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Input VAT newsletter

VAT deduction of branches

25 January 2019

Background

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

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

CJEU's findings

In summary, the CJEU found that it is necessary to consider the VAT recovery of supplies in both France and the UK, and only to the extent that those supplies give right to recovery in both Member States can the branch deduct the VAT on the associated expenses. This formalises the CJEU's earlier judgment in *Monte Dei Paschi Di Siena* (C-136/99).

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.

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.

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

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

As such, the following recovery calculation should apply:

$$\frac{\text{Taxable turnover to which the expenses relate, which permits VAT deduction in both the UK } \textbf{and} \text{ France}}{\text{Total turnover to which the expenses relate}}$$

Scenario 2 – Use by both the branch and principal establishment

The CJEU confirmed that in respect of costs incurred by the branch that are used both by the branch and the head office, the entire 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:

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

Comment

The CJEU has confirmed how the allocation of expenses by an establishment should be the first step to determine the applicable VAT recovery methodology.

Furthermore, the CJEU has 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. As noted above, the appropriate methodology to use and activities to include depends on the use, and allocation, of the expenses in question.

There also remain practical questions 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.

From a Luxembourg viewpoint, we should remind that the law and the administrative practice (circular 765 of 15 May 2013 and 765-1 of 11 June 2018) require that taxpayers should use first the direct allocation method and the special prorata method when appropriate to their economic situation. The turnover prorata is to be used when the two

first methods are not relevant or, after the application of these two methods, as residual method for non-allocable costs.

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

Deloitte will be hosting a webinar at 10am (GMT) on 29 January to discuss this judgment further.

To register, please click this link.

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