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VAT focus

Morgan Stanley: VAT recovery and the 'double layer' test

Speed read

The lack of clarity regarding the VAT recovery rules applicable to a branch supporting its head office has led to practical difficulties and the application of different deduction methods across the European Union. On 3 October 2018, Advocate General Mengozzi handed down his opinion in *Morgan Stanley* (Case C-165/17). If the court agrees with him, the method used to determine the recoverable proportion of input tax may become severely complex in cross-border scenarios. Taxpayers operating in the financial and insurance sectors may need to consider their current cross-border intra-entity flows and anticipate potential risks regarding their VAT recovery position.

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It has been 12 years since the landmark judgment in *FCE Bank* (Case C-210/04), in which the Court of Justice of European Union (CJEU) opined that 'a fixed establishment, which is not a legal entity distinct from the company of which it forms part, established in another member state and to which the company supplies services, should not be treated as a taxable person by reason of the costs imputed to it in respect of those supplies [i.e. between both establishments]'.

As a result thereof, the flows of 'services' between a non-independent branch and its head office are disregarded for VAT purposes, since no supply can possibly exist within the same legal entity due to the absence of legal relationship. It is thus accepted that a branch and its head office constitute one taxable person for VAT purposes, regardless of whether the branch and the head office are located in the same or in different member states.

According to settled case law, deduction of input tax on expenditure is allowed where there is a direct and immediate link between inputs and taxable outputs. When this nexus is lacking, recovery should be allowed, provided that the costs are part of the taxable person's taxable economic activity as a whole.

In the context of a branch supporting its foreign head office, and therefore providing 'transparent' output supplies itself, the issue is whether there are enough grounds to enable the branch to recover input tax it incurs in the furtherance of its supporting activity. Indeed, strictly speaking, the branch is not carrying out any economic activity as far as the supporting activity is concerned, albeit it does so *via* its head office.

In *ESET* (Case C-393/15), the CJEU has confirmed that a Polish branch – which was occasionally carrying out (only taxable) supplies to third parties – had the right to recover input tax it had incurred for the purposes of supporting its Slovakian head office. This order of the court thereby recognised the so-called 'look-through' principle. One could have closed off the debate here. However, since *ESET* was a fully taxable business, the court did not address the question of deductible *proportion*.

Arguably, if a head office is engaged in both taxable and exempt supplies (mixed taxable person), the determination of the deductible proportion of input tax for the branch, in connection with the costs the branch incurs for the purposes of its head office supporting activity, must imply a need to consider the head office VAT recovery position. This is because the branch is using input tax with the view to contributing to its head office output supplies either exclusively or also for the branch's own supplies if it makes any. In other words, one has no other option than looking beyond the 'border' at the foreign head office's turnover.

This approach was taken in *Monte Dei Paschi* (Case C-136/99). In addition to recognising the right for the Italian bank to recover input tax incurred by its French representative office as a non-established entity, the court held that the amount of VAT refundable should be calculated:

- first, by recognising which transactions give rise to a right to deduction in Italy; and
- second, by taking account solely of the transactions which would also give rise to a right of deduction in France if they were carried out there.

The question is whether such 'double layer test' should apply *mutatis mutandis* to the situation of an established branch.

In *Crédit Lyonnais* (Case C-388/11), the CJEU stated that a head office cannot take into account, when calculating the deductible proportion, the turnover of its branches located in the other countries (EU and non-EU). The court therefore rejected the so-called 'worldwide pro rata'.

On the face of it, one could therefore be of the view that *Crédit Lyonnais* precludes a '*Monte Dei Paschi* type approach' where a branch is involved. Nevertheless, in *Crédit Lyonnais*, it appears crucial to stress that:

- the head office's approach consisted of taking *all* of its branches' turnover into account when calculating its recovery, without any indication of direct and immediate link between that turnover and any inputs it would have incurred; and
- it did not involve any intra-entity flows of services from head office to branch.

Besides, the court regarded the issue at hand from a head office rather than from a branch's perspective.

In the current state of law, the determination of deductible proportion for a branch supporting its foreign head office (a mixed taxable person), is thus uncertain. The questions referred to in *Morgan Stanley* aim at addressing this very issue.

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Morgan Stanley: the facts

Morgan Stanley UK head-office (MS-UK) has a branch in France (MS-FR). MS-FR has incurred French VAT on:

i. expenditure it has borne for the purposes of carrying out 'supplies' to its UK head office (costs 'exclusively' used for the transactions performed by MS-UK, which are both taxable and exempt);
ii. expenditure used both for transactions made by MS-FR itself with third parties and for transactions made by MS-UK; and
iii. expenditure exclusively used for taxable supplies made by MS-FR to third parties (this was not in dispute before the domestic court).

MS-FR has recovered input tax in full in relation to categories (i) and (ii). MS-FR's argument was primarily based on the fact that, since supplies between MS-UK and MS-FR should be disregarded (and thus ignored), one should only take MS-FR's supplies to third parties into account for recovery purposes. Given that MS-FR has opted to tax such supplies in France, full recovery should be granted as MS-FR's only supplies for VAT purposes are taxable.

Instead, the French tax authority has challenged the recovery made by MS-FR on the grounds that input tax incurred by MS-FR for the purposes of exclusively carrying out its support of MS-UK were 'outside the scope of VAT' with no recovery (internal head office to branch transactions).

MS-FR disputed this position and the case went before the Conseil d'Etat. Against this background, the French administrative court has decided to refer to the CJEU by asking the following questions:

1. Which member state's input tax recovery rules should apply when expenditure is incurred *exclusively* for providing support to MS-UK: (i) French rules; (ii) UK rules; or (iii) a combination of both?
2. Which member state's input tax recovery rules should apply when expenditure is incurred *for both transactions* performed by MS-FR to third parties and for the support provided by MS-FR to MS-UK?

AG's opinion

In light of previous case law – namely *Monte Dei Paschi, Crédit Lyonnais* and *ESET* – and the relevant provisions laid down in Directive 2006/112/EC (i.e. articles 168, 169 and 173 to 175), the AG opines that the following recovery rules should apply in determining whether MS-FR should be able to recover French VAT it has incurred on expenditure:

(a) used exclusively by MS-FR for the purposes of carrying out transactions to third parties: in principle, French VAT recovery rules should apply;
(b) used exclusively by MS-UK for the purposes of carrying out exempt transactions to third parties: input tax recovery should be blocked even if these transactions would have been taxable if made in France (*via* an option to tax for financial services that French law permits);
(c) used exclusively by MS-UK for the purposes of carrying out taxable transactions to third parties: input tax recovery should be granted if these transactions would have been taxable if made in France ('double layer test');
(d) used exclusively by MS-UK for the purposes of carrying out exempt and taxable transactions to third parties: a 'pro rata' should be used whereby the numerator would be comprised of:
   - taxable supplies made by MS FR to third parties; and
   - taxable supplies made by MS-UK to third parties if these would have been taxable if made in France;

   and the denominator would be comprised of:
   - the whole turnover made by MS-FR; and
   - the whole turnover made by MS-UK to third parties; and
(e) used for both transactions made by MS-UK to third parties and by MS-FR to third parties: the same prorata method should be used as under point (d).

Following the AG, this middle ground approach satisfies the principle of neutrality (by granting some recovery to MS-FR) and the rational allocation of the spheres of application of national legislation as regards VAT deduction (by giving a say to both member states).

Practical difficulties

In the authors' view, the conclusion reached by the AG may appear satisfactory insofar as he strikes a balance by favouring a two-country approach through a lowest common denominator test as in *Monte Dei Paschi*. However, it may lead to significant practical hurdles for taxpayers involved in financial and insurance service transactions.

> VAT recovery of input tax incurred on costs exclusively used for the head office supplies would only be possible if the 'double layer test' is met: (i) it must be taxable in the member state of the head office; and (ii) it must be taxable in the member state of the branch.

First, VAT recovery of input tax incurred on costs exclusively used for the head office supplies would only be possible if the 'double layer test' is met: (i) it must be taxable in the member state of the head office; and (ii) it must be taxable in the member state of the branch. It will therefore require taxpayers to identify the supplies and determine their VAT liability in both countries in order to confirm the final VAT recovery position.

Consequently, the level of recovery in the member state of the branch will at best be either equal to the one where the head office is located, or lower if the former regards some of the taxable services as being exempt according to its own legislation. This approach will frustrate taxpayers that have opted to tax in the country of the branch when the supplies made by the head office are exempt in the latter's location.

Second, the use of a pro rata for expenditure incurred in relation to both transactions made by the head office and the branch to third parties may raise questions as to the compatibility of the UK legislation with EU law. The AG's approach provides for the inclusion of the head office turnover in the pro rata of the branch.

Prima facie, it might appear in contradiction with *Crédit Lyonnais*.

However, a careful reader will note that input tax incurred by a branch for the purposes of supporting its head office presents a link with output activities made

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by the head office, which justifies the inclusion of the turnover made by the head office.

In the UK, input tax can be attributed to supplies made by a foreign establishment through a sectorised method, which presupposes the identification of input tax that relates to such foreign establishment in the first place. The UK legislation does not extend as far as allowing the inclusion of the total turnover of the foreign establishment, although it may not necessarily lead to different economic results.

Unaddressed issues

First, in the case at hand, both establishments are located within the EU. In a situation where the head office is located outside the EU, would it have any impact on the recovery calculation when a pro rata is used?

Arguably, if the branch has to include the turnover of its non-EU head office (assuming that turnover is fully exempt with recovery and the same liability would apply if the branch made those supplies), it may likely inflate the VAT recovery of the branch; however, UK partial exemption rules would probably prevent this.

Second, the French referring court has not asked whether the existence of a VAT group would have any effect. It is unsurprising since France has not implemented VAT grouping and the UK applies *FCE Bank* in this scenario.

However, if a scenario includes a country that has implemented VAT grouping and *Skandia* (Case C-7/13) (and reverse *Skandia*), the question arises as to whether one should look at both establishments to constitute two separate taxpayers. Arguably, if one accepts that *Skandia* snaps the link between a branch and its head office, the answer should likely be positive. The 'recovery issue' in the case at hand would be swept away since the branch would be making taxable supplies to its head office.

What next?

The opinion of the AG is likely to significantly increase complexity. So what should taxpayers who would be adversely impacted if the opinion is upheld do now? The first thing is not to panic. We need to see what the CJEU says and then what the various tax authorities do in response, especially in the UK post-Brexit world. Whilst monitoring developments, practical steps could include identifying the current intra-entity flows and considering any option to secure VAT recovery.

> The opinion of the AG is likely to significantly increase complexity

One thing is for certain: double layer now has a whole new meaning that has nothing to do with the 'cushiony softness' of a certain essential bathroom product, or large sponge cakes, or sports clothing, which are the things that most of us have only ever previously associated the concept with. ■

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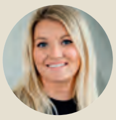

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