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VAT planning in cross-border service transactions: between fundamental freedoms and economic reality

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ABBREVIATIONS

VAT	Value Added Tax
The VAT Directive	Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax, recast
The COJ (also the Court)	The Court of Justice of the European Union
B2B	Business-to-business
The EU	The European Union
The Commission	The European Commission
Art.	article
Para.	paragraph
P.	page

1 INTRODUCTION

1.1 Problem description

The VAT Directive provides for certain instruments enabling companies to manage non-recoverable VAT in service transactions with associated parties, such as cost-sharing arrangements and VAT grouping. Cost-sharing arrangements are intended to create relief from VAT in a situation where a single business which had the resources to conduct the activity in-house would be able to do so without incurring any VAT.¹ Since transactions between the members of a VAT group are ignored, VAT grouping can also reduce the amount of irrecoverable input VAT as regards goods or services used both for taxable and non-taxable transactions.²

Additionally, taxpayers may establish business structures which are beneficial from VAT perspective, for example, by using branches in different jurisdictions in and outside the EU. Such branches may be used for shifting the place of supply of inbound services to jurisdictions with the lowest VAT rates or no VAT.³ Further, so acquired services can be redistributed within one legal entity free of VAT based on a judgment of the COJ in *FCE*.⁴ In this case the Court concluded that branches cannot be regarded as separate taxable persons and there cannot be taxable supplies of services between them and a head office.

The VAT planning tools indicated above are especially beneficial to taxpayers incurring non-deductible VAT, for example, banks and other financial institutions. However, the availability of the mentioned instruments may give rise to potential tax avoidance, and as a result, VAT leakage. Taking into account the volume of services in the European Union, which by 2007 represented just over 70% of gross value added in the European Union,⁵ the problem cannot be underestimated.

The major question arising in relation to cross-border service transactions, therefore, is how far a company could go in VAT planning, particularly, by use of fixed establishments, and what should be the limits of acceptable VAT planning. On the one hand, businesses have a freedom to select the most beneficial legal structure and a freedom to conduct their business activity; on the other hand, it is not clear whether tax advantages may still apply to a particular structure if it was aimed essentially at obtaining a tax benefit. Alike, it could be questionable that the Court's conclusions regarding non-taxation of allocation of services within one entity in *FCE* would still apply in situations where the structure does not correspond to economic reality.

¹ The Commission Staff Working Document accompanying document to the Green Paper on the future of VAT "Towards a simpler, more robust and efficient VAT system" (the "**Green Paper**"), para. 12.2.3

² Para. 12.2.2.1. of the Green Paper

³ This VAT planning tool became possible upon entering into force of new place of supply rules in relation to services on 1 January 2010 pursuant to Council Directive 2008/8/EC of 12 February 2008 amending Directive 2006/112/EC as regards the place of supply of services. Before 1 January 2010 it was available for 'non-material' services, such as transfers and assignments of copyrights, advertising services, services of lawyers, engineers etc. for which the place of supply was determined at the customer's location.

⁴ Case C-210/04 Ministero dell'Economia e delle Finanze and Agenzia delle Entrate v FCE Bank plc [2006] ECR I-02803

⁵ The information from the Green Paper, p. 12

Another set of questions related to VAT planning in service transactions concerns the responsibilities of the supplier in determining an appropriate place of supply. In particular, these imply obligations of the supplier to ensure that a supplied service is connected with a fixed establishment, as well as joint and several liability of the supplier and the customer in case of incorrect determining the place of supply resulting in non-payment of VAT.

1.2 Purpose and method

The purpose of this paper is to identify the limits of acceptable VAT planning in cross-border service transactions by use of fixed establishments. To that end, it will be considered how the notion of economic reality and the principle of prohibition of abuse of rights may influence VAT treatment of cross-border service transactions. In addition, a regard will be given to the liability of a supplier for correct determining the place of supply.

Formal juridical method will be applied for the purpose of the research.

1.3 Disposition

In the first chapter of this paper a regard is given to VAT planning in cross-border service transactions with the use of fixed establishments. The second chapter deals with the concept of economic reality with a focus of its application to determining the existence of fixed establishments and the place of supply. The last chapter concerns the interplay between fundamental freedoms and prohibition of abuse of rights from the perspective of determining the place of supply.

1.4 Delimitation

Findings and conclusions presented herein are based upon EU legislation and relevant court practice of the COJ. Citations of domestic legislation of particular Member States are made for illustration purposes only and do not imply an in-depth analysis of domestic norms.

The main focus in this paper will concern VAT planning with the use of fixed establishments and, particularly, determining the place of supply under new place of supply rules and with the view of the new Implementing Regulation which enters into force on 1 July 2011.⁶ It will also be analysed how the notion of economic reality may affect the concept of establishment and the place of supply in cross-border service supplies.

This paper does not include an analysis of VAT grouping and cost-sharing arrangements as instruments of VAT planning.

The analysis in this thesis will concern B2B transactions and will be limited to the general place of supply rule in relation to services.

⁶ Council Implementing Regulation (EU) No 282/2011 of 15 March 2011 laying down implementing measures for Directive 2006/112/EC on the common system of value added tax (Recast)

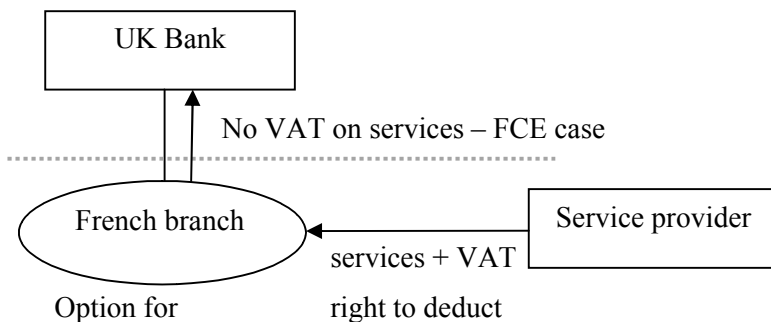
2 USE OF FIXED ESTABLISHMENTS

Taxpayers may use a variety of VAT planning tools for cross-border service transactions to optimize their VAT flows. This is especially crucial for the financial sector which incurs non-recoverable VAT. VAT planning techniques, therefore, purport to increase VAT recovery and bring down VAT cost at acquisition. One of the VAT planning tools for cross-border service transactions, which will be analysed herein, deals with the use of fixed establishments for acquisition and redistribution of services.

Companies are able to maneuver with the place of supply of services allocating it to different jurisdictions to ensure the most favorable VAT result. This is possible due to the existence of several points of reference and certain flexibility in the general place of supply rule for B2B service supplies.⁷ According to new place of supply rules the place of supply of B2B services has been shifted to the place of establishment of the customer.⁸ However, where services are rendered to a fixed establishment of the taxable person located in a place other than the place of establishment of its business, the place of supply of those services shall be the place where that fixed establishment is located.⁹ Hence, it may be concluded that the place of fixed establishment constitutes a specific point of reference which should apply provided the conditions for its application are observed. Noteworthy, this approach differs from the former practice, whereby the COJ considered the priority of the place of establishment of the supplier's business.¹⁰ More detailed analysis of place of supply rules will be provided in section 2.2 below.

Below an example is provided where a fixed establishment and different VAT treatment of financial services in two EU jurisdictions were used to elaborate a more favorable structure from VAT perspective.

Example 1. VAT planning: UK head office with a French branch



Information regarding optional taxation regime is taken from the article of Thierry Pons¹¹

⁷ Art. 44 of the VAT Directive

⁸ Council Directive 2008/8/EC of 12 February 2008 amending Directive 2006/112/EC as regards the place of supply of services

⁹ Art. 44 of the VAT Directive

¹⁰ Case C-168/84 Gunter Berkholz v. Finanzamt Hamburg-Mitte-Altstadt [1985] ECR 02251, para 17; case C-260/95 Commissioners of Customs and Excise v. DFDS A/S [1997] ECR I-01005, para 19

¹¹ Thierry Pons, "Option for Taxation of Financial Services in France", *International VAT Monitor*, May/June (2006): p. 182

In the presented example UK Bank used its fixed establishment in France to reduce non-recoverable VAT. If services were acquired by UK Bank directly followed by redistribution to a French branch, input VAT would constitute cost for the bank. Some Member States enable financial institutions to avoid passing on non-deductible input VAT to their business customers by opting for taxation.¹² That is true, for example, for French, German and Belgium tax systems.¹³

2.1 Concept of fixed establishment

Prior to analysing the application of the aforementioned place of supply rule, it will be considered what characteristics an establishment should possess to fall within the notion of “fixed establishment” as provided for in the VAT Directive.

Concept of “fixed establishment” is a pure notion of European law¹⁴ subject to uniform interpretation in all Member States. However, as of today, this term is ascribed a different meaning by Member States.¹⁵

The VAT Directive does not lay down a definition of a “fixed establishment” using this term primarily in rules for allocation of taxing powers among Member States.¹⁶ Criteria for the existence of a fixed establishment have been elaborated by the COJ in *Berkholz*, in which the Court stated that a fixed establishment must have a certain minimum size and entail permanent presence of human and technical resources necessary for the provision of services.¹⁷ Other cases of the COJ followed this approach and extended the definition.¹⁸

The existence of a fixed establishment does not depend on a legal form of the establishment. A branch without legal personality or a subsidiary which is a legal person may be treated as a fixed establishment of the parent company. Such a conclusion stems from *DFDS*,¹⁹ in which the COJ concluded that a company operating on behalf of its parent which acts as a mere auxiliary organ of the tour operator, has the human and technical resources’ characteristic of a fixed

¹² Thierry Pons, “Option for Taxation of Financial Services in France”, *International VAT Monitor*, May/June (2006): p. 182

¹³ Alan Schenk, Oliver Oldman, *Value Added Tax. A Comparative Approach* (Cambridge Law Series, 2007), p. 328

¹⁴ Pasquale Pistone, “Fixed Establishment and Permanent Establishment”, *VAT Monitor*, vol. 10 No. 3 (1999): p. 101

¹⁵ Ben J.M. Terra, Peter J. Wattel, *European Tax Law, Fifth edition* (Kluwer, 2008), p. 154. For example, in Austria, Germany and Italy two different terms are used in the official text of art. 9(1) of the Sixth Directive [now the VAT Directive] and domestic implementing provisions. Pasquale Pistone, Fixed Establishment and Permanent Establishment, *VAT Monitor*, Vol. 10 No. 3, May/June 1999, p. 101

¹⁶ Articles 38, 39, 44, 45, 58 of the VAT Directive

¹⁷ Case C-168/84 Gunter Berkholz v. Finanzamt Hamburg-Mitte-Altstadt, para. 19

¹⁸ See, for example, case C-190/95 ARO Lease BV v. Inspecteur van de Belastingdienst Grote Ondernemingen te Amsterdam [1997] ECR I-04383, para. 15; C-231/94 Faaborg-Gelting Linien A/S v Finanzamt Flensburg [1996] ECR I-02395, para. 17; C-260/95 Commissioners of Customs and Excise v. DFDS A/S, para. 20; C-73/06 Planzer Luxembourg Sàrl v Bundeszentralamt für Steuern [2007] ECR I-05655, para. 54

¹⁹ Case C-260/95 Commissioners of Customs and Excise v. DFDS A/S

establishment, may be considered as a fixed establishment. Also, the existence of a branch does not *prima facie* imply that it is a fixed establishment for VAT purposes.²⁰

2.1.1 Definition

Definitions of the term “fixed establishment” may be found in the recently adopted Implementing Regulation to the VAT Directive²¹ (hereinafter – the “**Implementing Regulation**”) which becomes effective from 1 July 2011. According to the preamble of the document the concept of fixed establishment, among others, should be clarified to ensure the uniform application of rules relating to the place of taxable transactions.²² Art. 11 of the Implementing Regulation provides for two definitions of a fixed establishment. One of them should be used for purposes of art. 44 of the VAT Directive, i.e. in cases where the place of supply is determined at the customer’s establishment, and another one for purposes of the rules according to which the place of supply is considered to be the place of the supplier’s establishment.²³

In the former case, an establishment must have a sufficient degree of permanence, and human and technical resources to enable it to receive and use the services supplied to it for its own needs. In the latter case, an establishment must have the same characteristics but from the perspective of ability to provide the services which it supplies.

The fact of having a VAT identification number should not be sufficient to consider that a taxable person has a fixed establishment.²⁴

Hence, in determining the place of supply, it is necessary to identify whether the establishment is capable to provide or receive services.²⁵ Therefore, notion of “fixed establishment” should be interpreted based on its objective, that is, using it as a point of reference in place of supply rules.

²⁰ Some examples of the existence of a fixed establishment are provided by the UK tax authorities in HMRC Notice 741A (January 2010), para. 3.4.1. A fixed establishment exists when:

- An overseas business sets up a branch comprising staff and offices in the UK to provide services. The UK branch is a fixed establishment.
- A company with a business establishment overseas owns a property in the UK which it leases to tenants. The property does not in itself create a fixed establishment. However, if the company has UK offices and staff or appoints a UK agency to carry on its business by managing the property, this creates a fixed establishment in the UK.
- An overseas business contracts with UK customers to provide services. It has no human or technical resources in the UK and therefore sets up a UK subsidiary to act in its name to provide those services. The overseas business has a fixed establishment in the UK created by the agency of the subsidiary.
- A company is incorporated in the UK but trades entirely overseas from its head office in the USA, which is its business establishment. The UK registered office is a fixed establishment.

http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageVAT_ShowContent&id=HMCE_PROD1_029955&propertyType=document#P153_18010

²¹ Council Implementing Regulation (EU) No 282/2011 of 15 March 2011 laying down implementing measures for Directive 2006/112/EC on the common system of value added tax (Recast)

²² Ibid, point (14) of the preamble

²³ Art. 45; art. 56(2) – from 1 January 2013; art. 58 of the VAT Directive – until 31 December 2014

²⁴ Art.11(3) of the Implementing Regulation

²⁵ These characteristics of a fixed establishment derive from the wording of the VAT Directive and are also referred to by the COJ.

2.1.2 Capability test

A “capability test” is described below including ability of a fixed establishment to provide and receive services supplemented with the relevant examples.

(i) *ability to provide services*

In accordance with the established case-law in the area of VAT, the existence of a fixed establishment implies a minimum degree of stability derived from the permanent presence of both the human and technical resources necessary for *the provision of given services*.²⁶ It thus requires a sufficient degree of permanence and a structure adequate, in terms of human and technical resources, to supply the services in question on an independent basis.²⁷ A fixed installation used by an undertaking only for preparatory or auxiliary activities, such as recruitment of staff or purchase of the technical means needed for carrying out the undertaking’s tasks, does not constitute a fixed establishment.²⁸

Thus, the ability to provide services should be verified based on the analysis of objective data enabling to make a conclusion that a fixed establishment permanently has sufficient resources to provide services in question. To illustrate, in *Aro Lease*²⁹ the question referred to the COJ concerned the existence of a fixed establishment of a Dutch company, Aro Lease BV, supplying cars under lease agreements in Belgium. For analysis of the existence of a fixed establishment, the Court applied the following test. First, the Court identified that the services supplied consisted principally in negotiating, drawing up, signing and administering the relevant agreements and in making the vehicles concerned, which remain the property of the leasing company, physically available to customers.³⁰ The Court came to a conclusion that a fixed establishment cannot be in a place when a leasing company does not possess in a Member State either its own staff or a structure which has a sufficient degree of permanence to provide a framework in which agreements may be drawn up or management decisions be taken and thus to enable the services in question to be supplied on an independent basis. The existence of other factors and transactions which took place in Belgium, were considered by the COJ as ancillary and supplementary to the leasing services.³¹

To summarize the above, the capability test from the standpoint of the ability to provide services could require the following steps of analysis:

- analysis of the scope and content of supplied services;
- determining what resources in terms of personnel and assets are required for the services to be carried out;
- identification whether an establishment in question has respective resources.

²⁶ Case C-168/84 Gunter Berkholz v. Finanzamt Hamburg-Mitte-Altstadt, para. 18; case C-260/95 Commissioners of Customs and Excise v. DFDS A/S, para. 20; C-190/95 ARO Lease BV v. Inspecteur van de Belastingdienst Grote Ondernemingen te Amsterdam, para. 15

²⁷ C-190/95 ARO Lease BV v. Inspecteur van de Belastingdienst Grote Ondernemingen te Amsterdam, para. 16

²⁸ Case C-73/06 Planzer Luxembourg Sàrl v Bundeszentralamt für Steuern, para. 56

²⁹ C-190/95 ARO Lease BV v. Inspecteur van de Belastingdienst Grote Ondernemingen te Amsterdam

³⁰ Ibid, para 18

³¹ Art. 19, 21 of the Implementing Regulation

(ii) *ability to receive and use services*

The criterion of ability to receive and use services for its own needs was adopted as the criterion for determining of the existence of a fixed establishment in the Implementing Regulation.³² There is no guidance there, however, as to what should be considered a fixed establishment capable to receive and use them. As of today, no cases with the respective clarifications of the COJ are available. Taking into account that art. 44 of the VAT Directive is the main provision for the place of supply of B2B services, the significance of correct understanding of this part of capability test for determining of the existence of a fixed establishment cannot be underestimated.

It is not clear whether the requirements in terms of human and technical resources should differ from those applicable to a fixed establishment capable to provide services. Proceeding from the wording of the Implementing Regulation which lays down two distinct definitions of a fixed establishment depending on place of supply rules it is used for,³³ it may be assumed that the assessment of ability to receive and use services should be conducted on its own merits. Such approach would be more compliant with the criterion of actual economic situation, which is a fundamental criterion for the application of the common VAT system³⁴. Where an establishment receiving services has sufficient human and technical resources at its permanent disposal enabling it to make use of the services it receives, it would be irrational for taxation of such services in the country of that establishment to be excluded merely on the grounds that it does not constitute a fixed establishment able to supply goods or services.³⁵

Therefore, one may arrive at a conclusion about the existence of two types of fixed establishments, specifically, fixed establishments capable to provide services and fixed establishments capable to receive and use the services for their own needs.

In my opinion, the expression “to receive and use the services” should be read altogether rather than regarded on a separate basis. Both elements seem necessary for the application of the test. For consideration whether a company has sufficient resources in a Member States to be able to receive and use for its own needs the services in question, the following factors may be taken into account:

- whether the existence of particular resources such as assets and qualified personnel is a condition precedent to the receipt of services; if yes, it should be analysed whether such resources are available in a Member State of location of an establishment under consideration;
- the scope and the content of activities carried on by the establishment from the perspective whether the acquired services are somehow related to those activities and may be used in the course of their conducting.

³² Art. 11 of the Implementing Regulation

³³ Para. 1, 2 of Art. 11 of the Implementing Regulation

³⁴ Case C-73/06 Planzer Luxembourg Sàrl v Bundeszentralamt für Steuern, para. 43

³⁵ Ben Terra, *The VAT Package and Anti-Tax Fraud Measures, Second edition* (Lund: Series on International Indirect Tax, University of Lund, Vol. 11, second edition, 201), p. 62

As an example, it would be doubtful to assume that a branch which does not have a license or other permit for a particular activity could benefit from services which are directly connected with such an activity.

2.2 Determining the place of supply

When the supply is governed by the location of the customer, it is necessary for the supplier to identify the place where his customer is established to determine where the supply will be taxed and who will be liable for payment of VAT.³⁶ As mentioned above, the VAT number is not decisive anymore in defining the place of the customer's establishment.

Former place of supply rules for service transactions were interpreted by the COJ proceeding from the criteria of "appropriateness".³⁷ In early cases³⁸ the Court assumed the place of establishment of business as a primary point of reference leading to a rational result that should be preferred to other criteria.³⁹ Only in cases of its non-feasibility, irrational result or conflict of jurisdictions, place of other establishments should have been considered. Such approach was feasible where fixed establishments were located outside the EU. As indicated by Pistone, in this case "the opinion of the Court may be indeed justified: applying the place of business may avoid an irrational result, or hinder non-neutral situations where VAT may not be levied at all."⁴⁰

New place of supply rules for services set forth a different approach. Proceeding from literal interpretation of art. 44 of the VAT Directive location of a fixed establishment should have a priority over the place of establishment of business if the services are rendered to a fixed establishment located in a place other than a place of the supplier's business establishment. Such an approach reflects the general principle of application of VAT at the place of consumption assuming that a fixed establishment consumes services provided to it. In cases where services are consumed in part at the place of a fixed establishment and in part of a head office, it would be appropriate to apportion payment of VAT on acquisition of such services to both of such places.

Therefore, under the new rules the distinctive point for determining the place of supply is the place of establishment which receives the services rather than contractual relationship, that is, an economic criterion.⁴¹ More detailed analysis of application of economic criterion to determination of the place of supply will be given in section 3.3 below.

³⁶ Ben Terra, *The VAT Package and Anti-Tax Fraud Measures, Second edition* (Lund: Series on International Indirect Tax, University of Lund, Vol. 11, second edition, 201), p. 58

³⁷ See, for example, case C-168/84 Gunter Berkholz v. Finanzamt Hamburg-Mitte-Altstadt, para. 17

³⁸ Case C-168/84 Gunter Berkholz v. Finanzamt Hamburg-Mitte-Altstadt; c-190/95 ARO Lease BV v. Inspecteur van de Belastingdienst Grote Ondernemingen te Amsterdam; case C-260/95 Commissioners of Customs and Excise v. DFDS A/S

³⁹ Pasquale Pistone, "Fixed Establishment and Permanent Establishment", *VAT Monitor*, vol. 10 No. 3 (1999): p. 102

⁴⁰ *Ibid*, p. 103

⁴¹ Ben Terra, *The VAT Package and Anti-Tax Fraud Measures, Second edition* (Lund: Series on International Indirect Tax, University of Lund, Vol. 11, second edition, 201), p. 53

For correct application of place of supply rules, the supplier has to consider a customer's status as a taxable or non-taxable person; its capacity, specifically, whether the services are used for private or business purpose, and location of the customer.⁴²

The place of establishment of the customer should be identified by the supplier based on information from the latter. Information from the customer has to be verified by the supplier by normal commercial security measures such as those relating to identity or payment checks. This information may include the VAT identification number of the customer.⁴³

According to the Implementing Regulation where services are supplied to the customer established in different countries the primary point of reference for determining the place of supply should be the establishment of the customer's business. However, if they are provided to a fixed establishment of the taxable person located in a place other than the place of business establishment, the supply shall be taxable at the place of the fixed establishment receiving and using the supplied services for its own needs.⁴⁴ Thus, in addition to capability test described in section 2.1.1.2 (ii) above, which determines the existence of a fixed establishment, the "actual use test" should be used to identify which establishments receive and benefit from the supplied services. Taking into account the wording of articles 11 and 21 of the Implementing Regulation ("to enable... to receive and use the services" and "receiving that service and using it for its own needs") it may be concluded that the mentioned tests are distinct and cannot be substituted.

2.2.1 Actual use test

For determining the place of supply of a service at the place of the fixed establishment, such fixed establishment has to receive the service and use it for its own needs.⁴⁵ Art. 22 of the Implementing Regulation provides for a hierarchy of criteria to be followed by the supplier in order to identify the customer's fixed establishment to which the service is provided. First, the nature and use of the provided service should be considered. Where this criterion does not enable the supplier to identify a proper customer, regard should be given to formal criteria, such as the contract, the order form and VAT identification number, as well as a payee for the services. If both sets of criteria do not allow determining the customer's fixed establishment, or if services are supplied under a contract covering one or more services used in an unidentifiable and non-quantifiable manner, the place of supply may be considered at the location of the customer's business establishment.

Based on the analysis of the actual use test laid down in the Implementing Regulations, one may arrive at the following conclusions:

- criteria for determining a fixed establishment receiving the service should be applied according to the order set forth in the Regulation. That is, formal criteria should not be used prior to "the nature and use of the service" criteria and so on;

⁴² Articles 17-19 of the Implementing Regulation

⁴³ Ibid, para. 2 and 3 of art. 20

⁴⁴ Ibid, art. 21

⁴⁵ Para. 2 of art. 21 of the Implementing Regulation

- criteria are rather subjective. Accordingly, suppliers, to avoid potential disputes with tax authorities, may be prone to use the general rule of business establishment to be in a safe position. Such approach may not always lead to a rational result, and may also be used for VAT planning;
- another question in this respect is who should be responsible for incorrect determining the place of supply if the customer, for instance, does not disclose information which may be definitive for determining the place of supply, and what actions the supplier should perform to be in a safe position. The question of liability will be considered in section 2.3 below.⁴⁶

In case of a doubt regarding which establishment of the customer receives services such factors as use of services at a particular establishment, taking by the supplier of instructions from a particular establishment, relation to business being conducted by the customer in an establishment in a particular country, may be helpful to make a decision.⁴⁷

It would be logical to call the above test as “beneficial test” since it presupposes the existence of an ability to obtain a benefit by a buyer of a service. Notably, this beneficial test is similar to “effective use and enjoyment” criterion applied in situations with third countries.⁴⁸

Therefore, as pointed out by the Commission, determining which establishment makes a supply of a service is ultimately a question of fact (according to new place of supply rules, it should be added also “establishment which receives a supply”).⁴⁹ Accordingly, determining the place of supply should be based on factual circumstances, and use of economic criterion seems the most appropriate for this purpose.

2.3 Liability for incorrect identification of the place of supply

It may be the case that incorrect determining the place of supply by the supplier could result in non-payment of VAT to the state. For example, in a situation where a supplier established in the EU considers that a supply is made to a fixed establishment located outside the EU of an EU customer, European VAT may be escaped. Such a branch may further transfer services to its EU

⁴⁶ According to HMRC Notice 741A (January 2010), para. 3.6.1 determining of the place of supply where the recipient of services has several establishments may be illustrated as follows:

- A UK supplier contracts to supply advertising services. Its customer has its business establishment in Austria and a fixed establishment in the UK created by its branch. Although day-to-day contact on routine administrative matters is between the supplier and the UK branch, the Austrian establishment takes all artistic and other decisions about the advertising. The supplies are received at the overseas establishment.
- A UK accountant supplies accountancy services to a UK incorporated company which has its business establishment abroad. However, the services are received in connection with the company’s UK tax obligations and therefore the UK fixed establishment, created by the registered office, receives the supply

http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageVAT_ShowContent&id=HMCE_PROD1_029955&propertyType=document#P153_18010

⁴⁷ HMRC Notice 741A (January 2010), para. 3.7 -

http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageVAT_ShowContent&id=HMCE_PROD1_029955&propertyType=document#P153_18010

⁴⁸ Art. 59a of the VAT Directive

⁴⁹ Proposal for a Council Directive amending Directive 77/388/EEC as regards the place of supply of services, COM (2003) 822 final of 23 December 2003, p. 9

head office free of VAT. Therefore, the question is who should be liable for non-payment of VAT.

Art. 205 of the VAT Directive laying down the possibility of joint and several liability of a person other than a person liable for VAT payment may also apply to intra-EU⁵⁰ supplies of services.⁵¹ So, hypothetically, Member States may extend that liability to suppliers of services for incorrect identification of the place of supply resulted in non-payment of VAT to the state. So far joint and several liability has been limited by Member States to domestic transactions.⁵²

According to art. 262 of the VAT Directive every taxable person identified for VAT purposes shall submit a recapitulative statement of, inter alia, taxable persons, and non-taxable legal persons identified for VAT purposes, to whom he has supplied services, other than services that are exempted from VAT in the Member State where the transaction is taxable, and for which the recipient is liable to pay the tax pursuant to art. 196 of the VAT Directive. The Commission considers that failure to comply with the reporting obligation in relation to cross-border transactions may be a reason to hold the operator jointly and severally liable for tax losses occurred.⁵³

Thus, the VAT Directive provides for a legal basis for the imposition of joint and several liability on a supplier of services in cases when he is not liable for VAT payment. The imposition of such a liability should be governed by general principles of the EU law, namely, the principles of legal certainty and proportionality.⁵⁴ Proceeding from the court practice of the COJ, it may be assumed that liability of the supplier should depend on its involvement in VAT fraud.⁵⁵ That is, the supplier acting in good faith should not be found liable for incorrect determining the place of supply resulted in non-payment of VAT. Where there is evidence that the supplier could have known a real beneficiary of the acquired service, he could be found jointly and severally liable for VAT payment in accordance with art. 205 of the VAT Directive. The tax authorities may, in principle, rely on a presumption of the existence of such knowledge. However, as indicated by the Advocate General Maduro in *FTI*, those presumptions must not *de facto* bring about a system of strict liability.⁵⁶

2.4 Transfer of services within one entity

Services acquired by a head office/establishment of a company may be transferred between structural units of the company located in different Member States and/or on the territory of third countries. The main question arising in relation to such transfers concerns the application of

⁵⁰ Throughout the paper the term “Community” has been substituted with the “Union” or “EU”.

⁵¹ Ben Terra, *The VAT Package and Anti-Tax Fraud Measures, Second edition* (Lund: Series on International Indirect Tax, University of Lund, Vol. 11, second edition, 201), p. 207

⁵² *Ibid*, p. 152

⁵³ *Ibid*, p. 207

⁵⁴ Case C-384/04 Commissioners of Customs & Excise Attorney General v Federation of Technological Industries [2006] ECR I-04191, para. 35

⁵⁵ Joined cases C-354/03, C-355/03 and C-484/03 Optigen Ltd, Fulcrum Electronics Ltd and Bond House Systems Ltd v Commissioners of Customs & Excise [2006] ECR I-00483, para. 55

⁵⁶ Opinion of Mr Advocate General Poirares Maduro delivered on 7 December 2005 in case C-384/04 Commissioners of Customs & Excise Attorney General v Federation of Technological Industries, para. 27

VAT, specifically, whether such transactions should be considered supplies between taxable persons subject to VAT, or within one legal entity and, thus, outside the scope of VAT.

In view of the Commission supplies of services between different branches of a company or between a branch and its head office (i.e., different establishments) are normally outside the scope of VAT, provided that they are part of the same legal entity. This is the case where the establishments are situated within the same Member State or in more than one country.⁵⁷ Such an approach has been confirmed by the COJ in *FCE*⁵⁸ and enables taxpayers operating in different Member States to establish more efficient business structures. Advantages of the non-taxation approach are especially significant for businesses incurring non-recoverable VAT.

Among the drawbacks of the non-taxation approach the Commission mentions a potential for a leak in the VAT system, whereby an institution acquiring services in a non-EU country can reroute them to an establishment in the EU without incurring any EU VAT. Where the non-EU country is one which regards cross-border transactions between branches as within the scope of their VAT (or similar tax), the institution may even be able to recover non-EU-country input tax if a supply to an EU branch is considered an export.⁵⁹

Some scholars opine that intra-company services fall outside the scope of VAT in view of that fixed establishments cannot be considered as taxable persons separate from the enterprise of which they form part, and that supplies within the same entity are not made for consideration.⁶⁰

In contrast to services, transfer of goods between head office and its fixed establishments in other Member States is considered a deemed supply subject to VAT according to art. 17 (1) of the VAT Directive.

In the following section it will be analysed whether the conclusions deriving from *FCE* are so clear-cut as it may seem at first glance.

2.4.1 FCE

FCE deals with a supply of services received by an Italian branch, FCE IT, from FCE Bank, its head office in the UK, in the form of consultancy, management, staff training, data processing and the supply and management of application software. FCE IT paid Italian VAT on services acquired from FCE Bank followed by application of its refund. Tax authorities refused to refund the tax, and FCE IT brought an action before the court.

The question referred by Corte di Cassazione (Supreme Court of Taxation) to the COJ concerned the application of VAT to the supply of services made by FCE Bank to FCE IT, whereby costs of

⁵⁷ Proposal for a Council Directive amending Directive 77/388/EEC as regards the place of supply of services, COM (2003) 822 final of 23 December 2003, p. 9; Commission Staff Working Document accompanying document to the Green Paper on the future of VAT “Towards a simpler, more robust and efficient VAT system”, p. 92

⁵⁸ Case C-210/04 Ministero dell'Economia e delle Finanze and Agenzia delle Entrate v FCE Bank plc. The conclusion stemming from the *FCE* is not so clear-cut in cases where third countries are involved.

⁵⁹ Para. 12.2.1.2 of the Green Paper, p. 94

⁶⁰ Raffaele Russo, Emiliano Zanotti, “VAT Personality of Fixed Establishments: Preliminary Ruling Requested from the COJ”, *VAT Monitor*, September/October (2004): p. 335

services were partially allocated to the latter. Specifically, it was asked whether 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, must be treated as a taxable person by reason of the costs imputed to it in respect of those supplies. Although having been asked, the Court disregarded the situation where a company would be located in a non-EU state.

According to the Court, a supply of services is taxable only if there exists a legal relationship between the service provider and the recipient in which there is a reciprocal performance. In this case that could only be possible if FCE IT would carry out an independent economic activity.⁶¹ For this purpose the Court considered whether FCE IT could be regarded as being an independent bank bearing the economic risk arising from its business. The COJ held that FCE IT is dependent upon FCE Bank and cannot be regarded as a separate taxable person in view of the absence of any endowment capital and no risks associated with the economic activity.⁶² Finally, the Court concluded 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.⁶³

No regard has been given by the COJ in relation to the question of compatibility with the fundamental freedom of establishment of taxation of services, as a case could be, received by a branch in another Member State from its head office.

2.4.1.1 Opinion of Advocate General

Some interesting observations may be derived from the Opinion of Advocate General Léger delivered on 29 September 2005.

As pointed out by the Advocate General, in accordance with art. 4(1) of the Sixth Directive [now art. 9(1) of the VAT Directive] a taxable person is ‘any person’ who independently carries out an economic activity in any place, irrespective of the purpose or the results of that activity. As such, the concept of taxable person is not restricted to individuals and corporate bodies only but can also apply to an entity devoid of legal personality.⁶⁴

According to the Advocate General the secondary establishment’s lack of legal personality in its own right stands in the way of its ability to act autonomously. Since FCE IT does not carry on business on its own account but as a projection of the credit institution,⁶⁵ does not have any assets and does not bear any liability, it cannot be regarded as an autonomous entity.⁶⁶

⁶¹ Case C-210/04 Ministero dell'Economia e delle Finanze and Agenzia delle Entrate v FCE Bank plc, para. 34-35

⁶² Ibid, para. 37

⁶³ Ibid, para. 41

⁶⁴ Opinion of Mr Advocate General Léger delivered on 29 September 2005 in the FCE, para. 36

⁶⁵ Which by virtue of the authorisation obtained in its State of origin is entitled, under Article 18 of Directive 2000/12/EC, to carry on business through a branch in another Member State.

⁶⁶ Opinion of Mr Advocate General Léger delivered on 29 September 2005 in FCE case, para. 46

Another set of arguments presented by the Advocate General for non-taxation of services transferred within one company implied several provisions dealing with situations where a taxable person supplies goods or services for the purposes of its own undertaking, in particular, art. 28a(5)(b) and art. 6(3) of the Sixth Directive [now articles 17(1) and 27 of the VAT Directive]. The mentioned provisions lay down a “deemed supply” approach in relation to transfer by a taxable person of goods from his undertaking to another Member State and the supply by a taxable person of a service for the purposes of his undertaking where the VAT on such a service, had it been supplied by another taxable person, would not be wholly deductible. The existence of such specific rules, in opinion of the Advocate General, supports the fact that the legislature inserted those provisions to show, by contrary inference, that such a transfer does not constitute, *prima facie*, a supply of goods for consideration.⁶⁷

The above arguments of the Advocate General are not so obvious and may be questioned. In my opinion, lack of legal personality *ipso facto* cannot stand in the way of ability of secondary establishment to act autonomously. It might be the case if an establishment possesses own capital and bears certain risks, for example, where a parent bank established outside the EU operates branches within the EU. If it is the case, it will not be so clear-cut whether the conclusions regarding non-taxation produced by the Court would be still beyond dispute. Legal criteria for identifying a taxable person should not be exclusive. According to the main characteristics laid down in art. 9 (1) of the VAT Directive a “taxable person” shall mean any person who, independently, carries out in any place any economic activity, whatever the purpose or results of that activity. Therefore, the main feature for the assessment of a taxable status of an establishment should be a certain degree of independence which implies an ability to adopt decisions and bear economic risks.

2.4.1.2 Implications of FCE

The judgment of the COJ in *FCE* only applies to businesses established in the EU with a fixed establishment in another Member State. Accordingly, fixed establishments located outside the EU are not covered by the judgment.⁶⁸ One of the issues, therefore, is the extrapolation of *FCE* to service transactions where non-EU jurisdictions are involved. It may be the case when a head office is located in a non-EU country, whereby its branch (-es) is (are) within the EU, or when an EU head office operates branches outside the EU. The question would be whether the supply of services from the head office to its branches or vice versa, and between the EU and non-EU branches of one company should be out of scope of EU VAT.

It may be reasonable to consider that the COJ’s conclusion in *FCE* regarding non-taxation of service transactions within one entity cannot be automatically applied to situations where non-EU countries are involved. Arguments could be as follows:

- the Court limited the scope of its decision to internal (EU) situations though having been asked to broaden the answer also to non-EU situations.⁶⁹ Logically, one may deem that

⁶⁷ Opinion of Mr Advocate General Léger delivered on 29 September 2005 in *FCE*, para. 57

⁶⁸ Joep Swinkels, “Fixed Establishments and VAT-Saving Schemes”, *International VAT Monitor*, November/December (2006): p. 416

⁶⁹ Case C-210/04 Ministero dell'Economia e delle Finanze and Agenzia delle Entrate v *FCE Bank plc*, para. 22

such omission has been done by the COJ not coincidentally. An explanation could be that VAT treatment of non-EU operations was not so univocal and required additional analysis;

- as mentioned above, non-taxation of services circulated between the EU and non-EU territories may lead to VAT leakage that is against the objectives of the VAT Directive, and, accordingly, should not apply.

3 CONCEPT OF ECONOMIC REALITY

3.1 General principles of application

According to the principle prohibiting the abuse of rights, the application of the EU legislation cannot be extended to cover abusive practices by economic operators, that is to say transactions carried out not in the context of normal commercial operations, but solely for the purpose of wrongfully obtaining advantages provided for by the EU law.⁷⁰ Thus, to be in compliance with the VAT Directive and legislation transposing it, transactions have to reflect economic reality.⁷¹ Criterion of “reflection of economic reality” (economic situation)⁷² has been applied by the Court in a number of cases as a fundamental criterion for the application of the common system of VAT.⁷³

Criteria for the existence of abusive practices in VAT, and, accordingly, lack of economic substance, have been developed by the COJ in *Halifax*⁷⁴ and include the following conditions precedent (twofold test):

- first, the transactions concerned result in the accrual of a tax advantage, the grant of which would be contrary to the purpose of relevant provisions of the Sixth Directive [now the VAT Directive] and of national legislation transposing it notwithstanding formal application of conditions laid down by the provisions granting the advantage,
- the essential aim of the transactions concerned is to obtain a tax advantage.

Peculiarities of the application by the COJ of the concept of economic reality to determining the existence of a fixed establishment and the place of supply in cross-border service transactions will be illustrated in cases presented below.

3.2 Economic reality and concept of establishment

3.2.1 DFDS

One of the cases in which the COJ applied economic reality concept for identifying the existence of a fixed establishment is *DFDS*.⁷⁵ This case concerns the application of VAT to sale of package tours in the UK by DFDS Ltd., an English subsidiary of the Danish company DFDS A/S, on behalf of its parent. An agency agreement concluded between two companies designated the subsidiary as a ‘general sales and port agent’ for the parent company in the United Kingdom

⁷⁰ Case C-255/02 *Halifax plc, Leeds Permanent Development Services Ltd, County Wide Property*, ECR [2006], I-01609, para 69; case C-162/07 *Ampliscientifica Srl and Amplifin SpA v Ministero dell’Economia e delle Finanze and Agenzia delle Entrate* [2008] ECR I-04019, para 27; case C-103/09 *The Commissioners for Her Majesty’s Revenue and Customs v Weald Leasing Ltd.*, ECR 2010 Page 00000, para. 26

⁷¹ Case C-103/09 *The Commissioners for Her Majesty’s Revenue and Customs v Weald Leasing Ltd.*, para. 39

⁷² I consider terms “economic reality”, “economic substance” and “economic situation” as synonyms.

⁷³ Case C-260/95 *Commissioners of Customs and Excise v.DFDS*, para. 23; case C-73/06 *Planzer Luxembourg Sàrl v Bundeszentralamt für Steuern*, para. 43; case C-162/07 *Ampliscientifica Srl and Amplifin SpA v Ministero dell’Economia e delle Finanze and Agenzia delle Entrate*, para 27-28

⁷⁴ Case C-255/02 *Halifax plc, Leeds Permanent Development Services Ltd, County Wide Property*, para. 86

⁷⁵ Case C-260/95 *Commissioners of Customs and Excise v. DFDS A/S*

and as 'central booking office for the United Kingdom and Ireland for all ... the passenger services' of the Danish company.⁷⁶ The UK tax authorities took a view that VAT on sales was payable in the UK inasmuch the supplies were made by DFDS A/S though a fixed establishment created there.

Considering the fact that DFDS Ltd. was wholly owned by its parent and various contractual obligations were imposed on the subsidiary by its parent, the Court concluded that DFDS Ltd. acted as an auxiliary organ of DFDS A/S and displayed the features of fixed establishment.⁷⁷

Although the criterion of actual economic situation is explicitly mentioned in this case in relation to determining the place of supply, it is apparent that the same principle was used by the Court in determining whether DFDS Ltd. constituted a fixed establishment of its parent. Such conclusion derives from the fact that notwithstanding that DFDS Ltd. was a separate legal entity and a taxpayer in the UK, the COJ looked into its actual functions coming to the conclusion that in substance it was a fixed establishment of DFDS A/S.

3.2.2 Planzer

Notion of "economic reality" was also applied by the COJ in *Planzer*,⁷⁸ one of the most illustrative cases in this regard. In this case a dispute arose between Planzer Luxembourg Sàrl (hereinafter – "**Planzer**"), a Luxembourg company, and German tax authorities regarding refund by the former of VAT on fuel supplies in Germany based on the provisions of the Eighth Council Directive⁷⁹ [now Council Directive 2008/9/EC]. German tax authorities denied the refund on the grounds that the applicant company was not established in Luxembourg, but rather in Switzerland and, as such, was not entitled for refund under domestic German law.

In compliance with the requirements of the Eighth Directive Planzer submitted a certificate issued by the Luxembourg tax authority in accordance with the specimens in Annex B to the Eighth Directive confirming its liability to VAT under a Luxembourg identification number. Thus, formal conditions for granting a tax benefit were satisfied. However, the issue remained whether Planzer was actually established in Luxembourg, thus being entitled to VAT refund. In these circumstances, the main question referred to the Court by the Finanzgericht Köln concerned a binding effect of the certificate for determining the existence of an establishment.

In answering the question⁸⁰ the Court proceeded from the general objective of the Eighth Directive which was to combat certain forms of tax evasion or avoidance.⁸¹ It further held that taking account of the economic reality constitutes a fundamental criterion for applying the common system of VAT and that the EU law cannot be relied on for abusive or fraudulent

⁷⁶ Case C-260/95 Commissioners of Customs and Excise v. DFDS A/S, para. 5

⁷⁷ Ibid, para. 26, 28

⁷⁸ Case C-73/06 Planzer Luxembourg Sàrl v Bundeszentralamt für Steuern

⁷⁹ Eighth Council Directive 79/1072/EEC of 6 December 1979 on the harmonization of the laws of the Member States relating to turnover taxes - Arrangements for the refund of value added tax to taxable persons not established in the territory of the country ("**Eighth Directive**")

⁸⁰ Although the question referred to the Court concerned a more general notion of an "establishment", conclusions of the COJ may be extrapolated to the existence of a "fixed establishment."

⁸¹ Case C-73/06 Planzer Luxembourg Sàrl v Bundeszentralamt für Steuern, para. 36

ends.⁸² Abusive practice in this respect would exist if a taxable person were to attempt to benefit from the refund system under the conditions laid down in the Eighth Directive in circumstances where the establishment whose address is given in the certificate in accordance with the specimen in Annex B of that directive does not correspond to any economic reality.⁸³ In conclusion, the Court stated that although the certificate issued in accordance with the specimen in Annex B of the Eighth Directive permits the assumption that the person concerned is established in Member State issuing the certificate (through business there or a fixed establishment from which operations are carried out), it cannot prevent the tax authorities of the refunding Member State from seeking assurance as to the economic reality of the establishment whose address is mentioned in such a certificate.

Therefore, the existence of an establishment must be assessed based on the concept of economic reality. Notwithstanding the fact that formal evidence is in place, a company may be considered not to be established in a Member State, should it not reflect economic situation.

3.2.3 Interim conclusions

To conclude, in order to be considered a fixed establishment, an establishment must reflect economic reality. Formal compliance with the requirements imposed by the national legislation should not be sufficient if there is no economic substance in the establishment. *Planzer* reiterated substance over form override in the area of the EU VAT.

3.3 Application of economic reality to determining the place of supply

In this section, it will be analysed how the notion of economic reality may influence the place of supply, in particular, in situations where branches are involved in cross-border service transactions.

3.3.1 General

The VAT Directive sets forth an approach of “effective use and enjoyment” for determining of the place of supply in relation to transactions where third countries are involved. According to art. 59a of the VAT Directive Member States may allocate tax jurisdiction to the place of the effective use and enjoyment of the services while determining the place of supply. The purpose of this provision is to prevent double taxation, non-taxation or distortion of competition. At the same time, the VAT Directive does not provide for a similar approach regarding the transactions within the EU in relation to which the actual use test is applicable.⁸⁴

As indicated earlier in this paper, the distinctive point for determining the place of supply should be an economic criterion. Most probably, the COJ will follow this principle in allocating tax jurisdictions between Member States. Peculiarities of the application of the mentioned criteria will be illustrated in cases below.

⁸² Case C-73/06 *Planzer Luxembourg Sàrl v Bundeszentralamt für Steuern*, para. 43-44

⁸³ *Ibid*, para. 45

⁸⁴ The use of “actual use test” derives from the wording of Articles 44 and 45 of the VAT Directive.

3.3.2 DFDS

As pointed out in section 3.2.1 above, the concept of economic reality has been applied by the Court for determining the place of supply in *DFDS*.⁸⁵ In this case the COJ departed from the place where the supplier has established his business and referred to the place of a fixed establishment from which the services of travel operator were supplied. The reason for such an approach was that the main fiscal point of reference at the place of supplier's establishment did not lead to a rational result for tax purposes because it did not take into account the actual place where the tours were marketed, as well as the possible diversification of travel agents' activities in different places within the Union. Moreover, allocating of taxing powers to the place of the supplier's establishment could lead to distortions of competition by encouraging undertakings trading in one Member State to establish their businesses in another Member State in order to avoid taxation. In the end, the Court concluded that determining the place of taxation of the services of travel agents should be made at the place of the fixed establishment from which the services in question were supplied, thus, proceeding from the actual economic situation which "is a fundamental criterion for the application of the common VAT system."⁸⁶

Therefore, since marketing and other activities required for the provision of services have been conducted by the fixed establishment of DFDS in the UK, the principle of the reflection of economic reality required the application of VAT at the place of the fixed establishment, that is, where the services were actually rendered.

3.3.3 Aro Lease

Remarkably, in *Aro Lease*, another case concerning allocation of tax jurisdiction between the Netherlands and Belgium, the Court refused to apply the notion of economic reality for determining the place of supply of lease services rendered by a Dutch company Aro Lease in Belgium though it was suggested by the Commission and the Danish Government. In my opinion, this may be explained by the fact that the company's presence in Belgium did not constitute a fixed establishment. In view of this, the use of a primary point of reference at the place of the establishment of the company's business led to a more rational result for tax purposes.⁸⁷

Thus, the application of economic reality to determining the place of supply does not presuppose that tax jurisdiction should be allocated to the Member State where services are physically carried out.⁸⁸ In situations where different points of reference are available (in case of the existence of a place of business establishment and a fixed establishment), priority should be given to the place which reflects a real economic situation, that is, a closer connection to the place of services' provision (the place where the services are benefited from according to new place of supply rules).

⁸⁵ Case C-260/95 *Commissioners of Customs and Excise v. DFDS A/S*, para. 23

⁸⁶ *Ibid*, para. 23

⁸⁷ Case C-190/95 *ARO Lease BV v. Inspecteur van de Belastingdienst Grote Ondernemingen te Amsterdam*, para 15

⁸⁸ In relation to certain services specific rules exist where such services are taxed at the place where they are carried out.

3.3.4 Interim conclusions

The existing judgments of the COJ dealing with the application of economic reality concept to determining the place of supply of service transactions relate to the former place of supply rules. In view of this, it is not clear how this concept will be used under the new place of supply rules entered into force starting from 1 January 2010.

Based on the cases presented above it may be concluded that reflection of economic reality does not presuppose that the services necessarily have to be taxed at the place where they are physically carried on. As the first step of determining the place of supply it should be considered whether a branch or other presence of the taxpayer constitutes a fixed establishment for VAT purposes. To that end, the economic reality criterion as described above should be applied. If there is no fixed establishment, the place of actual provision of services should not be taken into account (*Aro Lease*). If, on the contrary, there is a fixed establishment, it should be determined whether the services are provided from such a fixed establishment (under the former rules) or to such a fixed establishment (under the current rules).

4 FUNDAMENTAL FREEDOMS AND ABUSE OF RIGHTS

In this chapter it will be considered what should be the borders of acceptable VAT planning in cross-border service transactions; specifically, whether the companies should be free to select the most beneficial legal structures for cross-border service transactions and whether tax advantages may still apply to a particular structure if it was aimed essentially at obtaining tax benefit.

4.1 General

On the one hand, the freedom of establishment under art. 49 of TFEU⁸⁹ prohibits any restrictions on establishment of nationals of one Member State in another Member State including the right to take up and pursue activities as self-employed persons and to set up and manage undertakings. Based on the judgments of the COJ taxable persons are generally free to choose the organisational structures and the form of transactions which they consider to be the most appropriate for their economic activities and for the purposes of limiting their tax burdens.⁹⁰

On the other hand, one of the principles of the application of the EU legislation including EU VAT is that it cannot be extended to cover abusive practices by economic operators. The effect of that principle is therefore to prohibit wholly artificial arrangements which do not reflect economic reality and are set up with the sole aim of obtaining a tax advantage.⁹¹

If a company establishes a structure with the sole purpose to mitigate VAT in respect of service transactions, for example, by using fixed establishments to shift the place of supply to a favorable jurisdiction, the question arises under what circumstances such a structure may be challenged on the grounds of lack of economic reality. It should be noted that there is no relevant court practice of the COJ in respect of VAT. However, one of the cases providing some guidance in this regard is *Cadbury Schweppes*.⁹² Although the case deals with direct taxation, its conclusions may apply to determining the place of supply in VAT by identifying the location of the purported supplier or customer of services (depending on whose place of establishment is used for determining the place of supply).

4.2 Cadbury Schweppes

In *Cadbury Schweppes*, the case concerning the inclusion of the profits of a controlled foreign company (hereinafter – “**CFC**”) of the UK parent company into the latter’s tax base, the Court considered whether the UK CFC legislation was compatible with the freedom of establishment. In particular, the COJ examined whether the fact that a company incorporated in a Member State establishes companies in another Member State solely because of the more favourable tax regime applicable in that Member State constitutes an abuse of the freedom of establishment.

⁸⁹ Art. 49 of the Treaty of the Functioning of the European Union, Consolidated Version

⁹⁰ See, for example, case C-277/09 *The Commissioners for Her Majesty’s Revenue and Customs v RBS Deutschland Holdings GmbH* [2010] ECR 00000, para 53

⁹¹ Case C-162/07 *Ampliscientifica Srl and Amplifin SpA v Ministero dell’Economia e delle Finanze and Agenzia delle Entrate*, para 28

⁹² Case C-196/04 *Cadbury Schweppes and Cadbury Schweppes Overseas* [2006] ECR I-7995

As indicated by the COJ, the concept of establishment within the meaning of the Treaty provisions on the freedom of establishment involves the actual pursuit of an economic activity through a fixed establishment in that State for an indefinite period of time.⁹³ According to the Court the companies may not be precluded from establishing their presence in other Member States for the purpose of benefiting from more favourable legislation as it itself does not constitute an abuse of the freedom of establishment.⁹⁴ However, the freedom of establishment may be restricted by national legislations of Member States where it specifically relates to wholly artificial arrangements aimed at circumventing the application of the legislation of the Member State concerned.⁹⁵ The Court further held that this should not be the case where despite the existence of tax motives, the incorporation of a CFC (establishment) reflects economic reality.⁹⁶

It stems from the above that, in principle, taxpayers may improve their VAT position by the use of establishments in other Member States as long as such establishments carry on genuine economic activities (in this case they cannot be regarded as wholly artificial arrangements). Apart from a tax motive, an establishment should reflect economic reality, that is, constitute a real establishment from the standpoint of its economic activities. In addition to the compliance with the test of *Cadbury Schweppes* for claiming the freedom, to benefit from a particular VAT advantage, it should be proved that a particular establishment benefited from the supply (see section 2.2.1 above).

4.3 Prevention of abuse of rights in cross-border service transactions

The ability to maneuver with the place of supply of service transactions, as well as the COJ's judgment in *FCE*, provides the taxpayers with the possibility to create VAT efficient structures which are essentially aimed at obtaining a VAT benefit. An institution acquiring services in a non-EU country can reroute them to an establishment in the EU without incurring any EU VAT. Even within the EU it is possible to channel services to Member States in which the rate of input tax recovery is high, and subsequently reroute them, without any charge of VAT, to branches of the same entity in a Member State with a low rate of input tax recovery.⁹⁷

There are two aspects of the problem. First, it may result in distortion of competition between businesses with different corporate structures. Thus, businesses incurring non-deductible VAT with structures containing separate legal entities may be in a worse situation than those using branches. Second, the issue appears how to combat abuse of rights arising from the freedom of establishment in situations where branches are used in schemes circumventing VAT payment.

The VAT Directive provides for certain provisions which may be employed for this purpose. Some measures may not be applicable to structures within the EU, for example, determining the place of supply based on the place of effective use and enjoyment of a service, whereas others, such as deemed taxation of self-supplies of services, may be used in and outside the EU.

⁹³ Case C-196/04 *Cadbury Schweppes and Cadbury Schweppes Overseas*, para 54

⁹⁴ *Ibid*, para 37

⁹⁵ *Ibid*, para 51

⁹⁶ *Ibid*, para 65

⁹⁷ Para. 12.2.1.2 of the Green Paper, p. 94

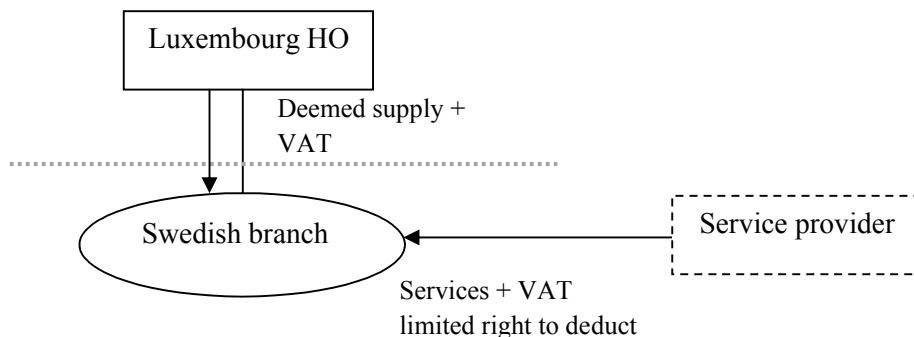
4.3.1 Taxable self-supplies of services

One of the measures proposed by the Commission in the Green Paper which may be used in a FCE-type scenario is the implementation of taxable self-supplies of services.⁹⁸ Art. 27 of the VAT Directive provides Member States with an option in order to prevent distortion of competition to treat as a supply of services for consideration and, as such, subject to VAT, the supply by a taxable person of a service for the purposes of his business, provided the VAT on such a service, were it supplied by another taxable person, would not be wholly deductible. This measure is also aimed at tackling abusive practices. As a condition precedent to the implementation, Member States must consult the VAT Committee.

As indicated by the Commission, cross-border application of taxable self-supplies of services would require a corresponding right to deduct input tax elsewhere or, alternatively, limitation of the tax on the deemed self-supply to the part of the value of the services that had not yet effectively been subject to VAT elsewhere.⁹⁹ Otherwise, the risk of double taxation or tax-cascading would persist. The Commission suggests that this measure should be applied to non-EU states only. However, taxable self-supplies of services can be also extended to EU situations.

An illustration of the application of art. 27 of the VAT Directive in a cross-border EU scenario is given below.

Example 2. Application of art. 27 of the VAT Directive



There should be the right to deduct input VAT in relation to a deemed supply or a limitation of tax to a non-taxed part of services' value

4.3.2 Concept of “effective use and enjoyment”

The VAT Directive sets forth a special provision for determining the place of supply in relation to service transactions with non-EU states. According to art. 59a of the VAT Directive Member States may allocate tax jurisdiction to the place of the effective use and enjoyment of the services while determining the place of supply. The purpose of this provision is to prevent double taxation, non-taxation and distortion of competition.

⁹⁸ Para. 12.3.1. of the Green Paper

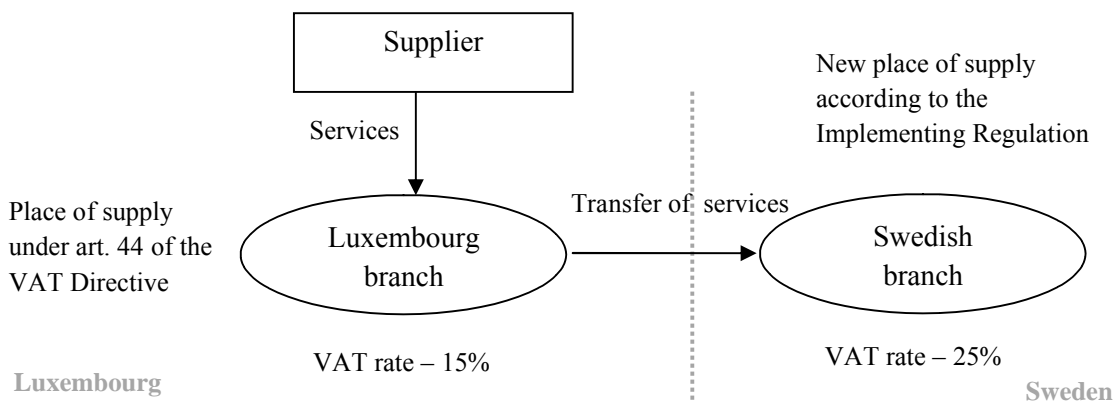
⁹⁹ Ibid.

Noteworthy, the notion of “effective use and enjoyment” is aimed at transactions with non-EU countries. In substance, a similar approach exists with respect to EU situations, where according to the new Implementing Regulation the actual use test (beneficial test) applies. Namely, the ability of the buyer to obtain a benefit from a service is considered resulting in taxation of a service where it is actually consumed. The distinction between EU and non-EU situations is that the allocation of tax jurisdiction to a Member State based on the beneficial test requires the existence of a business or fixed establishment of a taxpayer there. In contrast, determining the place of supply based on the effective use and enjoyment of a service does not presuppose the existence of any establishment in the place of taxation.

4.3.3 VAT adjustment

Another situation worth considering in the context of prevention of abuse of rights concerns a possibility of adjustment of VAT liability amount for the amount of tax paid in another Member State. For a purpose of convenience, first an illustration will be provided.

Example 3. VAT adjustment for tax paid in another Member State



In the given example a Luxembourg branch of a company acquires services followed by their transfer to another branch of the same company located in Sweden. Based on the actual use test (beneficial test) laid down in the Implementing Regulation the place of supply should be shifted to Sweden (insofar as a Swedish branch will be considered as a beneficiary of the services acquired by a Luxembourg branch). In this connection a question is whether VAT payable in Sweden may be adjusted for the amount of VAT already paid in Luxembourg in a case where a Luxembourg branch has not obtained a VAT deduction in relation to the transferred services. A similar situation may arise in a case of a taxable self-supply of services under art. 27 of the VAT Directive where VAT deduction in relation to self-supplied services has not been provided elsewhere.

There is not much guidance by the Court regarding the possibility of such an adjustment. Similar situation but concerning the goods was considered by the COJ in *Gaston Schul*,¹⁰⁰ where goods

¹⁰⁰ Case C-47/84 Staatssecretaris van Financiën v Gaston Schul Douane-Expeditie BV [1985] ECR 01491

supplied by a private person to a customer in another Member State incurred VAT burden in the Member State of the supplier prior to the importation. The Supreme Court of the Netherlands referred to the COJ a question whether the Member State of importation has to take account of the amount of the VAT paid in the Member State of exportation in order to prevent the tax from constituting internal taxation in excess of that imposed on similar domestic products which is prohibited by the Treaty.¹⁰¹ Eventually, the Court came to a conclusion that the VAT amount paid in the Member State of exportation should be taken into account in the Member State of importation where the latter does not charge VAT on similar supplies of goods within its own territory.¹⁰² The decision of the COJ was grounded, *inter alia*, upon the provisions of the Treaty establishing the European Economic Community (now art. 110 of TFEU) which prohibits the imposition by Member States, directly or indirectly, on the products of other Member States any internal taxation of any kind in excess of that imposed directly or indirectly on similar domestic products. However, no such provision exists in relation to services supplied from other Member States. Therefore, it is not clear whether the Court's conclusion in *Gaston Schul* could be extrapolated to situations concerning service supplies.

Proceeding from the basic principles of the common VAT system of neutrality and the right to deduct, as well as the TFEU principle of freedom of movement of services, a Swedish branch in the presented example should be able to make a VAT adjustment. As indicated by the Advocate General Rozès in *Gaston Schul*, a taxable person should be entitled to deduct from the VAT he is liable to pay the VAT charged at a previous stage on goods supplied and services rendered by another taxable person... services rendered to himself.¹⁰³ Domestic turnover taxes have, at least to some degree, lost their character of national taxation and become part of a "common system".¹⁰⁴ Noteworthy, the Commission mentioned the possibility of such a VAT adjustment in relation to taxable self-supplies in the Green Paper.¹⁰⁵ However, this possibility will depend on domestic legislations of the Member States involved. Additionally, to prevent potential tax avoidance, a Member State allowing the VAT adjustment should obtain reliable information about the payment of VAT on services in another Member States. A possible way forward in this respect could be a one stop shop system suggested by the Commission in the Green Paper.

¹⁰¹ Now article 110 of TFEU

¹⁰² Case C-47/84 *Staatssecretaris van Financiën v Gaston Schul Douane-Expeditie BV*, para. 23

¹⁰³ Opinion of Mr Advocate General Rozès delivered on 16 December 1981 in case C-47/84 *Staatssecretaris van Financiën v Gaston Schul Douane-Expeditie BV* [1982] ECR, p. 01409

¹⁰⁴ *Ibid.*

¹⁰⁵ Para. 12.3.1 of the Green Paper, p. 98

5 CONCLUSIONS

Economic reality and cross-border service transactions

Based on the respective court practice of the COJ and the provisions of the new Implementing Regulation, cross-border service transactions may be directly influenced by the notion of economic reality. This implies, first, determining the existence of a fixed establishment, and, second, the application of the actual use test (“effective use and enjoyment test” in relation to third countries) for determining the place of supply.

According to the Implementing Regulation two different types of fixed establishments may be distinguished, namely, fixed establishments able to provide services and fixed establishments able to receive and use them for their own needs. Two different tests should apply to determining the place of supply of service transactions. First, the capability test is designated to identify the existence of a fixed establishment of a particular type. Second, the actual use test (the beneficial test) should be used to determine which establishment receives and benefits from the supplied services. According to the Implementing Regulation an economic criterion is defined as the primary criterion for determining the place of supply. In case a service is partially used for the benefit of a receiving fixed establishment and partially of other establishments, taxing powers should be allocated among the involved Member States proportionally.

Noteworthy, the actual use test laid down in the new Implementing Regulation, resembles the notion of the “effective use and enjoyment” which applies to transactions with non-EU countries in accordance with art. 59a of the VAT Directive. Thus, it may be concluded that, in principal, the same approach is established for determining the place of supply in relation to both EU and non-EU situations. Notwithstanding the formal rules, according to this approach the place of supply of a service has to comply with a real economic situation.

Joint and several liability of the supplier

A supplier of cross-border services may, in principle, be found jointly and severally liable for incorrect determining the place of supply based on art. 205 of the VAT Directive. The imposition of such a liability should be governed by general principles of the EU law of legal certainty and proportionality. A “knowledge test” should serve as a condition precedent to the application of joint and several liability.

Fundamental freedoms and abuse of rights

Generally, the freedom of establishment may only be restricted to artificial structures not reflecting economic reality. However, the existence of economic substance in the establishment does not seem to be a sufficient condition for enjoying a VAT benefit deriving from a particular place of supply. In addition to the *Cadbury Schweppes* test, an establishment should meet the conditions of the actual use test (beneficial test) as described in section 2.2.1 above. This presupposes that a fixed establishment has to receive the service and use it for its own needs.

The non-taxation approach of services within one entity elaborated by the COJ in *FCE* does not seem feasible where non-EU jurisdictions are involved. Even if the concept of “effective use and enjoyment” would be used to allocation of tax powers between states, the non-taxation treatment may lead to VAT leakage that is against the objectives of the VAT Directive. In this respect, to attain the objectives of the VAT Directive and to protect the EU VAT tax base, taxation of cross-border service transactions between the EU and third states seems to be a proportionate measure. Art. 27 of the VAT Directive could serve as a legal basis for this purpose.

Aimed at prevention of abusive practices, Member States may apply taxable self-supply of services under art. 27 of the VAT Directive and the concept of “effective use and enjoyment” to determine the place of supply in relation to third countries. In case of taxable self-supplies of services or shifting the place of supply to another Member State based on the beneficial use test the VAT adjustment for the amount of tax paid in another Member State should be possible. This would ensure the compliance with the basic principles of the common VAT system of neutrality and the right to deduct, as well as the TFEU principle of freedom of movement of services.

In conclusion, the borderline between the right to enjoy fundamental freedoms and the prohibition of abuse of rights lies in the realm of economic reality, which, notwithstanding the freedom of establishment, may affect the place of supply and, as such, the ability to enjoy a tax benefit.

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