



Lund University

School of Economics and Management  
Department of Business Law

**Transactions between branch and head office and the right to  
deduct input VAT in cross-border scenarios**

by

**Jose Suazo Pariona**

HARN60 Master Thesis

Master's Programme in European and International Tax Law

2020/2021

Spring semester 2021

Supervisor: Marta Papis-Almansa

[FINAL DRAFT]

Author's contact information:

Jose.m.suazo@hotmail.com

+46 (0) 730 47 07 09

Word count: 13533

Submitted: 2021-07-01

## Table of contents

<b>Summary</b>	<b>3</b>
<b>Preface</b>	<b>4</b>
<b>Abbreviation List</b>	<b>5</b>
<b>1. Introduction</b>	<b>6</b>
1.1 Background	6
1.2 Aim	7
1.3 Method and material	7
1.4 Delimitation	7
1.5 Outline	8
<b>2. Branch, head office, and the concept of taxable person</b>	<b>9</b>
2.1 Introduction	9
2.2 Concepts	9
2.3 Scope of VAT	9
2.4 The Taxable Person in a VAT system	10
2.5 Taxable persons in a head office and branch structure	11
2.6 Conclusions	12
<b>3. The right to deduct of cross-border taxable persons</b>	<b>13</b>
3.1 Introduction	13
3.2 The right to deduct in a Cross-Border scenario	14
3.3 The uncertainty of the single and separate entity approach in regards to deduction	15
3.4 The Morgan Stanley case	18
3.5 Conclusions	20
4.1 Introduction	22
4.2 The territorial scope of VAT grouping schemes	23
4.3 Skandia America case	24
4.4 Danske Bank case	25
4.5 Discussion on the scope of VAT grouping	26
4.6 Conclusions	27
<b>5. A non-EU head office and the recovery of VAT</b>	<b>29</b>
5.1 VAT Grouping v the right to deduct in cross-border scenarios	29
5.2 A scenario of Morgan Stanley case with a non- EU head office	29
<b>6. Conclusions</b>	<b>33</b>

# Summary

Financial institutions and VAT are often like oil and water. If a financial institution is considering centralizing an activity in a certain jurisdiction, non-recoverable VAT could pose a serious problem. In addition to that, ambiguous judgments of the European Court of Justice have contributed to this issue. As of now, even services carried out within the same legal entity may trigger non-recoverable VAT when there is a cross-border component involved.

With a new interesting ruling in Danske Bank and a withdrawn request for a preliminary ruling in the Bank of China case, it appears to be possible to shake up the VAT area regarding VAT treatment of cross-border intra-entity services. This thesis places the above mentioned cases in context with the Skandia America and Morgan Stanley court cases and discusses their potential impact on financial institutions. Particularly for establishments located outside the European Union.

# Preface

This research is performed during the Master studies at Lund University, School of Economics and Management, Department of Business law. It is my pleasure to extend sincere thanks to Dr. Marta Papis-Almansa for sharing her expertise in indirect taxation during our classes as well as her valuable feedback, guidance, assistance and support in the writing of this thesis. It would not have been possible for this research to take place without her guidance.

I want to take this opportunity to thank professor Cécile Brokelind and all the professors that participated for freely sharing their knowledge and their experience, and for allowing me and all of the participants to explore international tax law.

My sincere gratitude goes out to all my classmates with good spirits which contributed to a great academic year in Lund. It was a year full of challenges, and I am very glad I was able to overcome them.

Lastly, I wish to thank my family and friends for their great support throughout the Masters Program.

## **Abbreviation List**

AG Advocate General

CJEU Court of Justice of the European Union

EU European Union

TFEU Treaty on the Functioning of the European Union

VAT Value Added Tax

VAT Directive Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax

# 1. Introduction

## 1.1 Background

Until the Skandia America<sup>1</sup> case, most countries considered it a common practice that cross-border intra-entity services between a head office and a branch are not subject to VAT on the basis of the FCE Bank<sup>2</sup> case, where the Court found that the branch was not considered to be independent and thus separate from its head office, since it did not bear economic risk. In the highly publicized Skandia America case, the CJEU ruled that a branch, through the joining of a Swedish VAT group also was considered to have “detached” itself from the taxable person that previously consisted of the branch together with its head office in a third country. Consequently, the branch and its head office was to be treated as separate taxable persons for VAT purposes. In connection with the Danske Bank<sup>3</sup> case, the issue of cross-border VAT groups has been raised again. The case is basically a follow-up to the FCE Bank and Skandia cases and concerned the VAT treatment of services provided by a Danish head office to its Swedish branch, where the head office had joined a Danish VAT group. The decision in Danske Bank concluded that the Skandia America principle should not be different when the head office is established in the EU and that the head office by joining a VAT group was “detached” from the branch and was its own separate taxable person.

For branches that are not entitled to deduct, the question of a separate taxable person and the detachment from its head office is of the utmost importance, as it affects the right to deduct input VAT when the branch purchases goods or services that also benefit the supplies of the head office. Article 169(c) of the VAT Directive provides that the branch may claim a VAT deduction on expenses incurred for providing exempt financial services to clients located outside the EU. It is not uncommon for financial sector branches in the EU to have their head offices located outside of the EU, such as China or the United Kingdom, which do provide financial services. Therefore, this question is of importance.

The inconsistent and unclear rules regarding VAT recovery applicable to branches providing support services for its overseas head offices have led to different deduction methods being applied across the EU. The most recent development in a series of judgments from the CJEU is the *Morgan Stanley*<sup>4</sup> case from 2019 where the Court ruled that the French branch with its head office in the United Kingdom was required to utilize a two-folded pro rata calculation to recover French VAT incurred. One regarding expenditures exclusively used to support its head office, and a second related to costs used to support both the head office and its own business. While the judgment clarifies important questions related to cross-border deductibility in the context of a head office and branch structure within the EU, some questions remain unresolved, such as whether the decision would have been different had the head office been located outside the EU.

Another unanswered question was what impact VAT groups created outside of the EU would have in such a situation.. Considering that the separation from the head office means that the branch cannot include the turnover of the head office when calculating the

---

<sup>1</sup> CJEU, 17 September 2014, Case C-7/13, Skandia America, ECLI:EU:C:2014:2225.

<sup>2</sup> CJEU, 23 March 2006, Case C-210/04, FCE Bank, ECLI:EU:C:2006:196.

<sup>3</sup> CJEU, 11 March 2021, Case C-812/19, Danske Bank, ECLI:EU:C:2021:196.

<sup>4</sup> CJEU, 24 January 2019, Case C-165/17 Morgan Stanley, ECLI:EU:C:2019:58.

deductibility of input tax, the issue of the territorial limitation in article 11 is of paramount importance to analyse for the branches, especially in the financial sector.

## 1.2 Aim

This thesis intends to analyze a number of cases regarding cross-border entities and their right to deduct input VAT, in addition to VAT grouping and the right to deduct in that regard. The thesis will later discuss the right to deduct in cross-border situations in scenarios going beyond the factual circumstances of these cases. Namely, the rules that would be applicable if, for example the head office would have been established outside the EU, i.e. China. Further, the focus will be made on the interplay of such rules and the rules on the right to deduct in cross-border situations, inside the EU, interpreted by the CJEU. As mentioned above, it becomes important to establish the difference between an export situation (outside EU) and an inside EU situation in regard to the right to deduct in cross-border situations. This depends on the lack of guidance in this area and the fact that there are no judgements from the CJEU in that regard. Therefore, this thesis seeks to answer the following questions:

*Would the Morgan Stanley case have a different outcome if the head office had been established outside the EU, and would the supplies made by the head office in China be considered for VAT purposes?*

## 1.3 Method and material

To achieve the aim of this thesis, the traditional legal dogmatic method<sup>5</sup> is applied. The basis for the analysis relies on a valid source of law. Interpretation of the legislation is guided by judicial practice, primarily by applying the case law of the European Court of Justice, as well as considering the legal opinions of other EU organizations.

Moreover, in order to provide a more comprehensive and holistic approach to the main questions in the thesis, legal doctrine in the form of articles, published papers, textbooks and commentaries is consulted and analysed. In addition to EU law, this thesis also draws upon national legislations and judgments to provide an in-depth legal analysis of the research question. Taking into consideration both the purpose of the thesis and the research question.

## 1.4 Delimitation

For the purpose of this thesis and as this work is characterized by the temporal framework provided by the scope of the course, it is necessary to implement certain constraints. Thus, the following aspects of the selected research area will not be addressed within the framework of this work.

This paper explores whether the deduction right in a head office and branch structure could possibly be exercised when the head office is situated outside the EU, and what the outcome of the Morgan Stanley case would be if the head office was a member of a VAT group. Therefore, No further regard will be made to other issues in that area, such as, inter alia, ascertaining the direct and immediate link between transactions.

---

<sup>5</sup> See Sjoerd Douma, *Legal Research in International and EU Tax Law* (Kluwer 2014), pg. 17 ff.

The selection of case law from the CJEU is based on the most relevant cases for the purpose of this thesis. This entails cases that have regarded the right to deduct in cross-border situations and VAT grouping. No further consideration will be made to cases that regard other VAT-related matters.

## 1.5 Outline

Following the introduction, the first chapter provides a quick overview of the scope of VAT and the relevant aspects of the European VAT system in general, in order to provide readers with a better understanding of the different aspects of the research question.

Following this, the second chapter, explains the major concepts associated with this thesis purpose and the way they interact with one another. In addition to a presentation to some fundamental case law, e.g. the FCE Bank case.

The third chapter deals with the right to deduct of cross-border taxable persons. An explanation of the legal regulation regarding deductibility in terms of VAT will be made, as well as the direct and immediate link. This will be followed by a presentation of some relevant case law in that area such as, inter alia, *Le crédit Lyonnais* and *Morgan Stanley*.

The fourth chapter addresses the consequences of VAT grouping on cross-border scenarios. A presentation of some general information in regard to VAT grouping is made followed by vital case law from that area.

The fifth chapter deals with the core question in this thesis, a hypothetical scenario is presented based on the *Morgan Stanley* judgment, but with the head office positioned outside the EU. This section, also, briefly discusses the possible tax consequences for VAT groups in this scenario and whether the judgement in *Morgan Stanley* can be applied in cases where VAT grouping is included.

The last chapter consists of conclusions of the above mentioned information and discussions.



## 2. Branch, head office, and the concept of taxable person

### 2.1 Introduction

In order to understand how the result of the Morgan Stanley case may differ if the head office or branch were located outside the EU, and what impact a VAT group created outside the EU would have had, it is necessary to examine the CJEU's position on the current VAT groups. Therefore, this chapter provides a clarification on concepts, basic background on the relevant aspects of the European VAT system in general and the scope of VAT to better understand the different aspects of the research question.

### 2.2 Concepts

For clarification purposes, it would be essential for the thesis to briefly define some concepts associated with the place of economic activity of a company, i.e., the head-offices and branches. The "head office" is referred to as the principal place of business or the headquarters of an organization, an example of this can be seen in the recently settled Danske Bank case, which had its head office established in Denmark. It must be noted that several provisions in the VAT Directive make reference to the "place of business" or "place where the customer has established his business" for the sake of mentioning the same concept. In this context, a company's 'place of business' has been defined by the CJEU as the place where essential managerial decisions are made and where key administrative functions are carried out.<sup>6</sup>

As for branches, they are referred to as a secondary establishment of a company. Business operations across borders and the presence of businesses in multiple jurisdictions are very common in a global economy. Many multinational companies choose to establish their own companies in the various jurisdictions in which they are active, whereas others choose to set up branches.<sup>7</sup> As mentioned above, the primary place of establishment of a company that sets up branches in other jurisdictions is referred to as its head office.

### 2.3 Scope of VAT

The European VAT Directive 2006/112/EC (VAT Directive)<sup>8</sup> sets out the common European framework for the national VAT systems in the Member States. The VAT Directive aims to create a single VAT system.<sup>9</sup> Upon a transaction falling within the scope of the VAT Directive, a member state can charge VAT, meaning that goods, intra community acquisitions, and services for consideration are taxed with VAT.<sup>10</sup>

VAT is intended not to be an economic burden and a cost component for business, and therefore, creates a neutral VAT system. The neutrality that is mentioned in the preamble of the VAT Directive regards the right of deduction.<sup>11</sup> The final tax burden associated with VAT is placed on the last party to the transaction, the consumer.<sup>12</sup> A brief explanation of

---

<sup>6</sup> CJEU, 28 June 2007, Case C-73/06, Planzer, ECLI:EU:C:2007:397, para. 61 and 63.

<sup>7</sup> Prof. Dr. Ad Van Doesum, Prof. Dr. Herman Van Kesteren, Prof. Dr. Gert-Jan van Norden, Fundamentals of EU VAT LAW, page 57.

<sup>8</sup> Council Directive 2006/112/EC on the common system of value added tax of 28 November 2006.

<sup>9</sup> Article 1 (1) of the VAT Directive.

<sup>10</sup> Article 2(1)(a)-(d) of the VAT Directive.

<sup>11</sup> Recital (5), (7) and (30) of the Preamble of the VAT Directive.

<sup>12</sup> Article 1(2) and 2(1)(a) of the VAT Directive.

economic activity, taxable transaction, and taxable person will be given below. The definitions of economic activity and taxable person have critical importance for this thesis, as only a taxable person who carries out taxable transactions can enjoy the right to deduct input VAT on costs incurred on acquisitions.

## 2.4 The Taxable Person in a VAT system

Article 9 (1) VAT Directive provides the definition of a taxable person in the VAT system. “Taxable person” shall mean any person who, independently carries out in any place any economic activity whatever the purpose or result of that activity”. Those who meet criteria will be considered a taxable person for VAT purposes.<sup>13</sup> As taxable persons can recover the VAT incurred on goods and services provided to them.<sup>14</sup> In principle, this right of recovery takes the form of the right of deduction, whereby the taxable persons deduct the VAT on their purchases, called input VAT, from the VAT on their sales, called output VAT.<sup>15</sup> Through this recovery system of input VAT, all businesses are relieved of the direct fiscal burden of VAT.

VAT is only charged on transactions carried out by someone having the status of a taxable person, therefore it is necessary to determine both whether a person meets the objective criteria of a taxable person, as well as whether the person is acting in his capacity as a taxable person.<sup>16</sup> Though, it follows from Article 9 (1) VAT Directive that economic activities are an essential element of the notion of the taxable person. Persons who do not carry out any economic activity, do not have the taxable person status, meaning that, for example, they do not seek any consideration for their activities.<sup>17</sup> Clearly, the VAT Directive and the CJEU Case law state that in order for transactions to qualify as services subject to VAT, they must be carried out for consideration.<sup>18</sup> If they are carried out free of charge, the transaction will not qualify as services for VAT purposes and, consequently, in the absence of other taxable activities, the service provider will not be qualified as a taxable person.<sup>19</sup>

Finally, a person can only be regarded as a taxable person if he acts independently, which means that there are no legal ties that can link this person to an employment and that he bears the economic risk entailed in the activities. The Criterion of the “economic risk” dates back to the judgement in the *Ayuntamiento de Sevilla* case which was handed down in 1991.<sup>20</sup> Advocate General Tassaro stated in his opinion that “it is obvious that in a relationship of employer and employee, the economic risk can fall only on the employer”. The CJEU found in the case that the profits that a taxable individual makes depend on the amount of expenses incurred on staffing and equipment.<sup>21</sup> In the case of *Van der Steen*, the CJEU ruled that a director-majority-shareholder, who had a hundred percent ownership of the shares in a Dutch BV could not be seen as a taxable person because of the existence of a contract of employment.<sup>22</sup> In the case of *Wroclaw*, the CJEU held that municipal budgetary entities did not bear the economic risk required of them as they did not own their own

---

<sup>13</sup> Alhager, Eleonor, Kleerup, Jan, Melz, Peter och Öberg, Jesper, *Mervärdesskatt i teori och praktik*, page. 34.

<sup>14</sup> Article 168 of the VAT Directive.

<sup>15</sup> Article 167 of the VAT Directive.

<sup>16</sup> Prof. Dr. Ad Van Doesum, Prof. Dr. Herman Van Kesteren, Prof. Dr. Gert-Jan van Norden, *Fundamentals of EU VAT law*. p. 56 and 58.

<sup>17</sup> CJEU, 1 April 1982, Case C-89/81 *Hong Kong Trade*, ECLI:EU:C:1982:121, para. 10.

<sup>18</sup> See Art. 2(1)(c) of Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax, OJ L 347 of 11 December 2006 (the “VAT Directive”), which provides that the supply of services for consideration within the Member State by a taxable person acting as such is subject to VAT.

<sup>19</sup> See judgment, CJEU, 1 April 1982, Case C-89/81 *Hong Kong Trade*, ECLI:EU:C:1982:121.

<sup>20</sup> CJEU, 25 July 1991 Case C-202/90 *Ayuntamiento de Sevilla v Recaudadores de Tributos de las Zonas primera y segunda*.

<sup>21</sup> *Ibid*, para. 14.

<sup>22</sup> CJEU, 18 October 2007 Case C-355/06 *J.A. van der Steen*, ECLI:EU:C:2007:615.

properties, nor did they earn their own income, nor did they bear the expenses in carrying out their economic activities.<sup>23</sup>

## 2.5 Taxable persons in a head office and branch structure

Legally, a branch forms a single entity with its head office. It also does so from a VAT perspective within the meaning of Article 9(1) VAT Directive, which considers that a head office and its branch form a single VAT entity. As such, a branch may have to carry out the same VAT administrative obligations as a legally independent entity.<sup>24</sup> However, in the FCE Bank case the CJEU held that a branch which does not carry out independent economic activities is deemed to have no legal relationship with the head office of the company located in another EU Member State.<sup>25</sup> In this way, the branch and the head office are deemed to be treated as a single taxable person. This judgement of the CJEU is of great importance to fully comprehend the issue of determining the VAT deductible rules for branches supporting their foreign head office. The FCE Bank case concerns a bank with its head office in the United Kingdom, and a branch in Italy. The branch was not its own legal person in Italy and its business consisted of conducting financial activities exempted from VAT. During several years, the head office supplied the branch with various kinds of different services that were in the scope of VAT.<sup>26</sup>

As a result, the branch initially accounted for non-deductible Italian VAT under the reverse charge mechanism but later applied for a refund of VAT, as it considered the transactions to not constitute supplies of services for consideration and thus excluded them from the scope of VAT. According to established case law, transactions are subject to VAT only if the parties have a legal relationship under which mutual performance is involved.<sup>27</sup> This was denied by the Italian tax authority. It was argued by the Italian national tax court that the services provided by the Italian branch to the head office were subject to VAT as it was a separate taxable person for VAT purposes.<sup>28</sup> According to the CJEU assessment, the central question was whether the Italian branch could also be considered independent of the company's head-office in the United Kingdom even though the branch did not possess a legal personality under Italian law.<sup>29</sup>

In this connection, the court attached special importance to whether the branch could be considered to bear the financial risk associated with the business.<sup>30</sup> In its assessment, the Court found that the branch did not contribute with its own capital and that it was the entire company that bore the whole risk of all its economic activities.<sup>31</sup> Consequently, the branch could not be considered to bear the financial risk associated with the activity, and the branch in Italy was deemed dependent on the head office in the United Kingdom, and as a result, they were considered to be a single taxable person.<sup>32</sup> Considering the branch's dependence on the head office, it could be established that there was no legal relationship that involved a reciprocal exchange of services between the branch and the head office.

---

<sup>23</sup> CJEU, 29 September 2015, Case C-276/14 Gmina Wrocław, ECLI:EU:C:2015:635, para. 34-39.

<sup>24</sup> Herman van Kesteren and Madeleine Merckx, 'The Concept of Taxable Persons (and Fixed Establishments) in EU VAT' in Thomas Ecker, Michael Lang and Ine Lejeune (eds), *The Future of Indirect Taxation: Recent Trends in VAT and GST Systems around the World*, page. 633.

<sup>25</sup> CJEU, 23 March 2006, Case C-210/04, FCE Bank, ECLI:EU:C:2006:196, para. 35.

<sup>26</sup> According to para. 15 of the FCE Bank judgment, supplies of services received from the FCE Bank include 'consultancy, management, staff training, data processing and the supply and management of application software'.

<sup>27</sup> *Ibid.*, para. 14.

<sup>28</sup> *Ibid.*, para. 28.

<sup>29</sup> *Ibid.*, para. 23.

<sup>30</sup> *Ibid.*, para. 35.

<sup>31</sup> *Ibid.*, para. 36.

<sup>32</sup> *Ibid.*, para. 37.

Due to the absence of a legal relationship, any supply between the head office and the branch would be disregarded for VAT as services are only taxable if a legal relationship exists between the head office and the branch and in which there must be a reciprocal performance.<sup>33</sup> As stated in the FCE Bank case, economic risk was not borne by the branch, therefore, the CJEU found that there was no legal relationship between them. According to the CJEU, a taxable service provision presupposes a legal relationship encompassing a reciprocal exchange of services between the provider and the recipient and in order for the services provided from the head office to the branch to be regarded as taxable transactions, it was required that the branch could be considered to be engaged in independent economic activities. This conclusion can also be drawn regarding a branch established in the same member state as its head office when the branch does not possess its own independence from the head office or parent company.

The “single entity approach” set out in FCE Bank implies that intra-entity flows of services between a head office and its branch will be regarded as nullities in a VAT context. By applying this approach, it is legally impossible to attribute VAT incurred on costs associated with intra-entity flows, since such flows between the head office and the branch are of the scope of VAT. However, this approach means that when establishing the branch's right to deduct input VAT from purchases to support its overseas head-office supplies, it will be necessary to include the outgoing supplies from the overseas head-office in order to determine how much input VAT can be recovered by the branch.

## 2.6 Conclusions

This chapter established the fundamentals of the topic in order for the reader to obtain an understanding. Starting with concepts, the Concept of "head office" is referred to as the principal place of business or the headquarters of an organization. As for branches, they are referred to as a secondary establishment of a company. The chapter also discussed the importance of VAT and its scope and that VAT is intended not to be an economic burden and a cost component for business, and therefore, creates a neutral VAT system. Further, Article 9 (1) of the VAT Directive is mentioned in relation to the concept of a taxable person in the VAT system.

Finally, a presentation of the FCE Bank case is made in regard to taxable persons in a head office and branches, where the CJEU held that a branch which does not carry out independent economic activities is deemed to have no legal relationship with the head office of the company located in another EU Member State. Moreover, the fact whether the branch could be considered to bear the financial risk associated with the business was also discussed. The Court found that the branch did not contribute with its own capital and that it was the entire company that bore the whole risk of all its economic activities. Thus, the branch could not be considered to bear the financial risk associated with the activity, and the branch in Italy was deemed dependent on the head office in the United Kingdom, and as a result, they were considered to be a single taxable person. Considering the branch's dependence on the head office, it could be established that there was no legal relationship that involved a reciprocal exchange of services between the branch and the head office, therefore, the branch would be disregarded for VAT as services are only taxable if a legal relationship exists between the head office and the branch and in which there must be a reciprocal performance.

---

<sup>33</sup> CJEU, 3 March 1994, Case C-16/93 Tolsma, EU:C:1994:80, para. 14.

## 3. The right to deduct of cross-border taxable persons

### 3.1 Introduction

This section intends to give an overview of the right to deduct in general, followed by an explanation of the right to deduct in cross-border situations and finally a presentation of relevant case law.

The right of input VAT deductibility is a critical element and a central component of ensuring complete neutrality of the tax system.<sup>34</sup> The right to deduct makes it possible for taxable persons as a rule not to have to bear the tax burden associated with taxable goods and services. Therefore, the right to deduct input VAT has the status of one of the basic principles underlying the VAT system<sup>35</sup> and a key element ensuring the neutrality of the VAT system.<sup>36</sup> VAT law affirms the principle of deductibility and grants the taxable person the right to deduct input VAT for expenses incurred in connection with its economic activity for goods and services provided by another taxable person, provided these goods or services are used in connection with a taxed transaction.<sup>37</sup> The right to deduct must therefore guarantee that the activities of the taxable persons are not burdened with VAT costs. It has been observed and stated by the CJEU on several occasions that the right of deduction inherent in the VAT Directive constitutes a fundamental aspect of the VAT system, which cannot be restricted in principle.<sup>38</sup>

The taxable person shall be entitled to deduct the VAT due for the acquisition of the good when acting as a taxable person in relation to the acquisition of the good.<sup>39</sup> In respect of deductions, one of the first cases that defined the principle of neutrality was the Rompelman case which concluded *“that the deduction system is meant to relieve the trader entirely of the burden of the VAT payable or paid in the course of all his economic activities. The common system of value-added tax therefore ensures that all economic activities, whatever their purpose or results, provided that they are themselves subject to VAT, are taxed in a wholly neutral way.”*<sup>40</sup> However, the CJEU has expressed this view in numerous cases.<sup>41</sup>

According to the above, Article 168 of the VAT Directive provides that a taxable person who uses goods or services for taxed output activities is entitled to deduct input VAT in the Member State in which he performs these activities. This is provided that there is a *direct and immediate link* that can be established between the goods and services purchased and the price of those supplies.<sup>42</sup> It is also essential to understand that a taxable person may also be eligible for a deduction even when there is no directly and immediately linked output transaction, but rather where the costs of the service are part of the taxable person's general costs. In that case, the costs are linked directly to the entire economic activity of the taxable person.<sup>43</sup>

---

<sup>34</sup> See, inter alia, Cases C-488/07, Royal Bank of Scotland, EU:C:2008:750, para 15; C-388/11, Crédit Lyonnais, EU:C:2013:541, para 27.

<sup>35</sup> Ine Lejeune and Jeanine Daou, “VAT Neutrality from an EU Perspective” in Michael Lang and Ine Lejeune, *Improving VAT/GST Designing a Simple and Fraud-Proof Tax System* (IBFD 2014) s. 480–482.

<sup>36</sup> See CJEU, 14 February 1985, Case C-268/83, Rompelman, ECLI:EU:C:1985:74.

<sup>37</sup> Article 168 of The Vat Directive.

<sup>38</sup> CJEU, 22 October 2015, Case C-126/14, Sveda, ECLI:EU:C:2015:712, para. 16.

<sup>39</sup> Henkow, *Neutrality of VAT for Taxable Persons: A New Approach in EU VAT*, EC Tax Review (2008), page. 235.

<sup>40</sup> CJEU, 14 February 1985, Case C-268/83, Rompelman, ECLI:EU:C:1985:74, para. 19.

<sup>41</sup> CJEU, C-37/95, 15 January 1998, Ghent Coal Terminal, ECLI:EU:C:1998:1, para. 15.

<sup>42</sup> CJEU, 6 April 1995, Case C-4/94, BLP Group, ECLI:EU:C:1995:107, para. 21.

<sup>43</sup> See CJEU, 6 September 2012, Case C-496/11 Portugal Telecom SGPS, ECLI:EU:C:2012:557, para. 27; CJEU, 14 September 2017, Case C-132/16, Iberdrola, ECLI:EU:C:2017:683, paras 28–29; CJEU, 17 October 2018, Case C-249/17 Ryanair, ECLI:EU:C:2018:834, para. 27.

In Midland Bank the CJEU clarified the nature of the “direct and immediate link”. Midland Bank had supplied financial services to a customer outside of the EU who was in the process of buying another business. Such a financial service is given the right to deduct, under what is now Article 169(1) (c) VAT Directive and therefore Midland Bank could deduct the VAT on a pro rata basis. Even though the CJEU indicated that it would not be realistic to attempt to be more specific in respect of the determination of a direct and immediate link.<sup>44</sup>

Under VAT grouping provision and in accordance with case law<sup>45</sup> it is possible to include persons with no or partial right to deduct input VAT. This possibility enables, to effectively partially deduct VAT on taxed supplies which are used to produce exempt supplies giving the taxpayer the advantage which he would have not received had the group not existed.<sup>46</sup>

### 3.2 The right to deduct in a Cross-Border scenario

It will naturally occur that a cost incurred by the branch which is established in one country, in part or in full will be in favour of or in effect used by the head office in other countries. For example, that one asset or service purchased by the branch is used by the head office in a different country.

Under Article 169 (a) of the VAT Directive, taxpayers can claim a deduction for VAT incurred on goods and services used to facilitate transactions outside the Member State in which the VAT is due or paid, if the transactions have been carried out within that State. In cross-border situations, this extends the scope of the deduction and applies to situations when a taxpayer makes a supply of goods or a service that is considered to take place in another country, but the goods or services he purchases are subject to VAT in the Member State of establishment.

If a taxable person in Sweden supplies a B2B advisory service to a customer in Bulgaria, that service will be taxed in Bulgaria. If the Swedish supplier has purchased legal services in Sweden from a tax lawyer in Sweden which he used to supply the advisory services to the company in Bulgaria, the question arises whether he can deduct the Swedish VAT on the legal services. In accordance with Article 169 (a) of the VAT Directive, the Swedish company is entitled to deduct the input VAT on legal services which are to be taxed in another Member State, this time Bulgaria, and which would have been deductible if the services had been performed within Sweden.

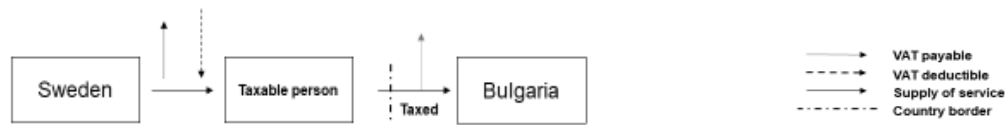
---

<sup>44</sup> CJEU, 8 June 2000, Case C-98/98 Midland Bank, ECLI:EU:C:2000:300, para. 19-21.

<sup>45</sup> C85/11 Commission v Ireland.

<sup>46</sup> J. Swinkles, “The Phenomenon of VAT Groups under EU Law and Their VAT-Saving Aspects”, International VAT Monitor, January/February 2010, p.39.

**Figure 1.0**



Following CJEU's case law as regards non-established taxable persons, the provision is subject to a two-fold condition: (1) the transaction must give rise to recovery right in the country where the establishment is located and (2) it must also give rise to recovery in the country where the VAT refund is requested.<sup>47</sup> By allowing the deduction for supplies which are deemed to be made in another Member State, the legislator prevents a possible violation of the fiscal neutrality which would occur if transactions that are taking place in a different Member State burdened the taxable person with non-deductible VAT.

It should be noted that if an acquisition is only partly attributable to an activity or transaction that entitles a deduction, only a portion of the input tax may be deducted.<sup>48</sup> This may be the case if the acquisitions are partly attributable to a non-financial activity or to transactions that are exempt from tax.<sup>49</sup> When the goods and services expenditures are used both for transactions where the input VAT is deductible and for transactions where it is not deductible, then only the input VAT that is directly connected with the taxable transaction is deductible.<sup>50</sup>

### 3.3 The uncertainty of the single and separate entity approach in regards to deduction

When establishing the right to deduct input VAT in a head office and branch structure, the national VAT legislation in the country in which the right of deduction is invoked must obviously be taken into account. Consequently, there may be some uncertainty regarding input transactions which initially are acquired by the establishment itself, but in part or in full also benefit the supplies that are carried out by other establishments. One scenario is if the branch in one Member State purchases goods or services that also benefit the supplies of the head office in another Member State. A problem with this situation is that the CJEU has ruled that a taxable person may only deduct input VAT on transactions that are used to perform the taxable persons own taxable output transactions.<sup>51</sup>

If VAT a single entity approach is applied, the costs incurred by a branch of a multi-jurisdictional business for the performance of its head offices should benefit from a VAT deduction. If a separate entity approach is applied, the VAT deduction for the costs incurred by the same head office for the performance of the same services is solely related to the turnover of the branch. Therefore, the question of the right to deduct in a head office and branch structure, i.e. when one of the establishments incurs costs that in part or in full

<sup>47</sup> See inter alia Case CJEU, 13 July 2000, Case C-136/99, *Societe Monte Dei Paschi Di Siena*, EU:C:2000:408 and Case CJEU, 22 December 2010, Case C-277/09, *RBS Deutschland Holding*, ECLI:EU:C:2010.

<sup>48</sup> Art 173-175 of The VAT Directive.

<sup>49</sup> See CJEU, 21 June 2016, Case C-393/15 *ESET*, EU:C:2016:481, para. 44 and CJEU, 22 October 2015, Case C-126/14, *Sveda*, ECLI:EU:C:2015:712, para. 32.

<sup>50</sup> Article 173.1 of The VAT Directive.

<sup>51</sup> See CJEU, 22 February 2001, Case C-408/98, *Abbey National*, ECLI:EU:C:2001:110, para. 32; CJEU, 15 September 2016, Case C-516/14, *Barlis 06*, ECLI:EU:C:2016:690, para. 40.

will be in favour or in effect consumed by another establishment located in another Member State is a big issue. The question is highly relevant to multinational enterprises and institutions that operate through branch structures, and particularly in industries where the right to deduct the input VAT is limited, such as the financial sector.<sup>52</sup>

In *RBS Deutschland Holding* the CJEU held that input VAT could not be deducted in a Member State for a subsequent transaction in another Member State in the case that those transactions would have been exempted from VAT in the latter state, whether or not the transactions would have entailed the right to deduct in the first Member State if they had been carried out there.<sup>53</sup> *ESET*<sup>54</sup> concerned a branch established in Poland which provided its head office in Slovakia with software-related services for the head office to sell to third parties. On the side of that service, the branch also provided taxable services to third parties. The branch wanted a deduction for the VAT it had paid to provide support services to their head office. The Polish tax authorities refused deduction due to the fact no supplies were made in Poland, only in Slovakia. The question therefore arose of whether the branch established in Poland could deduct input VAT despite the fact that the taxable transactions were performed by the head office in another Member State.

In *ESET*, the CJEU repeats that the right to deduct input VAT is an essential part of the VAT system and cannot be limited. Concerning that the branch and the head office form one taxable person the CJEU held that Even though Article 168 VAT Directive lays down a territorial requirement and this requirement is not satisfied, Article 169 (a) VAT Directive established a right to deduct input VAT and therefore has an “extra-territorial scope”. Which is logic, as the latter article refers to the concept of “economic activity” which is not constrained. In other words, the branch is entitled to deduct input VAT in its Member State of establishment by taking into account the head office's taxable turnover generated in another Member State. The Court had chosen to directly issue an order instead of a judgement which should mean that the issue in *ESET* was particularly straightforward to address. *ESET* confirmed the right to recover VAT on costs relating to services provided to another establishment. It appears as the Court almost has done a U-turn compared to the approach in the *Le Crédit Lyonnais*<sup>55</sup> case where the supplies made through other establishments should not be taken into account.

In *Credit Lyonnais* the CJEU decided on the question of whether a taxable person, when calculating the deductible proportion applicable to its head office in a Member State is allowed to take into account the turnover of its branches in other Member States.<sup>56</sup> The CJEU states that if a taxable person was allowed to take into account turnover from a branch when calculating the right to deduct for the head office, this would lead to the deductible share for the head office being given an incorrect value.<sup>57</sup> The arguments put forward in *Le Credit Lyonnais* by the plaintiff were based on the aforementioned understanding that FCE Bank prevents the deduction of the VAT incurred by a head office of a multi-jurisdictional business for the purpose of the operation of its non-domestic branches. The plaintiff argued that the income generated by the branches with third parties should be seen as the head office's own income. The main issue was therefore whether the French head office could include, in the numerator and the denominator, the turnover

---

<sup>52</sup> Yannick Zeippen, Jacques Verschaffel, Olivier Lambert, “how can VAT be recovered by branches rendering services to their head offices?” [https://www.ey.com/en\\_lu/tax/ey-luxembourg-tax-library/branch-head-office-supplies](https://www.ey.com/en_lu/tax/ey-luxembourg-tax-library/branch-head-office-supplies) (accessed 27/June/2021).

<sup>53</sup> CJEU, 22 December 2010, Case C-277/09, *RBS Deutschland Holding*, ECLI:EU:C:2010:810, para. 36-37.

<sup>54</sup> CJEU, 21 June 2016, Case C-393/15 *ESET*, EU:C:2016:481.

<sup>55</sup> CJEU, 12 September 2013, Case C-388/11, *Le Crédit Lyonnais*, ECLI:EU:C:2013:541.

<sup>56</sup> *Ibid.*, para.

<sup>57</sup> *Ibid.*, para. 38 and 40.



belonging to its overseas branch, when calculating its pro rata. The CJEU rejected the approach by the plaintiff because (1) it would seriously jeopardize the rational allocation of the spheres of application of national legislation in VAT matters and (2) it would enable the head office to recover VAT even when there is no direct and immediate link between the VAT incurred and the activities of the branches and (3) the deductible proportion is liable to impair the effectiveness of the VAT Directive as regards taxation policy.<sup>58</sup>

Thus the CJEU upheld that the French head office could not take into account the turnover of its foreign branches, located within and outside the EU. The judgement rejects the so-called “worldwide pro rata” where a head office could include the turnover of its branches regardless of any direct and immediate link between its own inputs and the income generated by those branches. Instead the CJEU leaned heavily on the principle of territoriality as far as the deductible proportion rules are concerned whereby each establishment determines it is pro rata in accordance with the turnover it generates. This may be seen as a fragile balance between the single entity approach, the principle of neutrality and the principle of territoriality. The application of the territoriality principle over the neutrality in this case, should be overlooked and is a problem which may lead to an infringement of the freedom of establishment on the ground that no VAT recovery would be granted in a cross-border situation in comparison to a domestic one. The CJEU ruling in *Le Credit Lyonnais* seems to dictate that the individual establishment in a cross-border head office and branch structure should have a single entity approach and be handled as a separate taxable person when calculating the pro rata. Obviously, this judgement is in full contrast to the single entity approach.

The logical consequence of the single entity principle established in *FCE Bank* would be to determine the right to deduct input VAT on a worldwide basis. Consequently, in the scenario of *FCE Bank*, the rate of deduction of the UK VAT by the head office and the Italian VAT by the branch should be determined on the basis of the total turnover achieved by the head office in the UK and the branch together. Support for the worldwide pro rata may also be derived from the practical consequences of the judgement in *FCE Bank* and the VAT grouping provision. They both lead to the conclusion that transactions between the taxable persons concerned are ignored and that they are not taken into account in order to establish the right to deduct input VAT. The rate of deduction of the member of the group is determined on the basis of the total output transactions of the group. The only deferens between the two is that, for the purposes of VAT group the various legal entities within the group must be located in the same Member State, whereas, under the *FCE Bank* Principle, the entities are located in different Member States.

Apart from the fact that member of a VAT group are legally independent, whereas the entities on *FCE Bank* formed part of the same legal entity, treating geographically dispersed entities as a single taxable person for VAT purposes do not ensure that the right to deduct input VAT is fully harmonised with respect to that in the financial sector there is no harmonisation between the Member States as regards the method for determining the turnovers.<sup>59</sup>

In the same way as in the *Le Credit Lyonnais* case, *Morgan Stanley*, deals with a business within the banking and financial sector with a head office and branch structure which are established in more than one Member State. After the judgement of *Le Credit Lyonnais* a question that was left unanswered was whether a branch can take into account the turnover

---

<sup>58</sup> *Ibid*, para. 39.

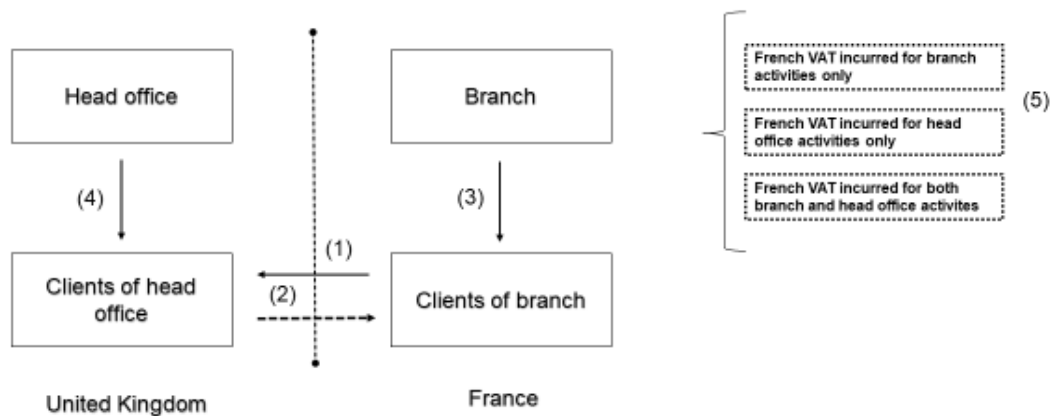
<sup>59</sup> C.Amand and V.Lenoir, “Pro Rata Deduction by Financial Institutions – Gross Margin or interest?”, *International VAT Monitor* 1 (2006), p. 17.

of the head office when calculating its proportional deduction. The Morgan Stanley case answered this and this case will be discussed in the upcoming chapter

### 3.4 The Morgan Stanley case

The head office of Morgan Stanley located in the United Kingdom has a branch in France. The French branch carried out banking and financial transactions for its local clients, which they had opted to be liable to VAT according to French tax law. The branch turnover is thus only made of taxable supplies. In addition, the branch supplied services regarding fixed income and equity sales to the head office in the UK. The head office in the UK provided both services subject to VAT and services exempted from VAT, and had thus implication access to partial deduction of input VAT on the mixed-use expenditures.

**Figure 2.0**



During a tax audit, the French tax authorities considered that the VAT incurred by the branch on expenses that was directly linked to transactions carried out by the head office could not be deducted. They argued that the VAT incurred in respect of the acquisition of the goods and services used solely for internal transactions with the head office in the UK was not deductible, since those transactions fell outside the scope of VAT.<sup>60</sup> Nonetheless, they allowed, by way of mitigation, deduction of a fraction of the tax at issue by deducting a proportion applicable to the head office, subject to the exceptions to the right of deduction applicable in France.

With regard to the 'mixed expenditures' attributable to transactions carried out with both the head office in the United Kingdom and the branch in France, the tax authorities considered that these transactions were only partially deductible.<sup>61</sup> The branch disputed this decision and the case was submitted before French Supreme Administrative Court which in its judgement held that a French branch is entitled to deduct VAT incurred on goods and services used for its own taxable transactions as well as for the taxable transactions carried out by its head office. Even if the right to recover was admitted to the branch, the Court underlines that the application of the deductible proportion rules in the VAT Directive in this context were unclear and decided to refer two questions to the CJEU.

<sup>60</sup> CJEU, 24 January 2019, Case C-165/17 Morgan Stanley, ECLI:EU:C:2019:58, para. 13.

<sup>61</sup> Consentini (n 88).

i. Which Member States deductible proportion rules should apply when expenditure is incurred exclusively for providing support to the head office in another Member State?

(a) French rules; (b) United Kingdom rules; (c) a combination of both? And

ii. Which Member States deductible proportion rules should apply when expenditure is incurred for both transactions performed by the branch in France to third parties and for the support provided by the branch to the head office in a cross-border situation.

On 24 January 2019, the CJEU delivered its long-awaited judgement in *Morgan Stanley*. The Court rules on expenditure borne by the branch, which is used, exclusively, both for transactions subject to VAT and transactions exempted from VAT, carried out by the head office of the branch whom is established in United Kingdom, and the general costs incurred by a branch, which are used for both transactions of that branch in France and transactions of the head office in United Kingdom.

As for expenditure used exclusively for transactions of the head office, firstly, the question regards deductible proportion rules to be applied in relation to expenditure exclusively used by the head office in the United Kingdom. The Court states that it is settled case law that the right of a taxable person to be entirely relieved of the burden of the VAT due or paid during all his economic activities according to Article 168 of the VAT Directive, provided that the direct and immediate link requirement is satisfied. In respect of supplies made in another Member State than the one in which VAT is claimed deductible, the Court highlighted the two-folded test required by Article 169 (a) of the VAT Directive and states that:

*(1) The output transactions are subject to taxation in the Member State of the head office, and (2) The output transaction would be subject to taxation in the Member State of the branch.*<sup>62</sup>

As interactions between the head office and its branch constitute non-taxable internal flows of funds in accordance with the *FCE Bank* doctrine, the CJEU upholds the right for the branch to deduct input VAT in France which has a direct and immediate link with taxable transactions made by the head office in United Kingdom, provided that these supplies would have been taxable if made in France.<sup>63</sup> The CJEU thus reverts to the single entity approach, as it is defined in the aforementioned *FCE Bank* case. In this connection, the CJEU established that the branch and the head office constitutes a single taxable person subject to VAT.<sup>64</sup> As a consequence, in the assessment of the extent of the right of deduction for mixed-use expenditures in the branch, the turnover of the head office in the United Kingdom must also be taken into account. In other words, the branch's right to deduct was extended because it was considered to form a single entity and the same taxable person together with the head office, even though they were located in different Member States.

The reasoning presented in the previous paragraphs was further contextualized by the Court in relation to transactions for which only the right to deduct is allowed in part or share, which is actualized in mixed activities. This deductible share is calculated in accordance with the calculation method established in the VAT Directive, the so-called pro-rate. However, in the present case, that calculation would include in the numerator only such turnover which the branch had for such taxable transactions carried out by the head office,

---

<sup>62</sup> CJUE, 13 July 2000, C-136/99, *Monte Dei Paschi Di Siena*, EU:C:2000:408, para. 28, and CJEU, 22 December 2010, C-277/09, *RBS Deutschland Holdings*, EU:C:2010:810, paras. 31 and 32.

<sup>63</sup> CJEU, 24 January 2019, Case C-165/17 *Morgan Stanley*, ECLI:EU:C:2019:58, para. 39.

<sup>64</sup> *Ibid.*, para. 36.

which would also give rise to a right of deduction in France.<sup>65</sup> The denominator would be the turnover made by the head office to third parties. Below is a representation of the equation.

*Turnover, exclusive of VAT relating to the taxed transactions carried out by the head office which would have been deductible if they had been carried out in France*

---

*Turnover, exclusive of VAT relating to those transactions that have a direct and immediate link, to the exclusions of the other transactions carried out by the taxable person.*

As for general costs of the branch used for the company as a whole, the Court tackles the second question with regard to deductible rules to be applied on general costs. Against this background, the Court upholds and asserts that these costs directly and immediately link with the taxable person's economic activity as a whole. A pro-rata should be used whereby the numerator would be comprised of (1) taxable supplies made by the branch to third parties and (2) taxable supplies made by the head office to third parties if these would have been taxable if made in France. And the denominator would be (1) the turnover made by the branch and (2) the turnover made by the head office to third parties. The equation is shown below.

*Taxed transactions carried out by the branch and the taxed transactions of the head office in respect of which VAT would be deductible if they had been carried out in France*

---

*Transactions carried out by both the branch and the head office*

### 3.5 Conclusions

From the above mentioned, it could be concluded that this chapter aims to, firstly, highlight the importance of the right of input VAT deductibility and the fact that it constitutes a critical element and a central component of ensuring complete neutrality of the tax system. Secondly, it discusses Article 169 (a) of the VAT Directive, and the taxpayers right to claim a deduction for VAT incurred on goods and services used to facilitate transactions outside the Member State in which the VAT is due or paid, if the transactions have been carried out within that State. In cross-border situations, this extends the scope of the deduction and applies to situations when a taxpayer makes a supply of goods or a service that is considered to take place in another country, but the goods or services he purchases are subject to VAT in the Member State of establishment.

The chapter further presents the problematic of the single and separate entity approach and the discussion presented by the CJEU in that regard. It can be said that in RBS Deutschland Holding the CJEU held that input VAT could not be deducted in a Member State for a subsequent transaction in another Member in the case that those transactions would have been exempted from VAT in the latter state, whether or not the transactions would have entailed the right to deduct in the first Member State if they had been carried out there. In ESET, the Court confirmed the right to recover VAT on costs relating to services provided to another establishment.

---

<sup>65</sup> Ibid, para. 46.

The chapter also discusses Le Credit Lyonnais case. According to the ruling of the Court in that case, it seems to dictate that the individual establishment in a cross-border head office and branch structure should have a single entity approach and be handled as a separate taxable person when calculating the pro rata. Furthermore, a comparison to the single entity approach, is made to the Judgment in FCE Bank, where it was established that the single entity principle would be, to determine the right to deduct input VAT on a worldwide basis.

Finally, the Morgan Stanley case was discussed as well, where the CJEU reverts to the single entity approach, as it is defined in the aforementioned FCE Bank case. In this connection, the CJEU established that the branch and the head office constitutes a single taxable person subject to VAT.

## 4. The consequences of VAT grouping on cross-border entities

### 4.1 Introduction

The Skandia America and Danske Bank case changes the perspective regarding branches of head offices that are members of a VAT group, which is the concern of this section. The following section provides a review of the material conditions associated with VAT grouping as well as examples when VAT grouping is involved, and how it compares to when it is not. As part of this section, a discussion will be made on cross-border VAT grouping, and also on how the CJEU and the Member States interpret Article 11 of the VAT Directive.

As a starting point for VAT, each company, head office and branch is to be regarded as an individual, separate tax subject.<sup>66</sup> Therefore, VAT should be charged on transactions between them.<sup>67</sup> However, the VAT Directive contains optional provisions (“may” clauses). Consequently, the Member States are at liberty to exercise the choice afforded to them. Several optional provisions in the VAT Directive lay down a procedural obligation which the Member States must observe in order to make use of the derogation it sets out. For example, after consulting the VAT Committee,<sup>68</sup> a Member State can use the option in Article 11 VAT Directive of VAT grouping and “may regard as a single taxable person, any persons established in the territory of the Member State who, while legally independent, are closely bound together by financial, economic and organizational links”.<sup>69</sup>

VAT grouping is a facilitation measure designed to ease administrative burden for both tax authorities and businesses. In addition, it has been argued that VAT grouping was intended to prevent the need for VAT to be paid on transactions between closely related entities.<sup>70</sup> The services provided between entities within a VAT group are therefore not subject to VAT.<sup>71</sup> In regard to VAT, a VAT group constitutes one taxable entity and, as a corollary with one single VAT number and the entities that comprise a VAT group cease to be separate entities.<sup>72</sup>

From the Explanatory Memorandum to the proposal for a Sixth Directive it follows that the rationale behind the VAT grouping facility is administrative simplification and combat of abuse.<sup>73</sup> The concept of a VAT grouping can be traced back to the German *Organshaft* which embodies the idea that substance should prevail over legal form and that companies which are technically independent but practically related should be treated as one.<sup>74</sup> A VAT

---

<sup>66</sup> See Nilsson (2014) page. 66; Henkow (2019) page. 47.

<sup>67</sup> See Henkow (2019) page. 47.

<sup>68</sup> The VAT Committee is an advisory body set up on the basis of Article 398 VAT Directive, consisting of representatives of the Member States and of the Commission. The Committee is consulted in the cases provided for by the VAT Directive and may also examine other questions raised by its chairman or at the request of one of its members in connection with the interpretation of the VAT Directive.

<sup>69</sup> European Commission, Communication on the VAT Group option provided for in Article 11 of council Directive 2006/112/EC on the common system of VAT, COM(2009)325 final, p. 2.

<sup>70</sup> Terra, B. and Kajus, J., Introduction to European VAT (Recast), IBFD, 2014, p. 343.

<sup>71</sup> AG Mengozzi, Opinion in joined cases C-108/14 and C-109/14 Larentia + Minerva, para. 47.

<sup>72</sup> C-162/07 Amplisientifica and Amplifin, paras. 19-20; Van Doesum, A. and Van Norden, G-J., “T(w)o become one: the Communication from the Commission on VAT grouping”, British Tax Review, 2009, 6, pp. 657-667.

<sup>73</sup> See S.Pfeiffer, “Written comment to the keynote paper taxable persons”, in: M. Lang, P. Pistone, J. Schuch, C. Staringer and D. Raponi, ECJ - Recent developments in Value Added Tax, the evolution of European VAT jurisprudence and its role in the EU common VAT system (Linde 2014), pp. 98-99.

<sup>74</sup> C. Amand, “VAT Grouping, FCE Bank and Force of Attraction - the Internal Market is Leaking”, International VAT Monitor, July/August 2007, p. 238.

group can provide substantial benefits to companies conducting business that are exempt from VAT such as avoiding the generation of non-deductible input VAT in connection with acquisitions from other group members as the transactions between them are within the same taxable person and thus out of scope for VAT.<sup>75</sup> This is particularly important for organizations in the financial sector since such an activity is typically exempt from VAT, and not entitled to deduct input VAT.<sup>76</sup> The CJEU has ruled that the condition of close financial, economic and organizational link, which Article 11 lays down in the context of VAT grouping, must necessarily be specified at national level.<sup>77</sup> The Member States of the EU are becoming increasingly interested in using this option.<sup>78</sup> In 2013, the grouping option had been adopted by fifteen Member States<sup>79</sup> and in more recent years it has been noticed an increasing interest for the creation of VAT groups.<sup>80</sup>

## 4.2 The territorial scope of VAT grouping schemes

In general, VAT grouping is limited to entities that are established within the territory of the member state.<sup>81</sup> Since Article 11 is only a brief statement of what VAT grouping is, and there are no other provisions that deal with it, the terms and effects of grouping can vary between the Member States. For example, there exists a major discrepancy between the Member States regarding the determination of the turnover of financial institutions for the purposes of pro rata deductions.<sup>82</sup> This involves a potential impact on the internal market, especially when group schemes do not ensure that the effects are limited to the national territory.<sup>83</sup> In the majority of EU Member States where there is VAT grouping, the effect of VAT grouping is to allow related legal entities to make intercompany supply of goods and services without charging VAT.<sup>84</sup>

One issue with VAT grouping in a cross-border context is that cross-border charges can be difficult to identify, and dealing with them in a correct manner can be difficult for tax administrations, especially when payments are made through intercompany accounts without invoices being issued.<sup>85</sup> The implementation of Article 11 varies widely on many levels.<sup>86</sup> Most Member States limit VAT grouping to their national territory following the territorial restriction set out in the Directive. However, others deviate from this rule. For example, in Netherlands, United Kingdom and Finland, non-resident companies with a resident fixed establishment are eligible for group registration, creating the possibility for branches with their place of business in another EU country to become a member of a VAT group formed within the EU country that is introducing VAT groups in its tax legislation.<sup>87</sup>

<sup>75</sup> Pfeiffer (2015) page. 3; Nilsson (2014) page. 66; Vyncke (2009) page. 299. CJEU, 22 May 2008, Case C-162/07 *Ampliscentifica and Amplifin*, ECLI:EU:C:2008:301, paras. 19-20.

<sup>76</sup> Certain financial activities are exempt from VAT under Article 135 (1) (b) - (e) of Council Directive 2006/112 / EC.

<sup>77</sup> CJEU, 16 July 2015, *Larentia + Minerva*, ECLI:EU:C:2015:496, paragraphs 50–51.3.

<sup>78</sup> European Commission, Communication on the VAT Group option provided for in Article 11 of council Directive 2006/112/EC on the common system of VAT, COM(2009)325 final, p. 2.

<sup>79</sup> Compulsory VAT grouping was considered by the European Commission (SEC(2010) 1455 final, 1 Dec. 2010, para. 12.3.2.) but it was never adopted. Bulgaria, Slovenia, Greece, Lithuania, Luxembourg, Malta, Poland and Portugal do not have a VAT group scheme. In Portugal, like in other Member States, cost-sharing groups (Art. 9(21) and (22) of the Portuguese VAT Code) have been used as a proxy for VAT grouping.

<sup>80</sup> See VAT Committee Working Paper No 879 s. 13; COM(2009)325 final page. 2; Massin & Vyncke (2009) s. 454; Dias Soares & Arnaldo (2015) page. 86.

<sup>81</sup> See Dias Soares, *The Territorial Scope of VAT Grouping Schemes in the Financial Sector*, page. 541-542

<sup>82</sup> Christian Amand (2007), *VAT Grouping, FCE Bank and Force of Attraction: The International Market is Leaking*, *International VAT Monitor*, 18, 4, July/August, 237–249, 247.

<sup>83</sup> See COM(2009) 325 final, 2 Jul. 2009, para. 3.3.2.1.

<sup>84</sup> Lizzy Bijl et al. (2012), *EU VAT Grouping Provisions: An Update*, *Indirect Tax Briefing*, Issue 5, August, Ernst & Young, 32–35, 32–33.

<sup>85</sup> Craig Rapson & David Bearman (2012), *Cross-Border Intra-company Transactions with the EU*, *Indirect Tax Briefing*, Issue 5, August, Ernst & Young, 36–39, 37.

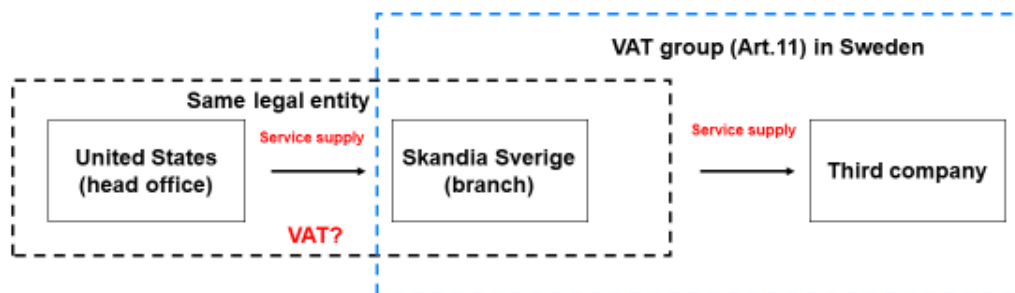
<sup>86</sup> I K. Vyncke, “VAT Grouping in the European Union: Purposes and Limitations”, *International VAT Monitor*, July/ August 2007, p.255;

<sup>87</sup> 10th of February 2015; Vyncke, K., “EU VAT Grouping from a Competitive Tax Law”

### 4.3 Skandia America case

One of the most important cases of the CJEU concerning the issue of VAT grouping in a cross-border scenario was delivered in the Skandia America case<sup>88</sup>, stating that the FCE-Bank principle and single entity approach is not capable of being applied when the branch is a member of a VAT group. Among the companies involved is a large multinational group that includes a head-office in the United States that functions as the global purchasing company on behalf of the Skandia group, and operates in Sweden through its branch, Skandia Sverige.

*The head office in the United States distributed externally purchased IT services to Skandia Sverige, which was a registered member of a VAT group.*



89

The Swedish branch had a responsibility to transform these services into a final product which it subsequently supplied to different Member States. The services supplied by the head office in the United States to the branch in Sweden were considered to constitute a taxable transaction by the Swedish tax authority. As a result, the branch in Sweden was identified as liable for VAT as a buyer in a B2B transaction. The branch did not operate independently, nor did it bear the economic risk arising from the exercise of its activity.<sup>90</sup> At first, the CJEU drew the same conclusions as in the *FCE Bank* case and pointed out that the branch is dependent on the head office and cannot therefore itself be characterized as an own taxable person. The big difference and the distinctive feature between the Skandia America and FCE Bank case was that the branch in the Skandia America case belongs to a VAT group under Swedish legislation.

From the perspective of the CJEU, the treatment of the group as a single taxable person in Sweden causes a rupture of the legal relationship between the head office and its branch. Thus, it would appear that supplies of services made by a head office to a member of a VAT group would be considered to have been made not to that branch, but rather to the VAT group as a whole.<sup>91</sup>

This statement leads to the conclusion that it is no longer possible to consider that the head office and its branch constitutes a single taxable person for VAT purposes as long as the branch belongs to a VAT group. Two important consequences result from this interpretation. First, it makes it impossible to consider these two entities as a single taxable person and breaks the single entity approach that was maintained in the FCE Bank. Second, the supply of services from the head office to its branch must be understood as a supply made to the

<sup>88</sup> CJEU, 17 September 2014, Case C-7/13, Skandia America, ECLI:EU:C:2014:2225.

<sup>89</sup> Value added tax Committee, Working paper No 845, 17 February 2015, p.2.

<sup>90</sup> CJEU, 17 September 2014, Case C-7/13, Skandia America, ECLI:EU:C:2014:2225, para 24-25.

<sup>91</sup> Ibid, para. 29.



VAT group as a whole and not to the individual group member.<sup>92</sup> The judgement generates a legal separation between the head office and a branch which is dependent on the head office but belonging to a VAT group. It confirms that upon joining a VAT group the group member dissolves itself from any possible, simultaneously existing legal form and becomes a part of a new separate taxable person for VAT purposes, namely the VAT group. Consequently, the VAT grouping provisions are given precedence over the legal ties between the parties.

In this respect, the CJEU stated in paragraph 31 of the *Skandia America* case that a service is only taxable in case a remuneration is provided.

*“Inasmuch as the services provided for consideration by a company such as SAC to its branch must be deemed, solely from the point of view of VAT, to have been provided to the VAT group, and inasmuch as that company and that branch cannot be considered to be a single taxable person, it must be concluded that the supply of such services constitutes a taxable transaction, under Article 2(1)(c) of the VAT Directive.”*

However, according to the Swedish version of the *Skandia America* case, it was not stated “inasmuch” but “i den mån” which means “insofar” or “provided that”. Consequently, it appears that a supply of services between a branch being a member of a VAT group, and its foreign head office is only taxable under the condition that remuneration for the supply was provided.

Even though *Skandia America* was a ground-breaking judgment, its decision by the CJEU restricted itself to the above-mentioned scenario and ignored a situation in which the VAT grouping regime in question was of a different type than that in Sweden. In the Swedish language version, the Court specifically limited its decision to the specific type of VAT groups presented in Sweden.<sup>93</sup> This terminology implies a narrow understanding of the territorial scope of VAT groups and the term “established” in Article 11 of the VAT Directive. The Court in *Skandia America* states that it is obvious in this case that the branch was part of the VAT group, leaving open the question of what would happen if a Member State applied a broad interpretation of the territorial reach of Article 11.

#### 4.4 Danske Bank case

On the 11 March, the CJEU ruled in the *Danske Bank*<sup>94</sup> case which answered precisely the latter mentioned question above. The *Danske Bank* case which often is referred to as the “reverse-Skandia case” concerns the question whether transactions between a head office and its branch should be taxable if the head office belongs to a VAT group in Denmark. The Danish VAT group supplies its Swedish branch a shared computer platform service. The dispute in the case concerns the question of whether the branch should be designated as an independent taxable person and whether the said services are VAT taxable.<sup>95</sup> The Swedish branch argued that they could not be separated from the head office insofar as they did not carry out independent economic activity and is not part of any VAT group in Sweden, therefore they were the same taxable person as the head office with the consequence that the services rendered by the head office should not be regarded as falling within the scope of VAT. The CJEU determines that a service supplied by a head office to a branch in another Member State is taxable only if there exists a legal relationship between the provider and the recipient of the service and that this cannot be the case if they form a

---

<sup>92</sup> Ibid, para. 32.

<sup>93</sup> CJEU, 17 September 2014, Case C-7/13, *Skandia America*, ECLI:EU:C:2014:2225, para 28.

<sup>94</sup> CJEU, 11 March 2021, Case C-812/19, *Danske Bank*, ECLI:EU:C:2021:196.

<sup>95</sup> Ibid, para. 17.

single taxable person. In such cases, reciprocal performance constitutes non-taxable internal flows of funds.<sup>96</sup>

Further, The CJEU ruled that Article 11 of the VAT Directive should be interpreted so that only establishments in the State of registration can be included in a VAT group. It is thus not possible to extend the legal effects of the VAT group so that establishments outside the State of registration are to be considered part of the VAT group, so-called ex territorial application.<sup>97</sup> However, according to the CJEU, this does not mean that the VAT group should not be seen as a separately taxable person when the issue of tax liability is to be assessed for transactions between the head office and the branch. It follows that the VAT group and the branch must be seen as two separate taxable persons. By virtue of the territorial limitation of the VAT group regime, a foreign branch cannot be a part of this VAT group, and thus cannot be regarded as being part of the same taxable person as the head office. The branch must be regarded as a separate taxable person and consequently, the services between the head office and its branch are taxable.<sup>98</sup> Additionally, the CJEU made it very clear in the *Danske Bank* case that the *Skandia America* principle applies only to VAT groups created on the basis of Article 11 VAT Directive.

## 4.5 Discussion on the scope of VAT grouping

In Article 11 of the VAT Directive, a reference to the term "persons" is made. As part of the personal scope of the VAT grouping, the question of how to interpret the term "person" must be addressed.<sup>99</sup> It has long been debated whether the term "persons" covers both taxable and non-taxable persons. This depends on the fact that Article 11 does not include the word 'taxable'. The CJEU has ruled on this issue in a number of cases,<sup>100</sup> after the European Commission's attempt to apply a functional approach by expressing that a non-taxable person cannot be part of a VAT group. Therefore the European Commission undertook a campaign of infringement procedures against Member States that applied a different approach.<sup>101</sup>

It must be noted that the wording of Article 11 does not refer to "persons" and "legal persons". This entails that Member States cannot restrict the VAT grouping to only legal entities unless it can be provided that it is done for an anti-abusive aim.<sup>102</sup> In this regard, groups of companies may include entities that are not taxable persons simply because from an economic perspective they should be regarded as one together with the group companies that are taxable persons.<sup>103</sup> As indicated before, the VAT grouping facility recognizes the single entity approach for VAT purposes. If non-taxable persons are an integral part of this single entity unit, they should also fall within the scope of the VAT grouping regime. Indeed

---

<sup>96</sup> Ibid, para. 20.

<sup>97</sup> Ibid, para. 24.

<sup>98</sup> Ibid, para. 35.

<sup>99</sup> Pfeiffer S., 'Current questions of EU VAT grouping', *World Journal of VAT/GST Law*, 4:1, p. 28.

<sup>100</sup> CJEU, 9 Apr. 2013, Case C-85/11, *European Commission v. Ireland*; UK: CJEU, 25 Apr. 2013, Case C-86/11, *European Commission v. United Kingdom of Great Britain and Northern Ireland*; NL: CJEU, 25 Apr. 2013, Case C-65/11, *European Commission v. Kingdom of the Netherlands*; FI: CJEU, 25 Apr. 2013, Case C-74/11, *European Commission v. Republic of Finland*; DK: CJEU, 25 Apr. 2013, Case C-95/11, *European Commission v. Kingdom of Denmark*; CZ: CJEU, 25 Apr. 2013, Case C-109/11, *European Commission v. Czech Republic*.

<sup>101</sup> B. Gryziak, *European Union - VAT Groups and the Right of Deduction across the European Union – Review and Analysis*, *International VAT Monitor*, 2021 (Volume 32), No. 4, Chapter 2.4.1.

<sup>102</sup> CJEU, 16 July 2015, Case C-108/14, *Beteiligungsgesellschaft Larentia + Minerva mbH & Co. KG v. Finanzamt Nordenham*.

<sup>103</sup> See CJEU, 23 March 2006, Case C-210/04, *FCE Bank*, ECLI:EU:C:2006:196, CJEU, 17 September 2014, Case C-7/13, *Skandia America*, ECLI:EU:C:2014:2225, CJEU, 11 March 2021, Case C-812/19, *Danske Bank*, ECLI:EU:C:2021:196

in *Commission v Ireland* and *Commission v The Kingdom of the Netherlands*<sup>104</sup> The CJEU ruled that taxable persons status is not a requirement for inclusion in a VAT group.<sup>105</sup>

In the case of *Larentia and Minerva*, there was an additional question regarding the wording “person”. The question was whether it was in conformity with EU law that the right to form a VAT group was solely reserved to entities with legal personality and linked to the controlling company of that group in a relationship of subordination.<sup>106</sup>

The CJEU ruled that national legislation which restricted the right to form a VAT group, solely to entities with legal personality and linked to the controlling company of that group in a relationship of subordination is precluded, except where those two requirements constitute measures which are appropriate and necessary in order to achieve the objectives to prevent abusive practices or behaviour or to combat tax evasion or tax avoidance, which it is for the referring court to determine.<sup>107</sup> Also, it follows from *Commission v Ireland* and the second paragraph of Article 11 that, in implementing Article 11, Member States are entitled to "adopt any measures needed to prevent tax evasion or avoidance through the use of this provision".<sup>108</sup> Therefore, under the second paragraph of Article 11, Member States may effectively exclude non-taxable persons.

The decision in *Danske Bank* concludes that *Skandia America* should not be different if the head office had been established in another Member State but it goes even further and emphasizes the territorial limitations of the VAT grouping provision of Article 11. CJEU is very clear that the principle only applies to VAT groups formed on the basis of Article 11 of the VAT Directive.<sup>109</sup> This can be interpreted as meaning that the CJEU considers that VAT groups created in countries outside the EU are not covered by the rules of Article 11, meaning that the head office should not be separated from the branch when the head office is part of a VAT group in a third country.

## 4.6 Conclusions

From the above mentioned, it can be said that VAT grouping does have consequences in regard to cross-border entities. These consequences are discussed in the *Skandia America* case and *Danske Bank* case. The *Skandia America* case stated that the FCE-Bank principle and single entity approach is not capable of being applied when the branch is a member of a VAT group which was the case here since *Skandia America* belonged to a VAT group under the Swedish legislation. The judgement in this case confirms that upon joining a VAT group the group member dissolves itself from any possible, simultaneously existing legal form and becomes a part of a new separate taxable person for VAT purposes, namely the VAT group. Consequently, the VAT grouping provisions are given precedence over the legal ties between the parties under the condition that remuneration for the supply is provided. In case one would consider that a taxable transaction is present in the event of a transaction between a branch being a member of a VAT group and its foreign head office, then it should be established how to determine the remuneration. In the event there is no remuneration, then it follows from the *Skandia* case, paragraph 31, that the transaction between a foreign branch of a VAT group and its overseas head office is outside the scope of VAT.

---

<sup>104</sup> CJEU, 9 Apr. 2013, Case C-85/11, *European Commission v. Ireland*; UK: ECJ, 25 Apr. 2013, Case C-65/11, *European Commission v. Kingdom of the Netherlands*; FI: ECJ, 25 Apr. 2013.

<sup>105</sup> Judgement 9 April 2013, *Commission v. Ireland*, C-85/11, EU:C:2013:217, paras. 41, 46 and 48.

<sup>106</sup> CJEU, 16 July 2015, Case C-108/14, *Beteiligungsgesellschaft Larentia + Minerva mbH & Co. KG v. Finanzamt Nordenham*, paras 34-46.

<sup>107</sup> *Ibid*, paras. 44-46.

<sup>108</sup> Judgement 9 April 2013, *Commission v. Ireland*, C-85/11, EU:C:2013:217, para. 40.

<sup>109</sup> *Ibid*, paras. 24,29 and 33.

The Danske Bank case answered the question that was not discussed in Skandia America, namely, where both the head office and the branch are located in the EU, and the head office belongs to a VAT group. In that regard, the CJEU stated that Article 11 of the VAT Directive should be interpreted so that only establishments in the State of registration can be included in a VAT group. It is thus not possible to extend the legal effects of the VAT group so that establishments outside the State of registration are to be considered part of the VAT group, so-called ex territorial application. The Court, also, added that the Skandia America principle applies only to VAT groups created on the basis of Article 11 VAT Directive. Therefore the branch, in the Danske Bank case, was regarded as a separate taxable person and consequently, the services between the head office and its branch were taxable.

## 5. A non-EU head office and the recovery of VAT

### 5.1 VAT Grouping v the right to deduct in cross-border scenarios

It is clear from the case law presented above, that the effect of using VAT groups is that individual taxable persons who are closely linked through financial and organizational ties are treated as one single taxable person for VAT purposes.<sup>110</sup>

*Danske Bank* and *Skandia America* have confirmed that the concept of single entity does not apply when either the branch or head office is a member of a VAT group; the mere existence of a VAT group is sufficient to recognize the two entities as two distinct taxable persons. In *Danske Bank*, the fact that the head office was a member of a VAT group separately overruled the single entity approach that ignores transactions between a branch and head office for VAT purposes. It will therefore result in that the deductible proportion in a cross-border scenario, which was included in *Morgan Stanley*, would be taken away since the supplies between the branch in France and the head office in the United Kingdom would be treated as supplies between two single taxable persons. In this case, it becomes apparent that the judgement that was reached by the CJEU in *Morgan Stanley* cannot be applied in cases where VAT grouping is included, e.g. *The Skandia America* case and the *Danske Bank* case.

Most Member States which have introduced VAT grouping provisions have a system where only the local establishments in the territory of that Member State are regarded as part of the VAT group. This was also true for *Skandia America* where the members of the VAT group had to be established in the Swedish territory and according to Swedish law. According to Professor Van Norden, Member States may implement VAT grouping laws that include both a foreign head office and its local operations and that the outcome of the *Skandia America* case would not apply in those Member States.<sup>111</sup> Contrary to this, the EU Commission is of the opinion that branches should only be allowed to join a VAT group if they are located within the same Member State as the VAT group. This position was upheld following *Skandia America*.<sup>112</sup>

In the *Danske Bank* case in paragraphs 24, 29 and 33 of its judgment, the CJEU put forward its view that Article 11 “contains a territorial limitation” and “that a Member State may not provide for a VAT group to include persons established in another Member State”. Can this be interpreted as meaning that the CJEU can consider that VAT groups created outside the EU where Article 11 has no meaning, do not have this territorial restriction? And thus a group and a branch can be the same taxable person regardless of whether there is a VAT group?

### 5.2 A scenario of Morgan Stanley case with a non- EU head office

In the *Morgan Stanley* case, both establishments were located within the EU as the United Kingdom was a member of the EU at the time. However, what if the head office is located outside of the EU? Would it have any impact on the recovery calculation? The purpose of this section is to provide an illustration and an answer to the research question in this thesis, by analysing and illustrating a possible outcome for *Morgan Stanley* in a scenario where the head office is located outside of the EU.

---

<sup>110</sup> See inter alia; Case C-162/07 *Amplificientifica/Amplifin* [2008] EU:C:2009:301, para. 23.

<sup>111</sup> Prof. Dr. Ad Van Doesum, Prof. Dr. Herman Van Kesteren, Prof. Dr. Gert-Jan van Norden, *Fundamentals of EU VAT law*. Page. 56 and 58

<sup>112</sup> VAT Committee (taxud.c.1(2015)747072), 24 (document issued by the EU Commission).

The deductible proportion rules set in the VAT Directive for taxable persons established within the EU that have head offices in other Member States should, in principle, equally apply when those head offices are located outside of the EU and if any other treatment was to be given in this regard it would require a change in legislation.<sup>113</sup> Further, in terms of the single entity principle of the taxable person, there should be no distinction between a place of business located within the European Union and one located outside of it.<sup>114</sup>

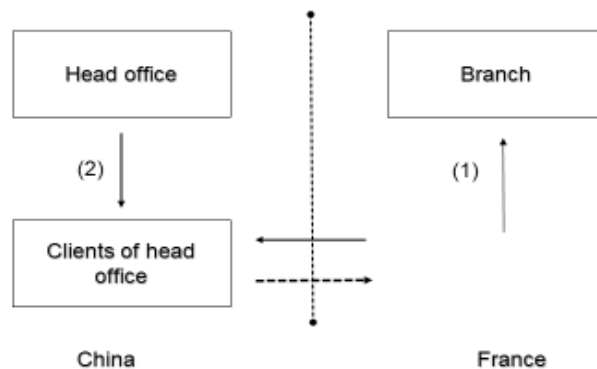
In accordance with Article 169 (c) of the VAT directive, taxable persons are entitled to recover VAT incurred on expenditure to perform exempt financial services when the customer is located outside of the European Union. In this regard, it becomes important to clarify whether the thrust of Morgan Stanley's judgment - namely, the use of transnational VAT pro rata recovery methods - can be applied to instances where the head office would be located outside of the European Union.

### The Bank of China and the branch in France

Let us assume that there is a branch in France that is claiming a right to deduct based on the expenditures incurred by it in connection with the supply of services for the benefit of its head office carrying out banking transactions, which is established in China.

Assume that the French branch engages in financial activities, whose turnover is EUR 1m, and with a **pro rata of 50%**. The head office in China accounts for **EUR 10m** of turnover. The branch also provides support for banking transactions in China. During the period, the French branch incurred input VAT of EUR 90k, composed of three categories of expenditures; (1) 30k directly attributable to its head office supplies, (2) 30k in general costs and (3) 30k directly attributable to the branch's own supplies.

**Figure 3.0**



<sup>113</sup> Bjerregaard Eskildsen, European Union - Pro Rata Deduction by Entities Established in Several VAT Jurisdictions, International VAT Monitor, 2012 (Volume 23), No. 1.

<sup>114</sup> CJEU, 17 September 2014, Case C-7/13, Skandia America, ECLI:EU:C:2014:2225, paras 26-27 where the Court has applied the single entity approach in a non-EU scenario.

***What are the characteristics of the supplies made by the head office in China for the purposes of VAT? Are these supplies taxable, exempt, exempt with recovery, or even not subject to VAT?***

The fact that the head office and the branch are the same taxable person and that the supplies satisfy the requirements of Article 24 VAT Directive makes such transactions obvious and be deemed taxable carried out by the same taxable person which is established both in the EU and outside the EU. This implies that the same taxable person is involved in both the French and the Chinese output transactions.

Financial transactions which are made by the head office in China are not exempt within the scope of VAT as they take place outside of the EU. Looking at the wording of Article 169 (c), where it is stated that the taxable person shall be entitled to deduct VAT in so far as the goods and services are used for the purpose of transactions which are exempt pursuant to points (a) - (f) of Article 135(1). The wording of this Article can be interpreted as meaning that these financial transactions are to be viewed as taxable supplies. This depends on the right to deduct VAT on such transactions which, in its turn, presupposes that VAT has been paid in order for it to be deducted.<sup>115</sup> To treat these services as outside the scope of VAT and giving the branch in EU no recovery right for the input VAT is not in line with the VAT neutrality viewpoint. By characterizing the supplies with a dual landscape approach, not only are the French rules applicable but also the outgoing transaction in China is taken into account. It is important to note that these supplies should be subject to the "double layer" interpretation of Article 169 (c) of the VAT Directive because, if the supplies would have been made in France, all the clients would have been in China.

With reference to the example and ***category 1*** VAT expenditures, the VAT of 30k should be directly attributable to taxable supplies made by the head office in China, with full recovery right to the branch in France.

Concerning the ***category 2*** expenditures, a consolidated pro rata should be applied. In addition, the numerator of the pro rata must include the supplies that are deemed taxable by the head office in China, which amount to EUR 10m. Thus the pro rata recovery will include in the numerator the taxable supplies made by the head office in China + the supplies with recovery made by the branch (0, 5) divided by the total turnover made in both establishments in the denominator. As is shown below this means that the input tax recovery would be 95, 45 % instead of 50 % if the head office turnover would be excluded. This will result in a significant increase in VAT recovery for the branch in France.

$$\frac{10\text{m} + 0,5\text{m}}{10\text{m} + 1\text{m}} = 95,45\%$$

$$10\text{m} + 1\text{m} = 11\text{m}$$

As we have seen, a pro rata consolidation would not have been compatible with *Le Credit Lyonnais*, since it includes the entire turnover of the head office in a foreign country. Morgan Stanley, however, recognizes the concept of global pro rata. It could potentially lead to greater recoveries, such as the one described above with regard to input VAT on general costs. As a result of the possible VAT benefit that may result for branches in such a circumstance, one might expect national tax authorities to prevent a taxable person from utilizing this scenario and to prevent the use of a consolidated pro rata method when an establishment is located outside of the EU.

---

<sup>115</sup> Article 169 (c).

For *category 3* VAT expenditures, the domestic rules should be applied. Thus, the branch in France should recover VAT incurred for the purpose of carrying out mixed supplies in line with its own pro rata recovery of 50 %.

This illustration shows a complexity and a large administrative burden for the recovery of categories 1 and 2 VAT. Thus this might lead to additional costs for cross-border businesses who want to recover the right VAT.

If such a scenario comes up to the CJEU it will be interesting to see how the Court will adopt the “double layer” test in light of the Morgan Stanley case. *The first test* would be to determine whether the output transaction of the head office in China allows for recovery of VAT according to the rules in China (a country that is not in the scope of the EU VAT system).

*If the CJEU finds that China, where the head office is located, does not have EU VAT rules nor is it subject to the VAT rules of a Member State, then it can be assumed the turnover of the head office in China will pass the first test. If this input VAT is disregarded for immediate deduction because of the location of the head office, then it can be argued that it would be in breach of the neutrality principle in VAT.*

*The second test*, thus whether the output transactions of the head office can be recovered under French VAT law is more challenging. In this case, the question is whether the financial services, if they are provided by the branch in France, are considered to be taxed or not taxed under French VAT regulations. It is likely that in such a scenario the financial services would fall within the scope of a VAT exemption in the majority of EU member states, however in France there is an option for taxation mechanism that would permit VAT to be applied to certain financial services. It is an option that France has incorporated into its national VAT law, but not all EU member states have done the same.

It was argued by the CJEU in Morgan Stanley that financial services of a foreign branch would pass the test if the branch is likely to exercise the taxation option if the services were provided in the branch's Member State. It is worth noting that the Court in the case did not provide a solution on how to substantiate the likelihood, and this will be of interest to financial institutions. The CJEU will hopefully be able to provide more clarity in the future.



## 6. Conclusions

From the above mentioned, it can be concluded that the FCE Bank case lies down the single entity approach which implies that intra-entity flows of services between a head office and its branch will be regarded as nullities in a VAT context. By applying this approach, it is legally impossible to attribute VAT incurred on costs associated with intra-entity flows, since such flows between the head office and the branch are of the scope of VAT. When applying the single entity approach, it becomes clear that this concept is only used between a head office and a branch in circumstances such as those in Morgan Stanley. This entails that in order for a head office and a branch to be regarded as a single entity, they cannot be two distinct taxable persons. The single entity approach presupposes that the branch is dependent on the head office such as the circumstances in FCE Bank.

This entails further that VAT grouping does have consequences in regard to cross-border entities in this case, since the single entity approach cannot not be applied. This depends on the fact that the mere existence of a VAT grouping entails that the two entities are regarded as two distinct taxable persons. These consequences are discussed in the Skandia America case and Danske Bank case. The Skandia America case stated that the FCE-Bank principle and single entity approach is not capable of being applied when the branch is a member of a VAT group which was the case here since Skandia America belonged to a VAT group under the Swedish legislation. The judgement in this case confirms that upon joining a VAT group the group member dissolves itself from any possible, simultaneously existing legal form and becomes a part of a new separate taxable person for VAT purposes, namely the VAT group. Consequently, the VAT grouping provisions are given precedence over the legal ties between the parties. However, it appears from the wording in the Swedish version of the Skandia America judgement that a supply of services between a foreign head office and a branch that belongs to a VAT group is only taxable if remuneration is provided for the supply.<sup>116</sup>

The Danske Bank case answered the question that was not discussed in Skandia America, namely, where both the head office and the branch are located in the EU, and the head office belongs to a VAT group. In that regard, the CJEU stated that Article 11 of the VAT Directive should be interpreted so that only establishments in the State of registration can be included in a VAT group. It is thus not possible to extend the legal effects of the VAT group so that establishments outside the State of registration are to be considered part of the VAT group, so-called ex territorial application. The Court, also, added that the Skandia America principle applies only to VAT groups created on the basis of Article 11 VAT Directive. Therefore the branch, in the Danske Bank case, was regarded as a separate taxable person and consequently, the services between the head office and its branch were taxable. Furthermore, the answer to the first question regarding whether both local turnover and the turnover of the head office in China should be accounted for when calculating the right of input VAT for the branch in France these supplies would arguably be regarded as deemed taxable. This is due to the fact that it would satisfy the definition of supply of services,<sup>117</sup> carried out by the same taxable person<sup>118</sup>, without any exemption being applicable to those supplies insofar as they take place outside of the EU.

---

<sup>116</sup> In paragraph 31 of the Skandia America case, the English version stated "inasmuch" and the Swedish version stated "i den mån" which means "insofar as" or "providing that."

<sup>117</sup> Art 24 of the VAT Directive states that a supply of services shall mean any transaction which does not constitute a supply of goods.

<sup>118</sup> See CJEU, 23 March 2006, Case C-210/04, FCE Bank, ECLI:EU:C:2006:196, para. 36, 37 and 51.

Morgan Stanley's judgement was crucial for businesses in that it returned to the single entity approach as it was demonstrated in FCE Bank. A lower recovery ratio leads to higher VAT costs for the branch, which might discourage a company from opening a branch in another Member State.

An additional problem in such a scenario is how the calculation should be executed practically. As can be seen in the above example, the head office in China only provides banking services to clients outside the EU. Therefore, the following question arises:

How is the branch going to determine the location of the clients of the head office in China? Under what conditions the location of the recipient of the financial services provided by the head office in China should be determined from the perspective of the French branch?

To conclude, additional guidance will be required by the CJEU in regard to the precise scope of Article 11 of the VAT grouping in order to clarify how FCE Bank, Skandia, and Morgan Stanley are related to one another under this specific circumstance.

# Bibliography

## Directives

Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax, Official Journal of the European Union, L 347, 11 December 2006.

## Other EU Documents

European Commission, Communication from the Commission to the Council and the European Parliament on the VAT group option provided for in Article 11 of Council Directive 2006/112/EC on the common system of value added tax, Brussels, 2 July 2009;

European Commission, Communication on the VAT Group option provided for in Article 11 of Council Directive 2006/112/EC on the common system of VAT, COM(2009);

European Commission, Communication on the VAT Group option provided for in Article 11 of Council Directive 2006/112/EC on the common system of VAT, COM(2009)325 final;

Explanatory Memorandum to the Proposal for a Sixth Council Directive on the harmonization of legislation of Member States concerning turnover taxes-common system of value added tax;

VAT Committee Working paper No 845 VAT Committee, Case Law, Issues Arising from Recent Judgements of the Court of Justice of the European Union, (taxud.c.1(2015)747072), Brussels, 17 February 2015;

VAT Committee Working Paper No 879 s. 13, Issues arising from recent judgments of the Court of Justice of the European Union, taxud.c.1(2015)4389038, Brussels, 322 September 2015.

## Case law

### CJEU

CJEU, 11 March 2021, Case C-812/19, Danske Bank, ECLI:EU:C:2021:196;

CJEU, 24 January 2019, Case C-165/17 Morgan Stanley, ECLI:EU:C:2019:58;

CJEU, 17 October 2018, Case C-249/17 Ryanair, ECLI:EU:C:2018:834;

CJEU, 14 September 2017, Case C-132/16, Iberdrola, ECLI:EU:C:2017:683;

CJEU, 15 September 2016, Case C-516/14, Barlis 06, ECLI:EU:C:2016:690;

CJEU, 21 June 2016, Case C-393/15 ESET, EU:C:2016:481;

CJEU, 22 October 2015, Case C-126/14, Sveda, ECLI:EU:C:2015:712;

CJEU, 29 September 2015, Case C-276/14 Gmina Wrocław, ECLI:EU:C:2015:635;

CJEU, 16 July 2015, Case C-108/14, Beteiligungsgesellschaft Larentia + Minerva mbH & Co. KG v. Finanzamt Nordenham, ECLI:EU:C:2015:496;

CJEU, 17 September 2014, Case C-7/13, Skandia America, ECLI:EU:C:2014:2225;

CJEU, 12 September 2013, Case C-388/11, Le Crédit Lyonnais, ECLI:EU:C:2013:541;

CJEU, 25 Apr. 2013, Case C-86/11, European Commission v. United Kingdom of Great Britain and Northern Ireland, ECLI:EU:C:2013:267;

CJEU, 25 Apr. 2013, Case C-65/11, European Commission v. Kingdom of the Netherlands, ECLI:EU:C:2013:265;

CJEU, 25 Apr. 2013, Case C-74/11, European Commission v. Republic of Finland, ECLI:EU:C:2013:266;

CJEU, 25 Apr. 2013, Case C-95/11, European Commission v. Kingdom of Denmark, ECLI:EU:C:2013:268;

CJEU, 25 Apr. 2013, Case C-109/11, European Commission v. Czech Republic, ECLI:EU:C:2013:269;

CJEU, 9 April 2013, Case C-85/11 Commission v Ireland, ECLI:EU:C:2013:217;

CJEU, 6 September 2012, Case C-496/11 Portugal Telecom SGPS, ECLI:EU:C:2012:557;

CJEU, 22 December 2010, Case C-277/09, RBS Deutschland Holding, ECLI:EU:C:2010;

CJEU, 25 February 2010, Case C-337/088 X Holding, ECLI:EU:C:2010:89;

CJEU, 18 December 2008, Case C-488/07, Royal Bank of Scotland, ECLI:EU:C:2008:750;

CJEU, 22 May 2008, Case C-162/07 Ampliscentifica and Amplifin, ECLI:EU:C:2008:301;

CJEU, 6 December 2007, Case C-298/05 Columbus Container, ECLI:EU:C:2007:754;

CJEU, 18 October 2007 Case C-355/06 J.A. van der Steen, ECLI:EU:C:2007:615;

CJEU, 28 June 2007, Case C-73/06, Planzer, ECLI:EU:C:2007:397;

CJEU, 23 March 2006, Case C-210/04, FCE Bank, ECLI:EU:C:2006:196;

CJEU, 21 March 2002, Case C-174/00, Kennemer Golf, ECLI:EU:C:2002:200;

CJEU, 22 February 2001, Case C-408/98, Abbey National, ECLI:EU:C:2001:110;

CJEU, 13 July 2000, Case C-136/99, Societe Monte Dei Paschi Di Siena, EU:C:2000:408;

CJEU, 8 June 2000, Case C-98/98, Midland Bank, ECLI:EU:C:2000:300;

CJEU, 15 January 1998, Case C-37/95, Ghent Coal Terminal, ECLI:EU:C:1998:1;

CJEU, 17 July 1997, Case C-190/95, ARO Lease, ECLI:EU:C:1997:374;

CJEU, 6 April 1995, Case C-4/94, BLP Group, ECLI:EU:C:1995:107;

CJEU, 3 March 1994, Case C-16/93, Tolsma, EU:C:1994:80;

CJEU, 25 July 1991, Case C-202/90, Ayuntamiento de Sevilla v Recaudadores de Tributos de las Zonas primera y segunda, ECLI:EU:C:1991:332;

CJEU, 8 March 1988, Case C-102/86 Apple & Pear, ECLI:EU:C:1988:120;

CJEU, 14 February 1985, Case C-268/83, Rompelman, ECLI:EU:C:1985:74;  
CJEU, 1 April 1982, Case C-89/81 Hong Kong Trade, ECLI:EU:C:1982:121;  
CJEU, 5 February 1981, Case 154/80 Coöperatieve Aardappelenbewaarplaats, ECLI:EU:C:1981:38;  
AG Mengozzi opinion in joined cases C-108/14 and C-109/14 Larentia + Minerva.

## **Books**

Alhager, Eleonor, Kleerup, Jan, Melz, Peter och Öberg, Jesper, Mervärdesskatt i teori och praktik;

Henkow, Oskar: Mervärdesskatt i teori och tillämpning, 5 uppl. Malmö: Gleerups, 2019;

Henkow, Oskar: Neutrality of VAT for Taxable Persons: A New Approach in EU VAT, EC Tax Review (2008);

Herman van Kesteren and Madeleine Merckx, 'The Concept of Taxable Persons (and Fixed Establishments) in EU VAT' in Thomas Ecker, Michael Lang and Ine Lejeune (eds), *The Future of Indirect Taxation: Recent Trends in VAT and GST Systems around the World*;

Ine Lejeune and Jeanine Daou, "VAT Neutrality from an EU Perspective" in Michael Lang and Ine Lejeune, *Improving VAT/GST Designing a Simple and Fraud-Proof Tax System* (IBFD 2014);

Nilsson, Ulf: *Moms för bank och finans*, Stockholm: Norstedts Juridik, 2014;

Prof. Dr. Ad Van Doesum, Prof. Dr. Herman Van Kesteren, Prof. Dr. Gert-Jan van Norden, *Fundamentals of EU VAT LAW*;

Pfeiffer, S. *VAT Grouping from a European Perspective*, 2015;

Sjoerd Douma, *Legal Research in International and EU Tax Law* (Kluwer 2014);

S.Pfeiffer, "Written comment to the keynote paper taxable persons", in: M. Lang, P. Pistone, J. Schuch, C. Staringer and D. Raponi, *ECJ - Recent developments in Value Added Tax, the evolution of European VAT jurisprudence and its role in the EU common VAT system* (Linde 2014);

Terra, B. and Kajus, J., *Introduction to European VAT*;

Thomas Ecker, Michael Lang and Ine Lejeune, *The Future of Indirect Taxation: Recent Trends in VAT and GST Systems around the World*;

Vyncke, K. "VAT Grouping in the European Union: Purposes and Limitations", *International VAT Monitor*, July/August 2007.

## **Articles**

B. Gryziak, *European Union - VAT Groups and the Right of Deduction across the European Union – Review and Analysis*, *International VAT Monitor*, 2021 (Volume 32), No. 4;

Bjerregaard Eskildsen, *European Union - Pro Rata Deduction by Entities Established in Several VAT Jurisdictions*, *International VAT Monitor*, 2012 (Volume 23), No. 1;

Christian Amand (2007), VAT Grouping, FCE Bank and Force of Attraction: The International Market is Leaking, International VAT Monitor;

C.Amand and V.Lenoir, “Pro Rata Deduction by Financial Institutions – Gross Margin or interest?”, International VAT Monitor 1 (2006);

Craig Rapson & David Bearman (2012), Cross-Border Intra-company Transactions with the EU, Indirect Tax Briefing, Issue 5;

Consentini, R. ‘VAT Deductibility for Fixed Establishments: The ECJ Ruling and the Italian Legal System’ (2019) September/October, International VAT Monitor;

Dias Soares, The Territorial Scope of VAT Grouping Schemes in the Financial Sector;

Ine Lejeune and Jeanine Daou, ”VAT Neutrality from an EU Perspective” in Michael Lang and Ine Lejeune, Improving VAT/GST Designing a Simple and Fraud-Proof Tax System;

Lizzy Bijl et alter (2012), EU VAT Grouping Provisions: An Update, Indirect Tax Briefing, Issue 5, August, Ernst & Young;

Pierre-Marie Glauser, ‘Head Office/Branch Relationships from the Perspective of Swiss VAT’ [2010] International VAT Monitor 31;

Swinkels J.J.P., ‘The Phenomenon of VAT Groups under EU Law and Their VAT Saving Aspects’, (2010) 21(1) International VAT Monitor, Journals IBFD;

Pfeiffer S., ‘Current questions of EU VAT grouping’, World Journal of VAT/GST Law;

Vyncke, K., “EU VAT Grouping from a Competitive Tax Law.

### **Digital source**

KPMG, France: Introduction of VAT group regime, October 13, 2020;

<https://home.kpmg/us/en/home/insights/2020/10/tnf-france-introduction-vat-group-regime.html> (accessed 24/5/2021);

Yannick Zeippen, Jacques Verschaffel, Olivier Lambert, “how can VAT be recovered by branches rendering services to their head offices?” [https://www.ey.com/en\\_lu/tax/ey-luxembourg-tax-library/branch-head-office-supplies](https://www.ey.com/en_lu/tax/ey-luxembourg-tax-library/branch-head-office-supplies) (accessed 27/June/2021).