VAT focus

Larentia + Minerva: VAT recovery for holding companies

SPEED READ Whether a holding company can recover the VAT it incurs on a share acquisition has never been a straightforward question. In recent years, however, many feel that HMRC has introduced conditions that are wrong at law or that go beyond what the law requires. The Advocate General's opinion in *Larentia + Minerva* suggests that HMRC's view that input tax should be apportioned between economic and non-economic activities where a 'management' holding company receives dividends from the managed subsidiaries is incorrect.

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On 26 March 2015, the Advocate General delivered his opinion on the joined cases of *Beteiligungsgesellschaft Larentia + Minerva mbH* (C-108/14) *(Larentia)* and *Marenave Schiffahrts AG* (C-109/14) *(Marenave)* (reported in *Tax Journal*, 10 April 2015)).

Larentia was a 98% limited partner in two limited partnerships that each operated a vessel. It provided each of these limited partnerships with administrative and business services for payment. Marenave was a holding company that acquired shares in four limited partnerships. It was also involved in the management of each of these for payment.

Three questions were referred to the CJEU. The first concerned the apportionment of VAT incurred in connection with the acquisition of shares in a subsidiary. (It was immaterial that the 'subsidiaries' in question were in fact limited partnerships, as the VAT analysis was the same.) The referring court considered that Larentia and Marenave were carrying on both economic and non-economic activities and sought guidance from the CJEU on the apportionment of input tax incurred by a holding company in such a situation.

The second and third questions concerned whether a partnership could be included in a VAT group. While of enormous interest, this is outside the scope of this article.

To fully understand why the Advocate General's opinion on the first question is relevant to the ability of a UK holding company to deduct VAT that it incurs on a share acquisition, we have to go back almost 25 years.

'Passive' and 'management' holding companies

There are two types of holding companies for VAT purposes – so-called 'passive' holding companies and 'management' holding companies. This dichotomy lies at the heart of why VAT recovery for holding companies is less than straightforward.

A 'passive' holding company is a holding company that only acquires and holds shares. As the CJEU ruled in *Polysar* (C-60/90), such a holding company does not carry on any economic activities. It is not, therefore, a taxable person and it cannot deduct any of the VAT it incurs.

A 'management' holding company is a holding company that, in addition to holding shares, is involved in the management of its subsidiaries. The CJEU suggested in *Polysar* that the position of such a holding company would be different from that of a 'passive' holding company. This was confirmed in *Floridienne* (C-142/99), where it ruled that a 'management' holding company is carrying on an economic activity 'insofar as it entails carrying out transactions which are subject to VAT … such as the supply … of administrative, accounting and information technology services to their subsidiaries'. Such a holding company is a taxable person, and is entitled to deduct the VAT it incurs (subject to the normal deduction rules).

The deduction rules

For a long time, almost everyone thought they knew how the deduction rules applied to holding companies. In fact, the position was never as clear as it seemed. There was much disagreement between advisors and, particularly, between advisors and HMRC.

Could a holding company secure deduction simply by recharging the relevant fees to its subsidiaries? What about if it formed a VAT group with its subsidiaries? Would it then be able to deduct the VAT it incurred on a share acquisition simply by pointing to the taxable supplies made by its subsidiaries?

The deduction rules require that the input tax in question – in our case, the VAT that the holding company incurs – be attributable to a taxable output supply. As art 1(2) of the Principal VAT Directive puts it, the input tax must be 'VAT borne directly by the various cost components' of the output supply. Or, as the CJEU put it in *Midland Bank* (C-98/98), there must be a direct and immediate link between the input tax and a taxable output transaction. How these rules should be construed and what they mean for holding companies is the cause of much of the disagreement between advisors and HMRC.

HMRC's position

HMRC considers that in order for there to be a direct and immediate link between an input transaction and a taxable output transaction, the costs of the input transaction must be components of the *price* of the taxable output transaction. This is a highly controversial proposition that most advisers dispute. Many advisers consider that HMRC has simply misconstrued the reference to 'cost components' in art 1(2) of the Principal VAT Directive; but HMRC remains adamant.

In order for even a 'management' holding company to deduct the VAT that it incurs, HMRC requires not only that it makes taxable supplies (such as providing management services to its subsidiaries), but also that it intends to recoup the cost of the relevant fees from the income from those taxable supplies (or management services).

Where a holding company is in a VAT group with its subsidiaries, HMRC requires two levels of linkage:

- the cost of the relevant fees being cost components of the services supplied by the holding company to the subsidiaries (notwithstanding that, for VAT purposes, such supplies are disregarded by virtue of the VAT grouping); and
- the supplies from the holding company being used by the subsidiaries to make their own taxable supplies to third parties outside the VAT group.

However, perhaps the most controversial element of HMRC's position is how it interprets *Securenta* (C-437/06). It considers that even a 'management' holding company that makes taxable supplies to its subsidiaries continues to carry on non-economic activities to the extent that it receives dividends from the subsidiaries it manages. Any VAT it incurs that is attributable to such non-economic activities is not deductible, and therefore an apportionment needs to be made between the economic and non-economic activities.

This is the same issue as underlies the first question in *Minerva*.

The first question

Strictly, the referring court was asking the CJEU for a method to apportion input VAT incurred for the purposes of both economic and non-economic activities. The Advocate General's suggested answer was that the CJEU should decline jurisdiction, on the basis that it was for the member state itself to establish the method.

He did not, however, stop there. Instead, he went on to question the premise behind the question; i.e. the view of the referring court that the holding companies were carrying on both economic and non-economic activities.

In addressing this, the Advocate General cited extensively from *Cibo* (C-16/00). Cibo was a holding company that acquired three subsidiaries. It sought to deduct the VAT it incurred in connection with the acquisition. It was involved in the management of the subsidiaries. The French tax authorities sought to disallow the deduction, arguing that Cibo was not carrying on an economic activity and that, even if it were, because it derived most of its income from dividends (from the three subsidiaries), that made it partially exempt with the result that most of the input tax was not deductible.

The CJEU ruled that Cibo was a 'management' holding company, and that the dividends fell outside the scope of VAT. It also ruled that the expenses Cibo incurred in connection with the acquisition were part of its general overheads (and thus deductible subject to the normal rules).

The Advocate General in *Larentia* considered that it followed that, in the case of a 'management' holding company, the expenditure it incurs is connected only with its economic activities and not even partially with its non-economic activities. In other words, once it is established that a holding company is carrying on an economic activity in managing its subsidiaries, any receipt of dividends from those same subsidiaries (and the non-economic activities that would otherwise have arisen) are left out of account. The input tax that the holding company incurs is treated as having a direct and immediate link with its economic activity as a whole. No apportionment is required and, if its economic activity were taxable, it would be able to deduct its input tax in full. This, the Advocate General thought, was 'the proper interpretation of *Cibo*'. (It is interesting to note that he was also the Advocate General on *Portugal Telecom* (C-496/11), a case that has been read to support such apportionment.)

The UK submitted written observations on *Larentia*, so the Advocate General's opinion on the first question can be taken as a rejection of HMRC's position on the point. Whether the CJEU will follow remains to be seen, however.

Even if it does, *Larentia* should not be taken to say input tax is never to be apportioned between economic and non-economic activities. Where a holding company is involved in the management of some of its subsidiaries but not others, it would be carrying on both economic and non-economic activities; and that, according to the Advocate General, 'entails the obligation to apportion input VAT between the economic and non-economic activities'.

Aftermath

It is generally accepted that in order for a holding company to deduct the input tax that it incurs on a share acquisition:

- it must be involved in the management of the subsidiaries;
- in the course of this, it must make taxable supplies; and
- there must be a direct and immediate link between the input tax and the taxable supplies (or its economic activity as a whole).

These requirements should not give rise to much difficulty in most cases. What is controversial, however, is HMRC's position that:

- the costs of the input transaction must be incorporated in the price of the taxable output transaction; and
- input tax should be apportioned between economic and non-economic activities where a 'management' holding company receives dividends from managed subsidiaries.

These requirements are more controversial (and, in the view of many, simply wrong).

The CJEU will, of course, have the last word, but the second of these requirements should fall away now with *Larentia*. The first requirement is considered in *Sveda* (C-126/14), and the Advocate General's opinion in that case does not bode well for HMRC either.

That leaves the question of whether one needs to establish two levels of linkage (as HMRC requires) where a holding company is in the same VAT group as its subsidiaries. Unfortunately, there does not appear to be an answer on the horizon. Therefore, for the foreseeable future at least, VAT recovery for holding companies will remain less than straightforward. But we're getting there. ■