KÜFFNER MAUNZ LANGER ZUGMAIER

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KMLZ VAT NEWSLETTER

Holding companies and VAT groups

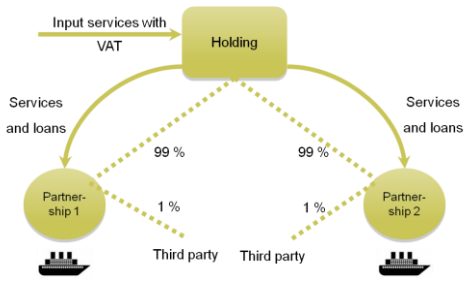
1. Background

The Federal Fiscal Court referred the question to the ECJ of whether a holding company may be entitled to full VAT deduction, as input transactions are partially connected to the non-taxable acquisition and holding of investments. The ECJ objected to this by judgment of 16 July 2015 (C-108/14, C-109/14, *Larentia + Minerva* – see Newsletter 19/2015). The ECJ confirmed that there is a right to fully deduct VAT if the holding company engages in the administration of the subsidiary and therefore generates taxable turnovers.

Regarding another question referred by the Federal Fiscal Court, namely whether a partnership may be a controlled company within the meaning of sec. 2 para. 2 no. 2 German VAT Act, the ECJ decided that this would generally be possible. Something different may apply only if Germany decided to intentionally exclude partnerships as controlled companies in order to prevent tax fraud. This would have to be examined by the national court (see Newsletter 18/2015).

Then came the XI Senate's turn to apply the ECJ's regulations to the case at hand. This was quite interesting, as the Federal Fiscal Court's V Senate had previously attempted to apply the regulations to national law. The V Senate concluded, by judgments of 2 December 2015, that partnerships may be included in VAT groups if the partners of the said partnerships (alongside the controlling companies) are persons who are financially bound to the business of the controlling company in accordance with sec. 2 para. 2 no. 2 German VAT Act (see Newsletter 2/2016).

2. Facts



VAT deduction for holding companies in jeopardy

By judgment of 19 January 2016 (XI R 38/12), the XI Senate of the Federal Fiscal Court handed down its decision for the ECJ-proceedings *Larentia + Minerva*. The judgment deals with questions regarding VAT deduction for holding companies and VAT groups. The XI Senate follows the V Senate (judgment of 2 January 2015, V R 25/13) in recognizing partnerships as potential controlled companies. This is a pleasing development. It is also positive that "pure" holding companies are entitled to full VAT deduction. However, there is one small drawback as VAT exempt financial transactions may restrict VAT deduction. Clearing accounts and cash pools may develop into a VAT problem.

The plaintiff was a holding company in the legal form of a stock company. The plaintiff was a limited partner for several partnerships and respectively held more than 99% of the shares. Another limited partner was a third party. The stock company rendered management services against payment to the partnerships and earned interest with respect to loans that were granted. The stock company additionally earned interest from investments held at credit institutions. VAT deduction from incoming invoices in connection with capital increase was in dispute.

3. VAT deduction for holding companies

As there were supplies rendered to both of the partnerships against payment, this company was an economically active holding company. The Federal Fiscal Court followed the regulations of the ECJ and granted the right to fully deduct VAT. The Federal Fiscal Court did not stick to its previous opinion that VAT may only be partially deducted as capital procurement in connection with the (non-economic) holding of investments. VAT may be deducted from these general costs. This statement is very positive. Tax offices are now no longer in a position to require proof that these costs are connected to an economic activity.

What is not so positive is the restriction of VAT deduction on a second step. According to the Federal Fiscal Court, it should be considered whether VAT deduction is to be denied with respect to interest derived income, as this type of income constitutes VAT exempt transactions within the meaning of sec. 4 no. 8 German VAT Act which exclude VAT deduction in accordance with sec. 15 para.2 German VAT Act. Something different would only apply if the transactions were "incidental transactions", which can be disregarded due to the simplification rule of sec. 43 no. 3 German VAT Implementation Code.

However, in the case at hand, the ECJ dismissed the assumption of incidental transaction. In this case, it was irrelevant what the relationship between the interest derived income and the transaction from the main activity was. What was decisive for the dismissal of incidental transactions was the fact that, according to the findings of the tax court, the interest income was part of the main activity of the holding company. The object of the company was the acquisition and administration of financial assets. In this respect, the Federal Fiscal Court referred to the fact-finding "on page 4 of the tax-court's judgment". Therefore, it remains unclear whether the Federal Fiscal Court made its decision based on the object of the company in the statutes or the daily common practice of the company.

What does this mean for the practice?

- It is evident that one may avoid the restrictions of VAT deduction by opting for VAT in accordance with sec. 9 German VAT Act regarding interest income for group-internal transactions. This can also be done at a later stage. However, it is necessary to have the respective invoices. It is only possible to opt for VAT for supplies to foreign subsidiaries if the foreign law allows such option for VAT. This is not the case in most of the Member States.
- Another way out of the dilemma might be that, in the case at hand, the transactions are actually seen as incidental transactions. A precondition would be that the financial assets are not part of the company's purpose.
- The issue may also be solved by forming a VAT group. The derived interest income would then not be regarded as taxable internal turnover.

In addition, companies can refer to the judgments of the tax court Hamburg of 4 September 1997 (II 117/96) and 10 December 2012 (2 K 189/10). According to this case law, it is justifiable to waive input tax reductions due to sec. 43 no. 3 German VAT Implementation Code and Art. 174 para. 2c VAT Directive. However, the present handling should be examined. The fiscal authorities would do well to publish an application bulletin with a transitional arrangement.

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4. VAT groups

The Federal Fiscal Court follows the case law of the V Senate and concludes that, although the wording of sec. 2 para. 2 no. 2 German VAT Act only states legal persons, a partnership may well be a potential controlled company. It justifies this by the interpretation of the term “legal person” in conformity with the directive. The V Senate has come to the same conclusions, however with the “trick“ of teleological extension. This extension is only possible if the partners of the partnerships (alongside the controlling companies) are persons who are financially bound to the business of the controlling company in accordance with sec. 2 para. 2 no. 2 German VAT Act. The XI Senate does not make this additional restriction. In this regard, the XI Senate simply finds that the interpretation, in conformity with the directive, is possible for capitalistically structured partnerships. This is not only demanded by the principle of neutrality, in terms of legal form, but also by the case law of the German Constitutional Court and the German Federal Administrative Court, which have also applied this interpretation in other cases.

The XI Senate affirms that it does not deviate from the case law of the V Senate with this judgment but from the justification. This is true at first glance, nevertheless it should be noted that the stock company only held 99% of the shares in the case at hand and that there was a third party with a minimum-share, who was not financially bound to the company. However, we believe that this does make a difference. Naturally it was expected by the “tax users“ that the VAT Senates would provide uniformity in their decisions. Unfortunately, this was not the case. Therefore, the situation will remain suspenseful and now it is, once again, the turn of the Federal Ministry of Finance. According to what we have heard, the Federal Ministry of Finance is currently refining a circular on this matter.

However, will the circular actually help? There will only be legal certainty for every party involved if the legislator finally provides VAT groups with the right of application as well as a determination procedure. The timing is right for this step. The Federal Fiscal Court provided a good opportunity to do so with its judgment of 2 December 2015 (V R 15/14) and found this option to be consistent with Union law. The findings of the Federal Fiscal Court regarding the criterion for organizational integration are also worth noting. As we know, the V Senate found that there usually needs to be personnel interweavement via the management board of the partnership. There is only integration if the right to intervene exists. The V Senate explicitly ruled out the possibility of expanding VAT groups to only closely connected persons on the grounds of Union law.

The practice will be happy to know that the XI Senate does not share such a narrow point of view. It left the question open due to missing actual findings of the tax court. It simply referred to the advocate-general's opinion, which finds a strict over- and subordination relationship to be critical.

Companies may still hope that group policies are sufficient for the organizational integration. It is not common practice to have the same representatives sitting on the management boards in a corporate structure. The implementation of decisions is also possible by other means. This can also be seen in the practical application: If a managing director of a subsidiary does not stick to the corporate guidelines, he will not continue to be managing director of the subsidiary. Therefore, it would be a good thing to bring a little bit more sense of proportion into this discussion.