CJEU sets complex rules for VAT recovery by businesses operating cross-border through branches

On 24 January 2019, the Court of Justice of the European Union (CJEU) ruled that branches, which incur VAT on expenses used wholly or partly for head office supplies, must consider the head office’s activity to determine the branch VAT recovery calculation (Case C-165/17 Morgan Stanley). This interpretation of the EU VAT rules is likely to result in additional complexity and cost for financial institutions operating through branch structures in Europe.

Background

The French branch of Morgan Stanley, a financial services business with a UK head office, has taxable income (banking and financial operations for which the branch opted to tax) and income that is outside the scope of VAT, as it consists of recharges to the UK head.

The taxpayer had been recovering the French input tax in full, in accordance with the recovery rate resulting from its French branch activities. The French tax authorities assessed Morgan Stanley, claiming that input tax recovery should be restricted where that input tax was used exclusively, or partly, for mixed liability activities carried out by the head office.

CJEU judgment
On the VAT recovery rules to be applied in such situations, the CJEU found that it is necessary to consider the VAT recovery status of the supplies under both French and UK legislation. The branch can only deduct VAT on expenses that relate to supplies that give right to VAT recovery in both Member States. This formalises the CJEU’s earlier judgment in Monte Dei Paschi Di Siena (C-136/99).

When defining which supplies had to be considered to calculate the VAT recovery entitlement, the CJEU limited its judgment to the two questions raised:

1. Costs incurred by a branch used exclusively by its ‘principal establishment’ in another Member State (i.e. the head office) where that principal establishment uses those costs to make supplies which both give the right to deduct VAT, and those which do not. This would for example apply where support functions are set up in a branch which are fully related to services rendered to clients by the head office.

2. Costs incurred by a branch used partly by that branch and partly by the principal establishment: in both cases, where those costs are used for supplies which do and do not give the right to deduct VAT. This would typically cover the overhead expenses of a branch that would have its own supplies towards clients and an internal activity towards the head office.

The CJEU proposed a different VAT recovery solution for the two scenarios. The references to the UK and France in the calculations represent how the calculations would work in the case at hand.

**Scenario 1 – Exclusive use by the principal establishment**

With respect to costs incurred by the branch that are used exclusively by the head office, only the supplies for which the expenses were exclusively used must be considered.

As such, the following recovery calculation should apply:

\[
\text{Taxable turnover to which the expenses relate, which permits VAT deduction in both the UK and France} / \text{Total turnover to which the expenses relate}
\]

This position seems to assume that the costs can be linked exclusively to particular supplies of the head office. If the activity which the branch performs for the head office cannot be allocated to a specific function, then this would require the full income of the head office to be requalified according to the branch country VAT recovery rules and included in the branch office calculation.

**Scenario 2 – Use by both the branch and principal establishment**

With respect to costs incurred by the branch that are used both by the branch and the head office, all activities of the branch
and principal establishment must be considered to determine VAT recovery by the branch.

As such, the following recovery calculation should apply:

\[
\text{Taxable turnover of the French branch + taxable turnover of UK head office (where that same turnover would also be taxable in France)}
\]

\[
\text{Total turnover of French branch and UK head office}
\]

**Deloitte comment**

With this judgment, the CJEU confirms how the allocation of expenses by an establishment should be the first step to determine the applicable VAT recovery methodology.

Furthermore, the CJEU confirmed that, to the extent overseas activities are included in a VAT recovery methodology, those activities must give rise to VAT recovery in both jurisdictions.

In practice, the appropriate methodology to use and activities to include depends on the use and allocation of the expenses in question. Practical questions also remain, such as how VAT group turnover and non-turnover based VAT recovery methods might be reflected in the above calculations.

However, it is clear that the CJEU intends businesses utilising a branch structure, and incurring VAT on costs in one jurisdiction to use them (in whole or part) to make supplies in another jurisdiction, to evaluate how those supplies give right to VAT recovery in both jurisdictions and to reflect this in VAT recovery methods.

How domestic tax authorities will practically interpret this judgment, particularly in scenarios other than the specific situations analysed by the CJEU, remains to be seen.

**Webinar on CJEU judgment**

Deloitte will be hosting a webinar at 11:00 am (CET) on 29 January 2019, where EMEA VAT experts will discuss this judgment in more detail.

[Register for this webcast](#)
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