

## VAT focus

## M&A input tax recovery by holding companies: an elementary issue?

## Speed read

VAT recovery in relation to corporate acquisitions has been a challenging issue across the EU for many years. The recent case of *Magyar Villamos Művek (MVM)* (Case C-28/16) confirmed that input tax may still not be reclaimable by a group holding company, even when it appears to carry on economic activity by being actively involved in the management of its subsidiaries. HMRC, which intervened in the *MVM* case, has now released an update to its draft guidance on the UK VAT position of holding companies. These developments illustrate the need for taxpayers to take practical steps to ensure they mitigate potential VAT costs on acquisitions.



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To challenges as to how he had reached his ingenious deductions, Sir Arthur Conan Doyle's famous detective, Sherlock Holmes, would famously respond, 'Elementary!', before setting out a detailed explanation, leaving his interlocutor in no doubt of the link between the observable facts and his final conclusion. Unfortunately, for taxpayers input tax deductions have proven anything but elementary where holding companies and acquisition costs are concerned. In many instances, tax authorities have challenged attempts to link input tax to onward taxable supplies – both in the UK and other EU member states.

### VAT perspective on holding companies

*'There is nothing new under the sun. It has all been done before.'* (A Study in Scarlet)

From a VAT perspective, the main questions have been clear for a long time: is the holding company a taxable person for VAT purposes; and, if so, to what extent is it entitled to input tax recovery? These issues may look straightforward but, in reality, this often proves to be far from the case.

The basic functions of a holding company are to acquire and hold shares in subsidiaries (from which it may receive dividends); to defend itself and its subsidiaries from takeovers;

and to make disposals. In the seminal decision in *Polysar* (Case C-60/90), the CJEU held that the acquisition, holding and sale of shares do not, in themselves, constitute economic activities meaning that associated VAT recovery is blocked. It also underlined, however, that the position may be different if the holding of the shares is accompanied by an active involvement in the management of subsidiaries.

About ten years later, the CJEU stated in three landmark decisions – *Floridienne* (Case C-142/99); *Cibo Participations* (Case C-16/00); and *Welthgrove* (Case C-102/00) – that active involvement in the management of the subsidiaries requires the holding company to provide taxable supplies to its subsidiaries for consideration, such as administrative, financial, commercial or technical services. Where involvement in the management of the subsidiaries includes supplies of taxable services, the holding company is allowed to recover input tax incurred on related overheads used to carry out these services.

### Input tax deduction: HMRC's current position

*'When a fact appears to be opposed to a long train of deductions, it invariably proves to be capable of bearing some other interpretation.'* (A Study in Scarlet)

HMRC's draft guidance on input deduction stresses the need for the holding company to be the recipient of the supply and for it to be undertaking economic activity for VAT purposes. To determine the recipient, HMRC will consider the contractual position (helpfully recognising the possibility of novations, e.g. in bidco scenarios). It will also look at which entity has made use of and been invoiced for the supply. The guidance asserts that who pays for the supply is relevant, although this seems to ignore the possibility of third party consideration and the principle that the right to deduct input tax is strictly not contingent on having paid it first. As regards economic activity, the guidance gives the example of providing 'genuine' (rather than nominal) management services for consideration to subsidiaries. It confirms the (non-controversial) point that a holding company with no economic activity cannot reclaim VAT on acquisition costs.

### Link to taxable supplies

*'It is a capital mistake to theorize before one has data. Insensibly one begins to twist facts to suit theories, instead of theories to suit facts.'* (A Scandal in Bohemia)

HMRC reiterates that, in addition to the two preconditions of receiving the supply and carrying on an economic activity, there must still be a direct and immediate link between the input and a taxable output transaction. Dividend income can be ignored for VAT deduction purposes, provided that management charges are made to all of a holding company's subsidiaries. However, where subsidiaries are acquired with no intention to make taxable supplies to them, this is seen as a non-economic 'investment' activity and VAT recovery must be restricted accordingly. Naturally, basic partial exemption considerations still apply; e.g. exempt loan interest earned by the holding company would also impact VAT deduction.

Extending the discussion on the link between a holding company's costs and taxable supplies, the guidance introduces a concept of a 'direct, continuous and necessary extension of a taxable economic activity'. The examples given suggest that input tax incurred on share acquisition costs may be deductible without the need for an acquirer to provide taxable management services to the acquired company. HMRC seems to advocate stepping back and looking at the broader circumstances to identify whether there is an 'enduring economic benefit' to either the buying or the bought business. If there is, input tax deduction may be possible. The contrast it

draws is with a share purchase for speculative purposes only; i.e. purely to receive a return on investment through dividends and/or an eventual onward share sale.

### The issue of consideration

*'The world is full of obvious things which nobody by any chance ever observes.'* (*The Hound of the Baskervilles*)

HMRC's guidance stresses the need for evidence of the holding company's intention to make taxable supplies, and the obvious point that these should take place in return for payment. It helpfully summarises a number of the UK cases (often involving mining companies) where the UK courts have found either insufficient proof of such intention, or else that the manner of remuneration does not meet the criteria to count as consideration for VAT purposes. It cites the most recent case of *Magyar Villamos Művek (MVM)* (Case C-28/16) (reported in *Tax Journal*, 10 February) approvingly.

### The recent CJEU decision in MVM

MVM was a Hungarian state-owned power company. It performed economic activities by leasing power plants and fiber optic networks. It also held subsidiaries involved with the generation or distribution of electricity. MVM was a recognised corporate group in Hungary but not a VAT group.

It was responsible for the strategic management of this group, but did not charge any explicit fee. On behalf of the group, MVM carried out legal, business management and public relations activities which were used for (i) its own activities; (ii) individual members' activities; and (iii) the activities of the entire group.

MVM claimed all the input tax incurred for the purpose of carrying out these services, on the basis that the entire group carried on only taxable activities from a VAT perspective. The Hungarian tax authorities disagreed and asserted that VAT in categories (ii) and (iii) was irrecoverable, as the activities were provided for free. The economic activity condition for deduction was not met.

The CJEU recited the classic principles and confirmed that the involvement of MVM in the management of its subsidiaries without consideration could not be regarded as an economic activity. The fact that MVM chose to receive higher dividends, rather than to levy a fee, was decisive. It was not possible to take this course but then to try and access VAT recovery as if a fee had been levied.

MVM confirms that it is not enough for VAT recovery that there be *some* remunerated economic activity in a holding company. The VAT in question must relate to the *specific* taxable person's ongoing economic activity. A holding company cannot deduct input tax incurred 'on behalf of' another subsidiary and merely rely on the fact that the latter performs taxable supplies to justify the claim.

What is interesting in *MVM* is that the Hungarian Supreme Court seems to have tried to look at the broader economic reality so as to overlook the technicality of the holding company not levying an explicit fee: 'the Kúria notes that, from an economic point of view, the charging by a holding company of its subsidiaries for services, in a purely national group of companies, is merely a technical matter. Furthermore, that court takes the view that MVM does not perform any acts free of charge since, in return for the services which it provides, ostensibly without remuneration, to its subsidiaries, it obtains higher dividends' (para 19).

Commercially, one can sympathise with the argument that it makes no substantive difference to a business (or to the management activities it might undertake) whether it extracts value from its subsidiaries by charging fees or by expecting

higher dividend payments.

It is surely arguable that the group-related costs incurred by MVM are ultimately an overhead and reflected in the price of the products of the entire group. Where, as here, all corporate group members are fully taxable, it seems anomalous to deny input tax recovery on costs which relate to the group's activities. However, while economic reality is cited frequently in VAT cases as being a determining factor in ascertaining the correct treatment, the court did not accept the Hungarian court's analysis in this instance.

### Does VAT grouping make a difference?

*'I never make exceptions. An exception disproves the rule.'* (*The Sign of Four*)

MVM was not in a VAT group, but would this actually have changed matters? In the UK, perhaps not. Despite a VAT group being deemed a single taxable person under case law principles, HMRC's draft guidance asserts that where a holding company joins a VAT group, this does not in itself change the position as regards VAT deduction on its costs. It suggests a link would still need to be traced through to the taxable activities of VAT group members, perhaps through the (disregarded) supply chain. No exceptions should be made. If input tax is incurred for a VAT grouped holding company which does not undertake economic activity and where a link cannot be traced, this should be blocked.

HMRC distinguishes a category of 'stewardship' costs, which by their nature would be seen as overheads with a sufficient link to the VAT group as a whole. This includes general group audit and legal fees, brand and bid defence and regulatory compliance.

Recent case law suggests there may be more instances where a link can be evidenced from acquisition costs to a group's activities without the need to trace through the internal supply chain. In *Heating Plumbing Supplies Ltd* [2016] UKFTT 753 (TC), the FTT has allowed VAT recovery of management buyout (MBO) costs, even though the holding company, in the VAT group, made no supplies.

The FTT took the view that these costs were overheads incurred for the 'direct benefit of the ... business', so as to enable employees to acquire a stake and incentivise them to develop the business. The input tax was thus recoverable, despite there not being any management services.

### What to do now?

In light of cases like *MVM* and the developing guidance and continuing challenges from HMRC and other EU tax authorities, taxpayers and their advisers need to:

- confirm that any VAT charged by suppliers is correctly levied;
- monitor the latest guidance from the relevant tax authority;
- identify who received and used relevant supplies considering contracts/economic reality;
- ensure evidence of the link to taxable supplies is captured at the time VAT is incurred;
- consider how to trace through a link to taxable supplies within (proposed) VAT groups;
- VAT register recipient companies promptly, ideally before VAT is incurred or soon after; and
- consider whether exempt or non-economic activity might require VAT apportionment and how to measure this in a fair and reasonable way.

Whilst Conan Doyle's famous detective was greatly skilled in combat when the need arose, the authors hope that the issue of input tax deduction will not call for such interventions too frequently in the future. ■