Skandia America Corp. (USA)/ VAT Grouping

On 13 October, 2014 HMRC issued Revenue and Customs Brief 37(2014) outlining HMRC’s position following the Skandia case. That position can be stated very simply. It is that the UK’s VAT grouping rules are different from the Swedish VAT grouping rules considered by the CJEU in Skandia and HMRC are going to consider what impact, if any (our emphasis), the Skandia decision has on the UK’s VAT grouping rules and whether any changes to legislation are required as a result.

In this briefing, we will look at the issues here in a little more detail and consider whether we believe any changes to the UK rules are required. In short, we do not, and we hope HMRC will in due course agree. However, HMRC will no doubt also be keeping an eye on how other Member States react to the decision and, indeed, whether the European Commission shows any appetite for getting involved itself, which could also influence the outcome.

1. THE PRINCIPAL VAT DIRECTIVE AND THE BASIC EU VAT CONCEPT OF A "SUPPLY"

Articles 2(1)(a) and 2(1)(c) of Directive 2006/112 EC (the Principal VAT Directive — “PVD”) define the basic concept of a supply within the scope of EU VAT.

This is a supply of goods or services made for consideration within the territory of a Member State by a taxable person acting as such.

Inherent in the concept of “consideration” is value moving from one person to another, since a person cannot meaningfully provide value to himself.

This was reinforced by the decision of the ECJ in Tolsma (Case C-16/93), which confirmed that a transaction falls within the scope of EU VAT as a taxable supply of services only if the following ingredients are present:

- a provider of a service and a recipient of that service;
- a legal relationship in place between provider and recipient; and
- pursuant to that legal relationship, reciprocal performance, with the remuneration received by the service provider constituting the value actually given by the recipient in return for the service supplied to the recipient.

None of those ingredients can be present if a transaction involves only a single taxable person. Such a transaction does not therefore fall within the basic EU VAT concept of a "supply".
2. 2009 CONSULTATION BY THE COMMISSION

In 2009, the Commission published a Communication to the Council and to the European Parliament on the option for VAT grouping provided for in Article 11 of the PVD.

In that communication, the Commission explained the background to Article 11, set out a general summary of how VAT grouping works and explained the Commission’s own views on some particular aspects of VAT grouping.

The Commission emphasised, in particular, a desire to achieve a more uniform application of VAT grouping across those EU Member States which have adopted it (not all Member States have).

In the communication, the Commission did not propose any specific amendments to Article 11 of the PVD or to any other provision of EU VAT legislation. Instead, the Commission stated that they would subsequently consider whether, in light of reactions to their communication, any amendments to Article 11 were appropriate.

As yet, the Commission has not published any proposed amendments to Article 11.

Further reference to the Commission’s communication is made in context below.

3. DECISION OF ECJ IN FCE BANK

FCE Bank (Case C-210/04) concerned the provision of various consultancy and technical services by a UK bank to its Italian branch. Guidance was sought by the referring Italian Court on whether this type of activity fell within the scope of EU VAT.

By its ruling, the ECJ effectively confirmed that it did not.

The Court began its analysis by reaffirming the basic EU VAT concept of a “supply”, as clarified by the Court in its prior decision in Tolsma.

In addition, the Court confirmed that a basic attribute of a "taxable person" for VAT purposes is status as an independent economic operator.

Having noted that a branch, by its nature as a local trading presence of a single legal person, lacks that quality of independence, the Court found (at paragraph 37 of its judgment) that the UK bank and its Italian branch together constituted only a single taxable person.

The Court then noted (at paragraph 40) that this finding was not disturbed by the existence of a cost sharing arrangement between company and branch, since that arrangement could not represent an agreement negotiated between independent persons.

In other words, such an arrangement was not a legally binding contract and anything paid under it was therefore not capable of being consideration for VAT purposes; and without consideration a transaction cannot be a supply for VAT purposes, as noted under heading 1 above.

The decision in FCE Bank, together with the prior decision in Tolsma, is often cited by commentators as authority for the proposition that it is not possible to have a supply for VAT purposes within a single taxable person, whether that person is organised only in one member state or in several. It is considered that this interpretation of the two judgments is correct.

Moreover, in their communication on VAT grouping, the Commission expressed (at paragraph 3.3.2.2) the same view: “a supply of services within the same legal entity does not fall within the scope of VAT” (although as noted in section 10 below the Commission then qualified that view in the case of an overseas company belonging to a VAT group).

Further support for the same proposition is to be found in Article 17(1) of the PVD. This stipulates that the transfer by a taxable person of goods forming part of that person’s business assets from an establishment of the person in one member state to an establishment of the same person in another member state is to be treated, for EU VAT purposes, as a supply (of goods) made for consideration. That provision would be otiose if the draftsman had thought that such a
“transaction” between different establishments of a single taxable person was in any event capable of falling within the scope of VAT.

4. CURRENT UK PRACTICE AND PUBLISHED HMRC GUIDANCE

HMRC’s current practice and published guidance is fully supportive of the analysis set out in section 1 above.

In VATSC03500, HMRC confirm that “a transaction will not be a supply for VAT purposes if the transaction is within the same legal entity”.

In VATSC30500, HMRC confirm that “in order that a supply for a consideration can be made, there must be at least two parties and a written or oral agreement between them under which something is done or supplied for the consideration”.

Further reference to current HMRC published guidance is made in context below.

5. RATIO OF THE DECISION OF THE CJEU IN SKANDIA AMERICA CORP (USA)

In paragraphs 21-28 of the judgment of the CJEU in Skandia (Case C-7/13), the Court effectively restates the analysis it adopted in its prior decision in FCE Bank and its decision in that case, without qualification or amendment.

In paragraphs 29 to 31 of the judgment, however, the Court finds that a different analysis applies to transactions between a company and its branch if the branch belongs to a local VAT group.

The reasoning of the Court in support of that conclusion appears to be, in essence, as follows:

- a company and its branch therefore cannot themselves be a single taxable person where the branch forms part of a VAT group;
- in such a case, services provided by a company to its branch must be treated, for VAT purposes, as supplied to the separate single taxable person constituted by the VAT group; and
- accordingly, that provision of services, being a supply by one taxable person (the overseas company) to another (the VAT group), falls within the scope of the EU VAT concept of a supply of services for consideration.

Fundamental to this reasoning are the following two propositions:

- only the branch of an overseas company forms part of the single taxable person constituted by the relevant VAT group while the overseas establishment of that company does not; and
- the overseas establishment of the company and its branch are thereby given separate identities for VAT purposes with only the branch’s identity being subsumed within the single taxable person, so that the overseas establishment remains capable, in itself, of making a taxable supply of services to the VAT group of which that company, through its branch, is a member.

No explanation is given by the Court of the analytical basis for either of these propositions. That includes, in particular, the very significant conceptual “leap of faith” represented by the second proposition and its severance of a single legal entity into effectively two separate identities for VAT purposes. Without that severance there could be no finding of a taxable supply since the Court did not depart from the decision in FCE Bank that a supply within the scope of VAT requires the participation of two persons.

Paragraph 16 of the judgment nonetheless contains a statement which appears to be meant to underpin the first of those two propositions.
In paragraph 16, the Court notes that Sweden has exercised the option, provided for in Article 11 of the PVD, to allow VAT grouping. The Court then says: “It follows from those provisions that only the fixed establishment, in Sweden, of an economic operator may belong to a VAT group ....”.

It is not altogether clear whether the Court, by that statement, was merely reciting its understanding of how the Swedish VAT grouping regime applies to the admission to Swedish VAT groups of companies established outside Sweden; or whether, alternatively, the Court was determining that, as a matter of EU VAT law, only the local branch of an overseas company, rather than that overseas company in its entirety, can properly be admitted to a VAT group.

It is suggested that the former of those two alternatives is the more plausible, because:

- the statement appears in the introductory part of the judgment under the sub-heading “Swedish law”, rather than in the substantive part of the judgment under the heading “Consideration of the questions referred”;

- despite the relative brevity of the judgment, it might fairly be assumed that if the Court was intending to make a specific ruling on the maximum permissible extent of VAT grouping under EU VAT law, it would make plain that it was doing so and offer at least some element of analysis as to why it was legitimate thereby to give radically different VAT treatments to two establishments of the same legal person; and

- that is particularly so when the provision of the PVD which authorises Member States to adopt VAT grouping, namely Article 11, is drafted in terms of persons established in a Member State who are closely linked being eligible for treatment as a single taxable person: it does not entitle, still less require, a Member State to treat only part of a person as a component of such single taxable person.

Notwithstanding that, it is understood that Swedish VAT law does not, in fact, purport to allow only the local branch of an overseas company, rather than such a company in its entirety, to join a Swedish VAT group.

Accordingly, if, as is considered to be the case for the reasons given above, the statement cited above from paragraph 16 of the Court’s judgment was intended to reflect only the Court’s understanding of how the Swedish VAT grouping regime operates, it appears that the Court’s understanding on this particular point was incorrect.

It is not considered, however, that this erroneous description by the Court of this aspect of the Swedish VAT grouping rules means, in itself, that that statement must properly be regarded as part of the Court’s ruling in the case, rather than being a feature delimiting the scope of that ruling.

That is partly because of the reasons already given above for considering the statement in paragraph 16 to be a premise (albeit apparently a false premise) on which the ruling was based rather than a formal determination by the Court on EU VAT law; and partly because of the manner in which paragraph 1 of the ruling at the conclusion of the Court’s judgment is expressed.

That ruling was not expressed, as it easily could have been if the Court had been so minded, in terms that where an overseas company provides services to a branch in a Member State and the company belongs to a VAT group in that Member State: (i) the single taxable person fiction extends only to the local branch and not to anything done to or by the overseas establishment of the company; and (ii) transactions between that overseas establishment and the local branch are therefore supplies within the scope of EU VAT.

Instead, the Court ruled solely that supplies from an overseas company to its local branch constitute transactions within the scope of EU VAT when that branch itself belongs to a local VAT group (emphasis added).

As noted above, the Court began the substantive part of its judgment with an express reassertion of its earlier decision in FCE Bank and the fundamental
concepts of “supply” and “taxable person” confirmed by that decision.

It is therefore appropriate to interpret the decision in Skandia as departing from those concepts only in a case where a Member State, having a VAT grouping regime, permits only the local branch of an overseas company to join a VAT group established in that Member State and thereby expressly creates, for local VAT purposes, separate identities of the overseas company’s local branch and of that company’s overseas establishment that would not otherwise exist under EU VAT law principles.

Moreover, it is considered that the judgment in Skandia should apply only to a provision between an overseas establishment and local branch of services acquired from third parties, rather than any provision of resources generated internally.

Paragraph 17 of the judgment makes it clear that the only services there in issue were services which the overseas company concerned had purchased from third parties: “…SAC distributed externally-purchased IT services to various companies in the Skandia group …” (emphasis added). Nothing was said about SAC distributing any type of service that was generated purely internally within the company.

It is acknowledged that the Court, in its ruling, does not expressly limit that ruling to services originating from third parties, rather than services that are generated internally. It is nonetheless considered that the judgment can properly be interpreted as applying only to supplies of externally purchased services.

That is partly because of the clear finding, noted above, in paragraph 17 of the judgment that externally purchased services were the only type of services there in issue; and partly because the Court, in paragraphs 26 and 27 of its judgment, accepted that a purely internal transaction between an overseas head office and its local branch, involving nothing more than a passing of resources from one part of the company to another in return for an appropriate allocation of costs within the cost centres of that company, could not properly be regarded as a "supply of services", for VAT purposes, at all.

The reference to “supplies of services” in paragraph 1 of the Court’s final ruling should therefore properly be regarded as extending only to an on-supply of externally purchased services of one type or another, rather than to a purely internal activity which, as such, could not properly be identified in VAT law as a “supply of services” in the first place.

6. ARE AMENDMENTS TO UK VAT LEGISLATION REQUIRED BY SKANDIA – AND IF SO WHEN?

UK VAT law does of course already prevent avoidance of UK VAT where one member of a UK VAT group acquires services that are of a taxable nature free of VAT overseas and then purports to on-supply those services equally free of VAT through the group registration, by virtue of subsections (2A) to (2E) of section 43 VATA 1994.

But those provisions apply only where the company which has acquired the VAT-free services overseas on-supplies those services to another company in the same group (see the opening words of subsection (2A) of section 43). The provisions do not apply where the company which has acquired the VAT-free services overseas purportedly supplies them to its own UK branch. Nor do they apply where the services supplied by the overseas company – whether to another member of the group or to its own UK branch – are internally generated, rather than bought in from third parties (as HMRC confirm in published guidance: see VGROUP01400).

The decision in Skandia might seem at first sight to suggest that both of those limitations on the scope of the charge under subsections (2A) to (2E) of section 43 are now discordant with EU VAT law, so that the provisions need to be amended.

It is nonetheless believed that that first impression is wrong, for the following reasons.

First, UK VAT law has no concept of only the branch of an overseas company joining a VAT group. If an overseas company has a fixed establishment in the United Kingdom, that company, in its entirety, can join a UK VAT group if the normal conditions for
group membership are satisfied (common control, etc) – see section 43A VATA 1994. HMRC confirm in published guidance that an overseas company which joins a UK VAT group does so in its entirety (see VGROUPS02400).

For the reasons explained in section 5 above, Skandia is believed to apply only in a case where a Member State has enacted VAT laws which permit solely the branch of an overseas company to become a member of a local VAT group. The United Kingdom is not such a Member State and its VAT grouping regime is fundamentally different from that considered by the Court in Skandia. Skandia should therefore have no effect here.

Second, as also explained in section 5 above, it is considered that the reference to "supplies of services" in paragraph 1 of the Court’s ruling in Skandia should properly be regarded as limited to an on-supply of externally purchased services. On that basis there is nothing wrong with the charge to VAT under subsections (2A) to (2E) of section 43 having the same limitation.

It is hoped that HMRC will, after due consideration, be able to agree that the decision in Skandia does not require any changes to be made to UK VAT legislation.

However, if, hypothetically, HMRC were unable to reach that conclusion, it is assumed that HMRC would follow their normal and long-standing practice of responding to a decision of the CJEU which may possibly call into question the validity of existing UK VAT law and practice by engaging in a consultation with interested parties before recommending any specific legislative changes to Ministers.

It is further assumed that HMRC would not, in that event, seek to apply their own interpretation of the decision in Skandia until the necessary changes to UK VAT law had been enacted (or, alternatively, until a specified future date), in accordance with HMRC’s published practice in this area, as recorded in section 2 of HMRC Brief 28/04.

7. **INCOHERENCE IN DIFFERENTIAL TREATMENT OF GROUPED AND NON-GROUPED BRANCHES**

If HMRC were, notwithstanding the views expressed in sections 5 and 6 of this paper, to take the view that the decision in Skandia did require some amendment to be made to UK VAT law, the outcome would, inevitably, be a huge disparity in (i) the VAT treatment of transactions between an overseas company and a branch in a Member State where that company was a member of a VAT group registration in that Member State and (ii) the VAT treatment of transactions between an overseas company and a branch in a Member State where the company was NOT a member of a local VAT group. The former would become taxable in accordance with the Skandia judgment while the latter would remain entirely free of VAT, in accordance with the decision in FCE Bank (which decision was not questioned or qualified by the Court in Skandia).

It is suggested that this highly differential VAT treatment of otherwise identical transactions or economic activities would represent a clear infringement of the fundamental VAT principle of fiscal neutrality.

Moreover, the distortive effects of such differential treatment across the EU would be further compounded by the feature, mentioned earlier, that a number of Member States have not adopted VAT grouping and would not, therefore, be affected by the decision in Skandia at all.

It is suggested that the existence of such a distortive and anomalous regime for the VAT treatment of transactions between overseas companies and branches could not be reconciled with the maintenance of a coherent, and properly harmonised, VAT regime across the EU.

8. **ADMINISTRATIVE AND PRACTICAL CONCERNS**

Should HMRC reach the conclusion, contrary to that expressed above, that UK VAT law should be amended to bring transactions between an overseas
company and its UK branch within the scope of VAT where that company is a member of a UK VAT group, it does not follow that this would have to apply to all activity taking place between overseas company and UK branch. That is because there is, as explained at the end of section 5 above, a separate argument to the effect that the decision in Skandia, properly interpreted, applies only to an intra-company provision of an externally-sourced supply.

If, however, HMRC felt unable to agree with that analysis of the scope of the Skandia judgment, very significant practical difficulties would arise in the application of UK VAT to the sharing between overseas company and UK branch of an internally generated resource. By its very nature, any such activity would not be a "transaction" properly so called. In consequence, the activity would not be documented in the same way as a commercial agreement between two separate persons would be. Nor would such an activity be reflected in the accounts of the overseas company, since it is no part of the function of the audited accounts of a company to show purely internal allocations of resources or costs between different establishments or offices of the company.

In consequence, the determination, as a practical matter, of exactly what type of services had been supplied between overseas company and UK branch, what was the VAT liability (if any) of those supplies and what amount should properly be regarded as the "consideration" for those supplies would give rise to very significant practical difficulties: both for the taxpayer, in terms of securing proper compliance with its UK VAT obligations, and for HMRC, in terms of auditing such compliance.

Those practical problems would be further worsened by the feature that it is not, of course, solely a provision of resource by overseas company to UK branch that would need to be scrutinised to determine what deemed supplies had been made for what consideration. Exactly the same analysis would need to be undertaken on any provision of resource in the opposite direction, i.e. by UK branch to overseas company. Moreover, any deemed supplies in the latter direction would potentially impact on the VAT recovery position of the UK VAT group as a whole, particularly in the case of a partly exempt group that was now found to be making hitherto unrecognised supplies to a non-EU recipient where the overseas company in question was established outside the EU.

9. POSSIBLE LOGIC IN APPLYING SKANDIA TO ALL BRANCHES

If the practical problem described in the preceding section of this paper could somehow be resolved (and it is far from obvious how that could be accomplished), or if, alternatively, HMRC were able to reach the conclusion expressed above that Skandia should apply only to a provision between overseas company and local branch of an externally-sourced service, the incoherence and illogicality referred to in section 7 above would, by definition, be eliminated through VAT being applied, instead, to all transactions between an overseas company and its local branch, entirely regardless of the presence or absence of VAT grouping.

However, given the fundamental principles of VAT outlined in section 1 above, as applied by the ECJ in the FCE Bank case described in section 3 above, that symmetrical application of the Skandia approach could not be achieved without an amendment being made to the relevant provisions of the PVD, so as to extend the concept of a supply to this particular type of cross-border intra-company activity.

Given the need for unanimity in the EU Council on any changes to EU VAT legislation and the practical problems of securing such unanimous consent, it is acknowledged that obtaining approval of the Council to any such amendment to the PVD may be difficult in practice. In particular, it might face objections from those Member States which have not adopted a VAT grouping regime and which, in consequence, are not currently affected by the Skandia decision.

Despite those practical and political problems, it is thought that this possible approach to eliminating the fundamentally distortive and incoherent outcome outlined in section 7 above may merit further consideration, both by HMRC and by the tax authorities of other EU Member States.
10. REFERENCE TO COMMISSION

In the course of the Commission communication referred to in section 2 above, the Commission expressed support for the analysis that, where an overseas company was admitted to a VAT group, only the local branch of that company, rather than the company in its totality, could become part of the single taxable person constituted by the VAT group: see paragraph 3.3.2.1 of the communication.

Moreover, in the same communication, the Commission expressed the view that, where an overseas company was VAT-grouped only to the extent of its local branch, a transaction between the company and that branch might then be brought within the scope of VAT: see the second sub-paragraph of paragraph 3.3.2.2 of the communication.

Against that background, it may be assumed that if HMRC were to reach the conclusion that the Skandia judgment did not require any changes to UK VAT legislation, that conclusion would not be supported by the Commission. It would therefore be pointless for HMRC to request any assistance from the Commission in reaching such a conclusion.

It would, however, be another matter altogether if HMRC were to reach the contrary conclusion, i.e. were to determine that the Skandia decision did necessitate some changes to UK VAT law, but were also to share the view, outlined in sections 7 and 9 above, that it would then be better for activities between overseas companies and local branches to be brought within the scope of VAT regardless of the presence or absence of VAT grouping.

In that event, it is thought that HMRC could properly request the Commission to undertake a general review of the treatment of cross-border intra-company activity under the common system of VAT and to consider what changes to EU VAT law should be made in order to achieve a consistent and coherent VAT treatment of such activity throughout the whole of the EU.

If the Commission were willing to undertake such a review, it is thought that there would be precedent for HMRC in that circumstance to defer making changes to UK VAT law until that Commission review had been concluded. Following the Arthur Andersen decision (Case C-472/03), HMRC announced (in Business Brief 23/05) that it would delay its decision regarding implementation of that judgment in UK VAT law until the Commission had itself concluded the more general review that it was undertaking of the VAT treatment of financial services and insurance. It is only now, several years later, that HMRC has revived its initial proposal to amend UK VAT law so as implement the Arthur Andersen decision, upon its having become clear that that Commission review is leading nowhere.

It is thought that there would be no difference in principle between the (perfectly proper) course of action which HMRC adopted in that case and that which it is suggested, as explained above, HMRC could adopt if the Commission were to be persuaded to undertake a general review of the treatment of cross-border intra-company activities.

If you would like to discuss any of these issues further, please contact Mike Lane at mike.lane@slaughterandmay.com or your usual contact at Slaughter and May.

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