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CJEU: no VAT deduction for 'setting aside' raised capital after unsuccessful acquisition of a participation

On November 12, 2020, the Court of Justice of the European Union (hereinafter: CJEU) rendered judgment in the Sonaecom case (C-42/19). The CJEU followed the Opinion issued by Advocate General Kokott (hereinafter: AG) and ruled that VAT may be deducted on purchased services in the event of a proposed but unrealized share acquisition. Furthermore, the CJEU confirmed that the 'setting aside' of capital in the form of a provided interest-bearing loan results in a VAT deduction limitation on the associated costs. Due to the corona crisis, many acquisition processes have been put on hold for a while. The negotiations have not, for example, been definitely terminated, but parties remain in discussion with one another. Even without a crisis, an acquisition or investment may be postponed for a certain period. It is then important for the investing party to anticipate the VAT implications of the temporary postponement of the transaction and, in particular, the manner in which the investor temporarily sets aside the raised capital.

1. Background

Sonaecom is a Portuguese holding company involved with the acquisition, holding and management of participations. In 2005 it wished to acquire the shares in Cabovisão, so that it could subsequently perform management services for it for a fee. Sonaecom had market research performed with a view to the acquisition. In addition, it engaged an investment bank to effectuate a bond issue, so that the capital raised from this could be used to acquire the shares in Cabovisão. Sonaecom fully deducted the VAT charged on the professional services and on the commission to the investment bank.

The shares in Cabovisão were ultimately not acquired. In the meantime, Sonaecom set the raised capital aside by providing an interest-bearing loan to its parent company. The Portuguese tax authorities took the position that Sonaecom should not have deducted the VAT on both the professional services provided and the commission paid to the investment bank, because the costs were not incurred for VAT-taxed transactions. The Portuguese court decided to ask the CJEU for a preliminary ruling on the deductibility of the VAT on these costs.

2. CJEU considerations and ruling

Just like AG Kokott, the CJEU first established that Sonaecom is a mixed holding company. For VAT purposes, it performs both economic activities (management services to participations in exchange for a fee) and non-economic activities (the passive holding of participations). Besides the intention to acquire the shares in Cabovisão, Sonaecom also intended to provide VAT-taxed services to this (potential future) subsidiary in exchange for a fee.

The basic assumption is that there is no VAT recovery right if only non-economic activities, such as the *passive* acquisition and holding of shares, are performed. Only as soon as a holding company performs VAT-taxed services for its participation, or intends

to do so, is there the *active* holding of shares and the VAT on the attributable costs is thus deductible.

The CJEU then addressed the amount of the VAT deduction on the professional services. Contrary to the AG's conclusion, the CJEU ruled that the professional services (market research) concern general overhead and are therefore not regarded as direct costs. According to the CJEU, there is no direct link between the VAT-taxed services performed by the holding company and the participation.

These costs are thus related to the overall business activity of Sonaecom. The CJEU clarified as such its earlier judgment in the Ryanair case (C-249/17). In that judgment the CJEU ruled that the VAT recovery on professional services for an unsuccessful acquisition is, in principle, permitted, but it was not entirely clear whether the CJEU regarded these services as direct costs or general overhead. The CJEU has now clarified that these costs are general overhead. In that case, the VAT recovery right is determined by the overall business activity of a holding company.

Lastly, the CJEU addressed the VAT deduction of commission paid to the investment bank for effectuating a bond issue. The CJEU considered whether for the purposes of the VAT recovery right on the commission the *proposed* VAT-taxed use or the *actual* VAT-exempt use of the capital is decisive. Sonaecom initially intended to use the capital raised with the bond issue to acquire Cabovisão (the future participation). When this did not proceed, Sonaecom set the capital aside by providing an interest-bearing loan to its parent company: a VAT-exempt activity. The CJEU confirmed, in accordance with the AG, that the *actual* use of the services is decisive for the VAT recovery right. According to the CJEU, because the services were actually used for a VAT-exempt activity, the VAT on the paid commission is non-deductible.

3. Dutch practice and options for VAT deduction

Current Dutch practice with regard to the VAT deduction on professional services for a proposed acquisition of a participation is in line with the CJEU's ruling in this case. The ultimate VAT recovery right for these costs is also in Dutch practice generally determined on the basis of the overall business activities of the holding company, provided the holding company intends to perform VAT-taxed services to the intended participation.

With regard to the VAT on professional services for the raising of capital (such as by an investment bank), we have the following comments.

Secure the VAT deduction for capital temporarily set aside
If, due to unforeseen circumstances, the capital raised cannot be immediately invested, there are options available to secure the VAT deduction on professional services as much as possible in anticipation of a new investment. If there are commercial considerations, then we see the following options:

1. The company that raised the capital provides an interest-bearing loan to a group company with which it forms a VAT group. The VAT group performs VAT-taxed services.
2. The company that raised the capital provides an interest-bearing loan to a group company that is established outside the European Union (as of January 1, 2021 the United Kingdom also falls under this).
3. The capital is held in order to realize the acquisition of a participation at a later date, to which VAT-taxed services will be provided. In that case it is crucial that you are able to convincingly demonstrate with objective documentation that this intention does indeed exist.

VAT exemption in the Netherlands on commission for a financial institution
The commission paid to a financial institution for arranging and effectuating a bond issue would be VAT-exempt in the Netherlands, unlike apparently in the Sonaecom case. This means that any non-deductible VAT on such commission paid to a financial institution should not be an issue in the Netherlands.

4. What can you do now?

If the intended acquisition of a participation cannot be realized, for example due to the corona crisis, we recommend that you examine the VAT implications of this in more detail. In a broader sense, this also applies to other situations in which a company raises capital for an investment in the VAT-taxed sphere, but where circumstances cause the investment to be postponed. Depending on the manner in which that raised capital is temporarily set aside, this may have significant implications for the exercised VAT recovery right. Despite the CJEU judgment in the Sonaecom case, there are various options available to arrive at a full or more optimal VAT deduction on professional services.

If you would like to discuss this judgment and/or in a broader sense the strategy that you can develop for the purposes of acquisitions and takeovers, feel free to contact the advisors of Meijburg & Co's Indirect Tax Group or your usual advisor.

Meijburg & Co
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