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VAT Recovery for Holding Companies

Introduction

Almost 20 years on from the CJEU's decision in *Cibo Participations* C-16/00 the VAT deductibility rules for holding companies continue to be one of the most fertile areas for tax litigation. Despite the jurisprudence at EU level, there is still a reluctance of tax authorities to fully accept what the courts have said, and this continues to lead to disputes with taxpayers. There remains a multitude of case law on the matter, including, from an Irish perspective, the notable 2018 Court of Justice of the European Union (CJEU) judgment in *Ryanair* C-249/17.

In July 2019 Revenue published its much anticipated Tax and Duty Manual on "VAT Deductibility for Holding Companies", which provides a useful reference point for Irish holding companies seeking to understand the principles governing entitlement to deductibility as set out in the CJEU jurisprudence.

In this article we look at the key principles set out in the manual and Revenue's perspective on the deductibility entitlements of holding companies.

The General Rules for VAT Deductibility

The guidance begins with the general rules on VAT deductibility for holding companies, as follows:

- VAT incurred on costs that have a direct and immediate link to taxable transactions or qualifying activities (i.e. certain VAT-exempt activities that give the right to deduct) is deductible in full.
- VAT incurred on costs that have a direct and immediate link to non-taxable or exempt transactions is wholly non-deductible.
- For costs that do not have a direct and immediate link to transactions that give rise to a right to deduct, there can be an entitlement to deduct some or all of the VAT incurred if it can be shown that such expenditure is a general cost of the business's economic activity as a whole.

The guidance clarifies that the term "direct and immediate link", which is the basic test of a right to deduct, is interchangeable with the term "use". Therefore, when determining whether a cost has a direct and immediate link with transactions/activities, it is necessary to consider how these costs have been used. In addition, the existence of a direct and immediate link presupposes that such costs are a cost component of that transaction and/or qualifying activity.

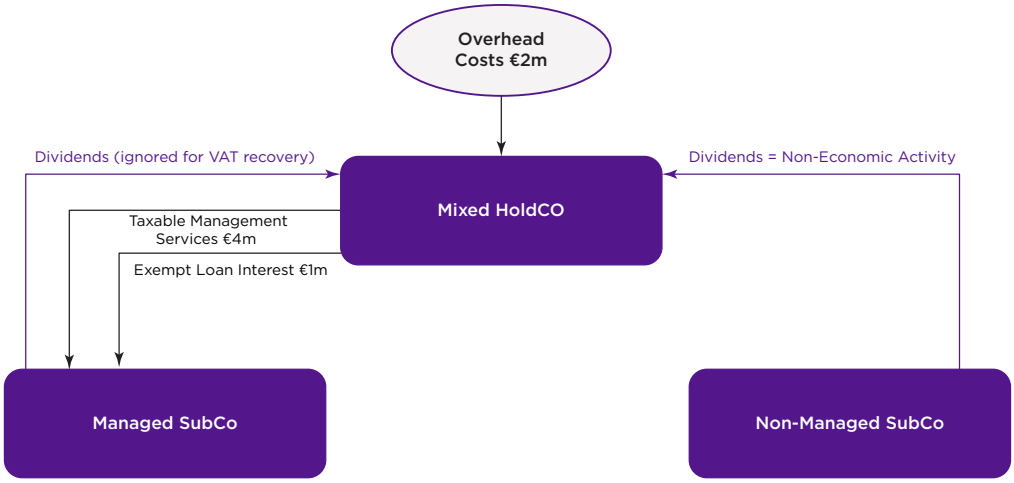
This is in line with s59(2) of the Value-Added Tax Consolidation Act 2010 (VATCA 2010), which provides that a person may deduct VAT incurred on the acquisition of goods or services acquired in so far as those goods or services are "used by him or her for the purposes of his or her taxable supplies or any of the qualifying activities".

However, the absence of a direct and immediate link does not always lead to the denial of the right to deduct. The CJEU has also held that a taxable person has a right to deduct, even where there is no direct and immediate link between a particular input transaction and an output transaction, if the expenditure incurred is part of the general costs and is, as such, a component of the price of the goods or services that the taxable person supplies.

However, as the decision in *Securenta* C-437/06 pointed out, there is a preliminary stage for holding companies that have holdings that they manage and holdings that they do not manage. An apportionment of overhead costs has to be made between the economic activity (i.e. those subsidiaries that are managed) and the non-economic activity (i.e. those subsidiaries that are not managed). That element of costs that relates to the economic activity may need a further apportionment between deductible and non-deductible economic activities. Given the complex and technical nature of this exercise, it is best illustrated by categorising the types of costs and the VAT deduction rules based on three typical holding company structures.

To illustrate by way of example:

- Mixed HoldCo has two subsidiaries – Managed SubCo and Non-Managed SubCo.
- It does not provide management services to Non-Managed SubCo, its only income from Non-Managed SubCo is dividends which are outside the scope of VAT.
- It provides taxable management services to Managed SubCo of €4m and has granted a VAT exempt loan, annual interest on the loan is €1m. It will also receive dividends from Managed SubCo.
- Mixed HoldCo has general overhead costs on which it has incurred VAT of €2m.



Step 1 of VAT recovery: Apportion the VAT on overhead costs between the economic and non-economic activity

Mixed HoldCo has two subsidiaries – one that it provides management services to (economic activity) and one that it does not provide management services to (non-economic activity). Assuming that the overhead costs are attributed equally to the economic and non-economic activity, the split will be 50:50. As such, €1m (€2m*50%) of the VAT incurred on overhead costs is attributable to the economic activity. The €1m related to the non-economic activity is irrecoverable.

Step 2 of VAT Recovery: Apportion the VAT attributable to the economic activity between taxable (deductible) and exempt (non-deductible) supplies.

The €1m of VAT on overhead costs attributable to the economic activity, needs to be further apportioned between taxable and exempt services made to Managed SubCo. The income from the taxable activity of providing management services is €4m, while the income from the exempt activity of lending is €1m. As such, assuming that turnover is an accurate reflection of the use of these costs, the split is 80:20 deductible to non-deductible. As such, 80% of the VAT attributed to the economic activities is recoverable €800k (€1m *80%). You will note that the dividend income received from the Managed SubCo is ignored.

Share Acquisition Costs

The manual splits the VAT recovery rules for share acquisition costs based on three types of holding company structures.

Passive holding companies

The purpose of passive holding companies is solely to acquire and hold shares, an activity that by itself, and as established in settled case law, is not an economic activity for VAT purposes. As the only income derived from the passive holding of shares is dividends (which do not fall within the scope of VAT), passive holding companies are not entitled to recover VAT on share acquisition costs.

This CJEU confirmed this position in the judgment in *Cibo* C-16/00, where it held that a holding company whose sole purpose is to acquire shares in undertakings and that does not involve itself directly or indirectly in the management of those undertakings is not

considered to be a taxable person for VAT purposes and therefore has no right to deduct VAT incurred.

Active holding companies

By contrast, active holding companies acquire shareholdings and involve themselves in the management of those acquired undertakings, and therefore active holding companies are considered to be carrying on an economic activity for VAT purposes.

Generally, the management services provided consist of administration, accounting, financial, commercial and IT services, but Revenue confirms in its guidance that the list of services that can fall within this category is not exhaustive and that any supplies by a holding company to a subsidiary can constitute a taxable economic activity where such supplies are made on a continuing basis and are subject to VAT.

The CJEU ruled in *Larentia + Minerva* C-108/14 that share acquisition costs are part of the general costs of an active holding company and that it has the right to deduct VAT incurred on deal costs based on the extent to which the company is engaged in taxable economic activities. Therefore, in the case of active holding companies providing only VATable management services to subsidiaries, the VAT incurred on share acquisition costs is deductible in full. If active holding companies provide a mixture of taxable and exempt services, it would be necessary to apportion the VAT incurred to determine the percentage recoverable.

In its guidance, Revenue confirms that the right to deduct arises at the time when the costs are incurred, but for holdings companies to support this right it is important they hold objective evidence that they intend to provide taxable management services. The question remains for holding companies of what "objective evidence" would be adequate.

The question of intention was key in the recent *Ryanair* case C-249/17, an Irish referral to the CJEU, in relation to the airline's failed attempt to acquire Aer Lingus. Ryanair sought to deduct VAT on costs incurred in relation to the proposed acquisition. The deduction was blocked by Irish Revenue on the basis that Ryanair did not acquire the shares and therefore it did not provide the intended taxable management services that granted it a right to deduct VAT. Upon referral from Ireland, the CJEU held that as Ryanair intended to pursue a taxable economic activity once the shares were acquired (i.e. the provision of taxable management services to Aer Lingus), it was entitled to deduct the VAT at the time its costs were incurred even though the planned activity was never in fact carried out.

Revenue importantly also clarifies in its guidance that the level of management fees charged does not affect the deductibility of VAT incurred on share acquisition costs and therefore the VAT incurred is deductible even if the management fees are less than the input costs incurred in acquiring the shares. This position was recently endorsed by the Advocate-General in *Sonaecom* C-42/19. However, there is a sting in the tail. UK case law exists that has held that where consideration is contingent or where the amount charged does not reflect the value of the services, it does not function as consideration for VAT purposes and consequently there is no economic activity to which to tie VAT recovery.

Therefore, although there is no requirement to match inputs to outputs, a nominal consideration or a contingent consideration may not be sufficient to make a holding company a taxable person.

Mixed holding companies

A mixed holding company is engaged in both economic activities (active shareholding) and non-economic activities (passive shareholding). To put it simply, mixed holding companies

provide management and other services to certain subsidiaries and not to others.

The deductibility of VAT incurred on share acquisition costs therefore depends, firstly, on whether such expenditure is linked to the company's economic or non-economic activity and, if linked to the economic activity, the extent to which this economic activity is taxable. Where acquisition costs are related to both taxable and exempt economic activities, the input VAT must be apportioned.

In *Larentia + Minerva* C-108/14 the CJEU echoed the rule established in *Cibo* C-16/00 – that the involvement of a holding company in the management of a subsidiary is an economic activity for VAT – but also confirmed the position in *Securenta* C-437/06 – that mixed holding companies must first establish the extent to which share acquisition costs relate to that economic activity. Once the proportion of costs that relates to the economic activity is determined, it must be then considered the extent to which this is used for taxable (e.g. administration, legal, IT) as opposed to exempt (e.g. granting of loans) transactions.

Ongoing Costs

The extent to which VAT on ongoing costs (e.g. group audit, legal, regulatory fees) is deductible by a holding company depends on whether such costs are used for the purpose of a taxable or qualifying activity.

Larentia + Minerva C-108/14 established the right for holding companies to deduct VAT on ongoing costs, even if there is no direct and immediate link with taxable output transactions, if it can be demonstrated that such costs are part of the company's general costs, in which case VAT is deductible based on the company's overall VAT recovery entitlement.

The key issue for holding companies, especially those with mixed activities, is determining the link between the costs incurred and their activities for VAT purposes. As reiterated by Revenue, this link must be based on an objective evaluation of the use of such costs. Additionally, companies must ensure that there is more than a causal link between input costs and the activities that grant a right to deduct. This is often referred to as the "but for" test; in other words, it is not a sufficient link to state that the cost would not be incurred "but for" the taxable activity. To illustrate this point, Revenue's guidance provides that expenditure incurred in relation to certain restructuring activities, issuing shares or defending a takeover bid would not have the necessary link to the economic activity of a company as these costs are incurred for the benefit of shareholders. This is an intricate and nuanced area of VAT recovery, and although undoubtedly VAT recovery is unlikely to be available for paying pure shareholder costs, cogent arguments can be made for VAT recovery on general restructuring costs.

Share Issue Costs

The issue of shares is not considered a supply for VAT purposes. Therefore, to determine the VAT deductibility of such costs, a holding company must first consider whether the shares were issued to raise capital for the purpose of its economic activity or for the purpose of its non-economic activity. Once this purpose is determined, any expenditure incurred that relates to the economic activity, and therefore that forms part of general costs, is deductible but only to the extent that it is linked to deductible economic activities.

Sale of Shares

The sale of shares is either a non-economic activity or an exempt economic activity, and VAT on costs directly linked to the sale of shares would generally not be deductible.

However, in its AB *SKF* C-29/08 judgment, the CJEU confirmed that where it can be demonstrated that there is a direct and

immediate link between the costs incurred in selling shares and the taxable economic activities of the company as a whole, there is an entitlement to deduct some or all of the VAT paid.

Although the exercise is by no means straight forward, when determining the right to VAT recovery on share sales costs, companies must consider whether the costs are incorporated in the sale price of the shares or they are among the cost components of the general transactions. Additionally and as provided by case law, the reason/motivation for a share sale can be a factor affecting the right to recover VAT.

Revenue has also confirmed its view that certain expenditure incurred, such as advice on the appropriateness/consequences of selling shares, on valuing and marketing shares or on transferring ownership of shares, will always be directly linked to the sale of shares and therefore the VAT incurred is generally not deductible. By exception, the sale of shares to a non-EU party is regarded as a qualifying activity for VAT purposes that grants right to deduct VAT incurred on costs.

The AB *SKF* C-29/08 case has largely been ignored or, where it has been addressed, has been seen to be of very limited application. Indeed, in practice it is difficult to think of an instance when the sale of shares to an EU counterparty has given rise to VAT recovery. Although this case is not the easiest of reads, it feels as if the story of the right to recover VAT on deal fees relating to share sales has a few twists yet to come.

VAT Groups

The Revenue guidance concludes by providing guidance for VAT groups.

VAT groups must determine the extent to which expenditure incurred has a direct and immediate link with taxable transactions of the VAT group as a whole. The guidance provides a number of examples of the effects of VAT grouping on the VAT recovery position for holding companies and their subsidiaries.

The guidance also confirms Revenue's view of the impact of a passive holding company joining a VAT group; in this scenario it considers that only the non-economic activity of the passive shareholding in other VAT group members can be disregarded from the non-economic activities of the VAT group as a whole. Therefore, the passive shareholding in non-VAT group companies must be taken into account when measuring the non-economic activity of the VAT group. Including the holding company in a VAT group will bring its VAT recovery in line with that of the group. Any increased deductibility entitlement is a natural and proper consequence of grouping.

Conclusion

The VAT deductibility rules for holding companies are extremely complex, and there is no one-size-fits-all approach. The VAT deduction decision is further complicated when holding companies have mixed activities, are part of a VAT group or wish to determine whether the formation of a VAT group may have a positive impact on VAT recovery. With that said, Revenue's comprehensive manual is a useful starting point for holding companies to refer to when considering their VAT recovery position.

Read more on taxfind From Irish Tax Institute Revenue Tax and Duty Manual; *VAT and VAT on Property, Finance Act 2016; Law of VAT, Finance Act 2019*.