industry and tax operators had treated internal transactions as not subject to Spanish VAT based on the lack of independency of the branch from its head-office (considering that transactions carried-out within the same legal entity should not be recognized for VAT purposes).

The ECJ issued, back in 2014, its decision on the Skandia case, which constituted a relevant milestone on the VAT treatment of cross-border intra-entity services. In this case, with a deep impact within the financial sector and subject to an intense debate, the ECJ established that the dealings made by the US head-office in the benefit of its branch in Sweden, which was part of a VAT group, should be deemed a taxable transaction for VAT purposes, as the branch was part of a single taxable person (being that the Swedish VAT group is different from the US head-office).

This decision, as anticipated, left a few open questions. Mainly, whether the case should be interpreted broadly being the conclusions reached therein applicable to all intra-entity-transactions (where at least one is part of a local VAT group) or if it should be restricted to cases where the branch receiving the services is the one forming part of the VAT group (a "establishment only" approach, as depicted in the Skandia situation). The VAT treatment was still unclear where the head-office providing the services is the one forming part of a VAT group (reverse Skandia situation). The extraterritorial effects of the option adopted by one EU member state (to implement the optional VAT group regime) raised some concerns in this regard.

The subsequent ECJ decision on the Morgan Stanley case C-165/17, which dealt with the deductibility of the input VAT borne by a branch incurring in costs which are wholly or partly used for the benefit of its head office, did not expressly address the recoverability of this cost in a Skandia or reverse Skandia situation.

In Spain, the peculiarities of the formula adopted by the Spanish lawmaker to implement the Spanish VAT group regime (where the entities preserve its own status as individual taxpayers and intra-group transactions are not disregarded for VAT purposes) also raised some controversy regarding the applicability of the Skandia conclusions in cases where one of the establishments belongs to a Spanish VAT group.

Even though the Spanish VAT group rules presumably intends to replicate the "single taxpayer" principle on which Article 11 of the VAT Directive relies, its effects may not always be consistent with the said principle.

Whereas the Spanish General Directorate of Taxes has not yet issued any ruling applying expressly the Skandia doctrine, the Spanish Tax Authorities recently launched a number of tax audits challenging the VAT treatment applied to services received by branches in Spain provided by its foreign head-offices, being the conclusions reached applicable even when the head-office does not form part of a VAT group in the EU country where it was established (forming what could be seen as the Spanish interpretation of FCE Bank decision).

In a nutshell, the Spanish Tax Authorities have argued that for the FCE Bank decision to apply, it is necessary to determine whether the branch is economically dependent from its head-office or not (based on different indicia such as the human and material means

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attributed to the branch, the risk-taking decision-making process, the funding of the branch's activities, etc.). By doing so and applying its own economic independency analysis, the Spanish Tax Authorities required some branches to self-assess the Spanish VAT on internal cost allocated by its foreign head-offices.

In its ruling issued on January 23, 2020, the Spanish Central Administrative Court ("SCAC") upheld this interpretation of the FCE Bank case by the Spanish Tax Authorities (in a specific case of a Spanish branch, formerly a subsidiary of an insurance entity). The SCAC also considered that the Skandia conclusions where applicable even though the peculiarities of the Spanish VAT grouping regime. This case is currently being further appealed before the Spanish judicial courts.

ECJ judgment on the Danske Bank case

The ECJ was asked to analyze the VAT treatment applicable in a reverse Skandia situation. In the case, it was a bank with its head-office in Denmark and was part of a VAT group in such country. The Danish head-office allocated costs from an IT platform to its fixed establishment in Sweden which was not part of any VAT group. The question was whether the fixed establishment in Sweden was required to self-assess Swedish (reverse-charged) VAT on these costs.

The ECJ held that the provision of services between the Danish head office of the bank and its Swedish fixed establishment were subject to VAT. The ECJ, thus, followed a broad interpretation of the position taken by previous in the Skandia case.

The Court concluded that services between a head-office and a fixed establishment are only taxable if a legal relationship exists between them in which there is a reciprocal performance of obligations. In the absence of such a legal relationship between a head office and a fixed establishment which, in principle, form one and the same taxable person, the services are non-taxable internal flows.

To that respect, it should be determined whether the head-office and/or the fixed establishment may be part of a VAT group that, pursuant to Article 11 of the VAT Directive, constitutes a separate taxable person of which the other establishment cannot be part of.

If so, the establishments would be seen as a separate taxable persons and the supplies between the head-office and the fixed establishment would be taxable for VAT purposes.

KPMG's input in Spain

The Judgment implies that, for the qualification of the relationship between the head office and a fixed establishment, the fact of whether one of them is part of a VAT group in another EU Member State should be considered. The legal characteristics of the foreign VAT grouping regime also need to be considered, to the extent that the Judgement specifically refers to VAT groups implemented under Article 11 of the VAT Directive ("single taxpayer" approach).

This Judgment also clarifies other pending questions after the ECJ decision on Skandia. For instance, the fact that it is the head-office (reverse Skandia/Danske) or the branch (Skandia) the one forming part of the VAT group seems now to be irrelevant. Also, the nature of the cost recharged (external or internal) does not appear to be a relevant to the analysis.

Although not expressly analyzed in the Judgment, it seems reasonable to conclude that the rationale of the ECJ in the Morgan Stanley case would not be applicable under a Skandia/Danske scenario, as the services rendered by the fixed establishment to the head office should be treated as any other supply (and be included or excluded from the numerator of the pro-rata, depending on their VAT treatment).

With regards to its impact in Spain, in our view, the Judgement still leaves room to different questions and interpretations.

In particular, it is unclear whether this Judgment would be applicable in cases where the head office belongs to a Spanish VAT group, given the peculiarities of the Spanish VAT grouping legal regime. The Italian Tax Authorities, for instance, decided to rely on the view of the Spanish Tax Authorities regarding the consistency between the Spanish VAT group rules (advanced level) and the single taxpayer VAT group regime provided for in Article 11 of the VAT Directive. However, the applicability of the Skandia considerations in this context should be further clarified by the Spanish courts, to the extent that there seem to be substantial arguments to challenge the current interpretation of the tax authorities in this regard.

It is expected that the Spanish courts also clarify whether the Spanish interpretation of the FCE Bank case and the indicators used by the Spanish Tax Authorities to challenge the dependency of branches from its head-offices are in line with the applicable Spanish and EU legislation.

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What are the next steps for fixed establishments in Spain?

The recent legal developments on the VAT treatment of internal dealings between establishments of the same legal entities should encourage group tax specialists within financial and insurance companies to thoroughly review the following matters:

1. Fixed establishments in Spain, as the recipients of supplies rendered by other establishments of the same legal entity, should analyze whether said establishments form part of a VAT group in another EU country.

   If that is the case, it should be then considered whether the features of the VAT group implemented in said jurisdiction are consistent with the “single taxpayer” principle provided for in Article 11 of the VAT Directive.

2. If the Spanish fixed establishment is the one included in a VAT group, group tax specialists will be expected to analyze whether the conclusions reached in the Danske case are applicable to them, in light of the peculiarities of the Spanish VAT group regime (and its notable asymmetries with the “single taxpayer” principle).

3. In the absence of a VAT group in the corporate structure, fixed establishments in Spain should be prepared to face the Spanish Tax Authorities' challenge on the application of the Spanish interpretation of the FCE Bank case and, specifically, determine their position is and the level of risk assumed in light of the “economic independence” indicators used by the Spanish Tax Authorities in past tax audits. Audit trail and defense files will be key to uphold any conclusions in this regard.

4. If significant risk areas are identified, fixed establishments will need to assess (i) the level of risk assumed in previous tax periods; (ii) whether a change in the current criteria is appropriate; and (iii) whether there are any alternatives to reduce the risk or to improve the recoverability of the eventual Spanish VAT accrued on these internal transactions.

5. Finally, Spanish based financial institutions belonging to a Spanish VAT group and engaged in internal dealings with its EU establishments should outline the tax treatment that its being applied in said jurisdictions, in view of the peculiarities of the Spanish VAT group regime.

What does the provider of the internal transaction should consider now?

Establishments providing services to the head-office and/or other branches should also consider if these transactions need to be taken into account for purposes of calculating their VAT recovery rate, and whether they can increase or reduce their right to deduct input VAT.

The analysis be quite different for establishments that may find themselves in a Morgan Stanley scenario, where the deductibility of input VAT should take into account the turnover of the foreign permanent establishment and for those establishments that are already under the scope of Skandia/Danske cases, where the deductibility should be determined in view of the VAT treatment of the respective internal flows, now being treated as a supplies between two different taxpayers.

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