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VAT'S UP

VAT NEWSLETTER

Federal Ministry of Finance on the input VAT deduction of shareholders and pre-foundation companies

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1 Background

In principle, input VAT deduction is only granted if the supplies received are directly related to one's own taxable transactions or are at least included in these as a price component. In practice, prior to the incorporation, shareholders or so-called pre-incorporation companies often purchase supplies that the later company will benefit from. In these cases, the ECJ and the German Federal Fiscal Court exceptionally allow the shareholder (or the pre-incorporation company), who is actually not a taxable person, the right to deduct input VAT under certain conditions. However, the German tax authorities have not yet applied this case law.

2 Federal Fiscal Court's decision of 11 November 2015 (V R 8/15) and ECJ decisions

The ECJ already ruled in 2004 and 2012 in the respective cases of *Faxworld* (C-137/02) and *Polski Trawertyn* (C-280/10), that shareholders can claim input VAT in connection with non-taxable transactions to companies. In contrast, the ECJ denied the right to deduct input VAT in the *Malburg* case (C-204/13), in which a shareholder had acquired a company's client base and subsequently transferred it free of charge to a new company. The free letting was not an economic activity, meaning that it did not constitute preparatory activity in terms of the new company.

The German Federal Fiscal Court adopted the ECJ principles in its judgment of 11 November 2015 (V R 8/15). The plaintiff intended to take up a taxable activity via a German limited liability company (GmbH) and received consultancy services for setting up the business, as well as for the planned acquisition of a company. However, the establishment of the company was not ultimately realised. The German Federal Fiscal Court denied a right to deduct input VAT on the grounds that the

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services received were not transferable to the German limited liability company to be founded. Rather, transferable assets ("capital goods") would have to be created for the company.

3 Letter of the German Federal Ministry of Finance of 12 April 2022

In a letter of 12 April 2022, the German Federal Ministry of Finance declares the German Federal Fiscal Court's ruling of 11 November 2015 and the associated ECJ case law principles to be generally applicable. A new paragraph 4 has been added to section 15.2b of the German VAT Circular.

In the case of transfers outside the scope of VAT, the right to deduct input VAT exists if, from the perspective of the (planned) company, the supply is an investment transaction and the company is generally entitled to deduct input VAT. Both, supplies of goods and services, can qualify as investment transactions. However, a distinction must be made between services that generally cannot be transferred to the company but are used or consumed by the shareholder or the pre-incorporation company itself, and those which are used by the company but not transferred to it.

If the planned company formation fails, this does not affect the input VAT deduction. Private consumption or resale subsequently constitute taxable supplies without consideration or taxable auxiliary transactions.

4 Consequences for the practice

The new administrative guidelines give rise to mixed feelings. On the one hand, it is positive that the principles of the relevant case law have now been adopted by the tax authorities. On the other hand, the scope of application is too narrow due to the required investment transaction of the company. Further, the resulting differentiation issues are complex.

Both the German Federal Fiscal Court and the German Federal Ministry of Finance fail to recognise that the ECJ does not necessarily require an investment transaction. Insofar as an investment transaction was the subject of the case, this fact was not decisive. In the *Faxworld* case, for example, the rental agreement had already been at least partially consumed by the pre-founding company. It remains unclear, and thus open to dispute, which services cannot generally be transferred to the company and when consumption by the shareholder is harmful for the deduction of input VAT.

The fact that the (unsuccessful) founder of a corporation is denied the right to deduct input VAT for consultancy services is, for several reasons, not convincing. Firstly, this leads to unequal treatment vis-à-vis a sole trader, who would certainly be granted the deduction right. Secondly, the result disregards the consumption tax character of VAT. This is because these expenses do not affect the shareholder's consumption sphere and should therefore not lead to a tax burden.

If possible, shareholders are advised to provide services to their company for consideration themselves. This can secure the input VAT deduction by virtue of their own status as a taxable person. However, in some constellations - such as the one in the German Federal Fiscal Court case - this would probably lead to the foundation of a VAT group relationship with the corresponding liability consequences.

The German Federal Ministry of Finance's letter is to be applied in all open cases. Shareholders and pre-founding companies that have been denied the right to deduct input VAT should immediately check whether an input VAT deduction can still be applied for.

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