VAT focus

Cost sharing: all shook up?

Speed read

The advocate general's opinion in *DNB Banka* and *Aviva* would, if upheld by the CJEU, result in a dramatic narrowing of the scope of the VAT exemption for cost sharing groups. The AG opined, inter alia, that: the VAT cost sharing group exemption has direct effect; the exemption is territorial in nature and is not intended to be applied on a cross-border basis; and any amounts charged by a cost sharing group over and above the exact reimbursements of costs will prevent the VAT exemption from applying, even where an uplift is required for direct tax purposes. The opinion not only has serious implications for existing cost sharing groups, it also raises much broader and vital questions as to the proper extent of the principle of territoriality, and the relationship between EU VAT law and the domestic legal system of the member states, as well as between the VAT Directive and other tax regimes.

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It seems fashionable of late to update old classics. Elvis Presley, despite being dead for 40 years, is currently touring with the Royal Philharmonic Orchestra, who have overlaid their interpretation over his original recordings. They are to appear in Brussels in May this year, 40 years since the Sixth VAT Directive was passed, bringing in the cost sharing exemption (CSE) in what is now article 132(1)(f).

This exemption allows a cost sharing group (CSG) to exempt supplies of services to its members, where these services are directly necessary for the exempt activities of the members, or for activities in respect of which they do not act as taxable persons. The charge to each member must reflect exact reimbursement for its share of the joint expenses and the exemption must not be likely to cause distortion of competition. It is listed under a public interest heading in the directive.

This has been settled law since 1977, and only three cases on it have been referred to the CJEU in the first 35 years or so of its existence. However, there have recently been four referrals on member state interpretations of the original words. This article will consider two of these in detail on which the advocate general has recently opined: *DNB Banka* (Case C-326/15) and *Aviva* (Case C-605/15).

I ain't askin' much of you...

The three previous CJEU references were: *Stichting Acties* (Case C-348/87) on lotteries; *Taksatorringen* (Case C-8/01) involving insurers; and *Stichting Toetsing* (Case C-407/07) dealing with a healthcare group. In *Acties*, the court decided the exemption could not apply to supplies by one foundation to another as the membership condition was not met. In *Taksatorringen*, the questions referred concerned distortion. In *Toetsing*, the issue was whether the CSE required the services to be offered to all members of the CSG.

The issue of who could take advantage of this exemption, or what services were directly necessary for the member's activities was not examined.

DNB Banka concerned financial services, IT services and software licences invoiced to DNB Banka AS in Latvia by related companies in Denmark. The charges carried a 5% uplift required under direct tax law.

Aviva concerned shared service centres to be set up in the form of a European Economic Interest Group (EEIG) supplying cross-border services arguably directly necessary for insurance activities (HR, finance, accounting, IT, customer service, administration and product development).

Wie du wirklich solst (treat me like you really should)

In *DNB Banka* and *Aviva*, the AG reached the following key conclusions:

- The CSG exemption has direct effect. As a result, member states have no discretion to impose rules on the legal form and rules of membership of CSGs.
- The CSG exemption can only encompass supplies to members with activities in the 'public interest' included in the Principal VAT Directive (PVD) art 132. By implication, it does not cover the financial and insurance sectors (or indeed social housing, for which exemptions derive from art 135).
- As a rule, services supplied by a CSG within art 132(1) (f) will not give rise to a distortion of competition, as the intention of the exemption is to remove a competitive disadvantage. Instead, this condition should aim at striking out abusive schemes where the exemption is inappropriate.
- The CSG exemption is territorial and is not intended to be applied on a cross-border basis.
- The CSG has to be a taxable person distinguishable from its members but does not need to be a legal person.
- Any amounts charged by a cost sharing group over and above the exact reimbursements of costs will prevent the VAT exemption from applying, even where an uplift is required for direct tax purposes (i.e. transfer pricing adjustment).

Apart from the relatively uncontentious conclusion on direct effect, we shall now consider these issues in order.

I forgot to remember to forget?

Suspicious minds might query why the CJEU never mentioned in the earlier lottery and insurance CSE cases that only those whose supplies are covered by PVD art 132 can benefit from the CSE.

In *RAL* (Case C-452/03) and *BUPA* (Case C-419/02),

reference was made to the potential need for the AG and CJEU to take into consideration points not raised in the reference in order to better assist the referring court. If insurance companies could not access the CSE at all, one would have expected the court in *Taksatorringen* to have said so, as the questions about distortion would have been irrelevant to the proper tax position. Instead, it seems the court implicitly accepted, as in *Acties,* that the exemption could in principle apply.

The AG has based her conclusion on the limited scope of the CSE on the purpose behind the provision, its drafting history, its location in the Directive and the schematic approach applied by the CJEU in *TMD* (Case C-412/15). She also references the Commission proposals to amend the finance and insurance exemptions.

When these (now defunct) proposals were first mooted the CSE was indeed touched upon, but only because it has not been implemented consistently by those member states that had adopted it. The suggestion was made that its scope should be clarified. This is, however, a long way from saying that this exemption did not cover finance and insurance activities when originally drafted. The primary purpose of the CSE is to remove a competitive disadvantage for smaller companies. This concept does not of itself exclude the finance, insurance or indeed the social housing sectors.

Well respected commentaries on the Directive and several Commission papers all seem to agree that the exemption is open to anyone whose activities are exempt or in respect of which they are not taxable persons (subject to the other conditions being met). Indeed, as noted in the papers, many of the CSGs operating successfully in the EU comprise financial and insurance sector members.

TMD concerned blood plasma used for industrial purposes. Human blood is exempt under PVD art 132. The CJEU, however, concluded this industrial use plasma was not exempt as it had no connection to healthcare, so exempting it would have been contrary to the purpose of the exemption. It is difficult to see this case demonstrating that the headings in the PVD restrict the extent of the main articles' scope, particularly as in *Hoffmann* (Case C-144/00) the court seemed quite content that the public interest heading of what was then art 13A (now art 132) does not 'of itself entail restrictions on the possibilities of exemption'.

Too much?

In *Aviva*, the AG concludes that the distortion of competition condition should be read in light of PVD art 131, which caters inter alia for the prevention of abuse. In her view, appropriate use of the CSE should not lead to distortion of competition, as the purpose of the exemption is to remove a competitive disadvantage for small businesses that lack in-house resource to provide the services, or the ability to source services VAT free from fellow VAT group members. One of the reasons for this is that a CSG only provides services to its members and as such does not compete on a wider open market.

Rather than providing specific criteria to assess whether the application of the CSE would distort competition, the AG instead suggests three examples which cross the line and where the exemption would be inappropriate.

First, she suggests that CSGs providing services to non-members leverage their synergies to compete in the wider market. They should therefore be considered distortive, even though the services to non-members would not be exempt.

The second example is where the 'primary purpose' of forming the CSG is to optimise the input VAT burden, rather than establishing the conditions for 'reciprocal cooperation'. This is a critical and difficult point. The exemption exists to reduce the burden on small operators. It does this by not levying VAT which is an obstacle to their reciprocal cooperation. Provided that the creation of a CSG is a commercially viable proposition, what is to prevent a taxpayer from choosing the option if it results in a lower incidence of VAT, even if that is the primary purpose?

Her third and last example indicates that if the services of the CSG are not tailored to the specific needs of its members, this may be an indication that the application of the CSE would distort competition as then the members would not have needed to cooperate to obtain these services.

Many existing CSGs across Europe would certainly fail the AG's test on distortion of competition, both as regards the provision of (VATable) services to non-members, and of overhead services not tailored to the specific needs of their members. It is also rare for a CSG member to be wholly exempt. Is the criterion too strict for the exemption to have effect?

Green, green grass of home?

The AG also concludes that only services a CSG supplies to members located in the same territory are covered by the exemption. She considers that this is supported by the territorial heading of the old Sixth Directive location of this exemption, the need for consistency with the VAT grouping provision, the need to facilitate assessment by each member state of the distortion of competition position by confining this to their national markets, and by the need to prevent non-taxation through the use of non-EU CSGs.

More fundamentally, precluding the CSE's application in cross-border situations would arguably be contrary to the overriding objectives of the EU single market

Several objections naturally arise. First, the wording of the current section of the PVD, where the CSE is located is not territorial. Secondly, despite 'territorial' wording, it is clear that not all member states view VAT groups as limited to their borders. The UK allows overseas establishments of UK VAT group members to be included in the UK VAT group, unless this is prevented by the way that the member state where the overseas establishment is located has implemented *Skandia* (Case C-7/13). Part of the delay in formulating an EU-wide response to that case arises from the differing approaches of member states in this regard. It is therefore questionable whether one can align the CSE with any consistent view of VAT grouping.

More fundamentally, precluding the CSE's application in cross-border situations would arguably be contrary to the overriding objectives of the EU single market and hamper smaller operators from linking up with their peers in other member states to compete successfully with larger businesses. If services supplied domestically were exempt, whilst the same services cross-border were taxable based solely on the place of establishment of the

CSG and its members, this would raise serious questions as to the principles of freedom of establishment. Although one must acknowledge that the application of the CSE in cross-border situations may create difficulties in terms of control and assessment, this is less a matter of VAT law than a matter of international tax cooperation that could be mitigated by virtue of mutual assistance.

To our knowledge, none of the member states currently preclude the setting-up of cross-border CSGs, even if restrictive conditions may apply. In practice, the CSG exemption has been largely applied in cross-border situations across the EU for decades, especially in Belgium, France, Luxembourg and the Netherlands. If the CJEU follows the opinion of the AG, this could have detrimental consequences on existing cross-border structures, and perhaps force countries such as France and Luxembourg to introduce VAT grouping provisions.

I just can't make it by myself

In the *DNB Banka* case, the reference asked whether a CSG must be a separate legal person created by a specific agreement or can exist by the simple fact that related undertakings provide each other with services. The AG considers that a CSG does not need to be a legal person, but must constitute an independent taxable person acting as such, as otherwise its activities could never be potentially subject to VAT in the first place. The concept of independence has been dealt with by the CJEU on several occasions, although the only explicit argument mentioned by the AG is the criterion that an independent person must be capable of owning property.

In *DNB Banka*, the fact that the group of associated companies is not a legal person would not be a problem. As it is unable to own property, however, it cannot qualify as a taxable person and the CSE is not possible.

The UK already requires the CSG to be a separate legal person, but in countries where the CSE is commonly used (such as France and Luxembourg), it has historically accepted that the existence of a CSG can derive from the mere existence of separate accounts in each group company that cater for the costs and revenues of the relevant intra-group services. If the CJEU follows the AG, this will not be possible any more.

The application of such a condition here is particularly interesting, given that EU VAT law is usually meant to sit above national legal systems, whereas the ability to own property is linked to the member state's domestic provisions. If the principle is extended logically, can a UK VAT group itself own property? If not, does it lose the ability to be treated as a taxable person?

Caught in a trap?

The AG believes that the Directive clearly states the CSE cannot apply where consideration paid for shared services goes beyond the exact reimbursement of expenses. Mark-ups required by transfer pricing direct tax legislation therefore disqualify a CSG from the exemption.

As with the territoriality and independence criteria, this again raises a question of overlapping jurisdiction. It is possible that, due to domestic transfer pricing rules where the group is established, the CSG has to apply an uplift to be compliant. This is a regime governed by different principles from those that apply to VAT. Indeed in *FCE Bank* (Case C-210/04), the CJEU says: 'It should be noted that the OECD Convention is irrelevant since it concerns direct taxation, whereas VAT is an indirect tax.' A transfer pricing adjustment mandated by law may arguably not be consideration in the true VAT sense. Although an assessment made at transaction level by one of the traditional transfer pricing methods (such as cost plus) may have VAT consequences for the underlying service if there is an actual re-evaluation of the initial consideration as a result of transfer pricing requirements, this is not a general rule. After all, a transfer pricing adjustment can also be reflected by a tax return entry rather than by an above the line charge, leaving the value of the supply for VAT unaltered. Should a domestic direct tax provision make an EU VAT exemption impossible or excessively difficult to access?

The wonder of EU?

Taken together with AG Kokott's opinion in *Commission v Luxembourg* (Case C-274/15) on the meaning of directly necessary (where general use overhead type services, supplied to a CSG member who also makes taxable supplies, were not viewed as directly necessary for the exempt and/or outside the scope of activities of the CSG members), these opinions would, if upheld, make the scope of this exemption exceptionally narrow. It is rare for a group member to be wholly exempt, and the overhead type services are generally the ones that are most relevant and valuable for CSGs and their members. This could truly be the 'end of the end' for this exemption.

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The opinions also raise much broader and vital questions, however, as to the proper extent of the principle of territoriality, the relationship between EU VAT law and the domestic legal system of the member states, as well as between the VAT Directive and other tax regimes. A fourth CSE case, *Commission v Germany* (Case C-616/15), is also pending. This will have an advocate general's opinion (from a different AG) in early April. However, it looks more straightforward. Germany limits the scope of the CSE to healthcare businesses and this does look to be too restrictive an application.

As with the Elvis tour, modern interpretations are now being placed on old classics and the question for the CJEU is whether this is 'too much'. So what should CSGs who would be adversely impacted if these opinions are upheld by the CJEU do now? The first thing is not to panic unduly. We need to see what the CJEU says and then what the various tax authorities do in response. Whilst monitoring developments, practical steps could include considering the strength of current arrangements and the feasibility of alternative options to achieve or maintain VAT efficiencies. ■

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- Cases: *European Commission v Luxembourg* (11.10.16)
- VAT exemption for cost-sharing arrangements (Tony Jaras, 23.2.12)
- The public sector and the VAT cost sharing exemption (Rowena Clifton, 16.2.17)