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VAT: Cross border pro rata applies to costs incurred by fixed establishment

On October 3, 2018, the Opinion issued by the Advocate General ('AG') to the Court of Justice of the European Union ('CJEU') in the Morgan Stanley & Co International plc ('Morgan Stanley') case (case no. C-165/17) was published. This case concerns the VAT recovery of costs incurred by a fixed establishment that are also used for the activities of a foreign head office. The AG concluded that a pro rata recovery right must be applied to such costs. This cross border pro rata must be calculated on the basis of both the activities of the fixed establishment and the activities of the head office. To this end, VAT can only be recovered if turnover for which there is a VAT recovery right is generated according to the standards of the fixed establishment's country of residence and according to the standards of the head office's country of residence.

The case

Morgan Stanley has its head office in the United Kingdom ('UK head office') and a branch in France ('French fixed establishment'). The French fixed establishment performs VAT taxed banking and financial services for its French clients. It is possible to charge VAT on these services due to an option-to-tax rule under French VAT legislation. The French fixed establishment also performs activities for the UK head office, which are not subject to VAT because these take place within the same legal entity.

The French fixed establishment fully recovered the VAT on the costs it incurred, also insofar as all or part of these costs were used for activities of the head office. Morgan Stanley believed that the activities for the UK head office had to be ignored, which meant that for the purposes of calculating the right to recovery, only the French-sourced turnover remained which allowed VAT recovery.

Following a tax audit, the French tax authorities stated that the French fixed establishment's VAT recovery on costs must be corrected insofar as these costs were also used for activities performed by the UK head office. The UK head office does not have full VAT recovery entitlement, but applies a pro rata. This case was taken to the French court, which requested the CJEU for a preliminary ruling on, in short, the following issues.

1. ***Cost category 1 (costs used by the head office)***
   The right to recover VAT on the costs incurred by the French fixed establishment that are solely used by the UK head office. Does the French fixed establishment have to recover this VAT in accordance with:
   a) the pro rata of the French fixed establishment;
   b) the pro rata of the UK head office; or
   c) a combined recovery right?

2. ***Cost category 2 (costs used by the head office and the fixed establishment)***
   The right to recover VAT on the costs incurred by the French fixed establishment that are used for both this fixed establishment and for the UK head office for their banking and financial services to third parties. What is the extent of the VAT recovery entitlement?

Analysis

The AG assumed that the UK head office and the French fixed establishment are a single taxpayer for VAT purposes. According to the AG, the activities (cost recharges) by the French fixed establishment to the head office are not relevant for VAT purposes. However, the AG concluded on the basis of earlier decisions rendered in the ESET case (case no. C-393/15) that VAT recovery right for such irrelevant activities cannot automatically be refused (cost category 1).

The AG emphasized that it is wrong to determine the recovery right for cost category 1 and 2 solely on the basis of the activities of the French fixed establishment as this does not correspond to the ultimate destination or the use of the expenditure. The AG indicated that a pro rata recovery rate must be determined which takes account of both the activities of the UK head office and the French fixed establishment. This pro rata recovery rate should apply to both cost category 1 and 2.

The AG briefly explained how such a pro rata recovery rate must be determined. We understand from the AG's Opinion that he believes that the turnover of the French fixed establishment must be included in full in the turnover that gives a right to recover VAT. The AG appears to use a double test with regard to the turnover of the UK head office. In the pro rata recovery calculation, the head office turnover is only regarded as turnover that gives rise to VAT recovery if this turnover would give a right to recover VAT under both the UK VAT rules and the French VAT rules. This double test applies to both cost category 1 and 2.

The AG qualifies the impact of the Le Crédit Lyonnais judgment (case no. C-388/12). In that judgment the CJEU concluded that the French head office was not allowed to include turnover originating from fixed establishments in the pro rata recovery calculation. In practice, this raised the question whether a pro rata recovery calculation is always geographically constrained. Based on the AG's Opinion in Morgan Stanley, this does not appear to be the case and should probably be approached more casuistically. The AG argued that an important difference between the Morgan Stanley case and the Le Crédit Lyonnais case is that in the latter the relationship between the costs of the head office and the turnover of a fixed establishment is not certain. This is certain in Morgan Stanley. Another difference between the two cases is that the judgment in the Le Crédit Lyonnais case was specifically rendered in the context of the possibility, as implemented by France, to determine the pro rata recovery right on the basis of sectors. A sector based approach does not appear to apply to the Morgan Stanley case.

Practical consequences

Using the aforementioned double test in cross border situations can have a disruptive effect. We understand from the AG's Opinion that for the purposes of VAT recovery entitlement it makes a difference in which Member State the costs arise. In this respect, a proportion of a potential VAT recovery limitation can probably be avoided by directly incurring the costs in the country where the establishment is located which undertakes

the activities to which the costs relate. After all, if in the Morgan Stanley case the costs had arisen directly in the United Kingdom, the VAT recovery entitlement would only have to be assessed on the basis of UK standards. Taxpayers are not always free to choose the location where costs are reported for VAT purposes, but this can to some extent be managed.

The Morgan Stanley case covers the years 2002-2009. The question that can be asked here is whether the double test applied by the AG is still entirely appropriate in light of the place of supply rules in B2B situations, which are in force since 2010, and the trend towards taxation of services in the country where they are used. The EU VAT Implementing Regulation applying as of July 1, 2011, dictates that as a starting point the nature of services and their use must be the basis for determining the establishment that should be regarded as the customer. This means that the standard B2B services could possibly fall outside cost category 1, because these may be regarded as having been purchased by the UK head office.

Furthermore, including the turnover of the UK head office in the pro rata recovery calculation of the French fixed establishment can have a disruptive effect. If the turnover of the UK head office is a multitude of the turnover of the French fixed establishment, then the UK head office can have a disproportionately large influence on the outcome of the pro rata recovery calculation. This is especially the case if the general costs incurred are in fact mostly related to activities of the French fixed establishment itself.

The potential recovery limitation caused by applying a pro rata at the entity level can probably be avoided by allocating expenditure as much as possible directly to turnover with a right to recover input VAT. The AG's Opinion is leaves room for such a conclusion. Furthermore, in his Opinion the AG does not address the principle of actual use by, for example, the head office (or a business unit), if no direct attribution takes place. Within the Dutch (and broader European) context, the principle of actual use could offer an alternative to a pro rata recovery calculation.

The policy of the Dutch Ministry of Finance already offers the possibility of a pro rata at the entity level, as well as direct attribution and actual use. After the Le Crédit Lyonnais case, a pro rata at the entity level was however often rejected in practice. Whether a pro rata at the entity level has actually been given a new lease of life can only be answered with certainty after the CJEU renders its judgment.

Besides the question whether a pro rata must be calculated at the entity level, other questions also play a role in practice. For example, the situation where the head office or the fixed establishment is part of a VAT group. The Skandia (C-7/13) decision is relevant here. These questions will probably also remain unanswered after the CJEU judgment in the Morgan Stanley case.

In practice we notice that more attention is being paid to the manner in which the right to recover VAT must be calculated, also on the part of the Dutch tax authorities. This applies in a wider sense to more than just head office-fixed establishment situations. It

is therefore advisable to more broadly examine the manner in which the recovery right is determined and, where necessary, undertake further analysis.

The tax advisors of Meijburg & Co's Indirect Tax Financial Services Group would be pleased to help you identify the potential implications of this Opinion and the subsequent CJEU judgment. Please feel free to contact one of them or your regular contact at Meijburg & Co.

Meijburg & Co
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