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VAT: Recovery right on the basis of cross-border use costs

On January 24, 2019, the Court of Justice of the European Union ('CJEU') rendered its judgment in the Morgan Stanley & Co International plc ('Morgan Stanley') case (case no. C-165/17). This case concerns the VAT recovery of costs incurred by a fixed establishment that are also used for the turnover of a foreign head office. In answer to the question how the VAT recovery on such costs should be calculated, the CJEU replied that the turnover of the foreign head office should be taken into account. Depending on the use made of the costs, the recovery right should be calculated on the basis of the turnover of the fixed establishment and/or the turnover of the head office. VAT can only be recovered if turnover is generated, for which there is a VAT recovery right, according to both the VAT rules of the head office's country of residence and the VAT rules of the fixed establishment's country of residence. The judgment differs from Dutch practice on a number of points.

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 under French VAT legislation (French implementation of Article 137(1)(a) of the VAT Directive). The French fixed establishment also performs (internal) 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 by the head office, for both turnover that gives a right to recover as well as turnover for which there is no recovery right ('mixed use'). Morgan Stanley believed that the activities for the UK head office had to be ignored, which meant that for the purposes of calculating the recovery right, only the French-sourced turnover would remain, on the basis of which there would be a (full) VAT recovery right.

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 turnover realized by the UK head office. This head office does not have a full VAT recovery right, but applies a pro rata recovery right. This case was taken to the French court, which ultimately requested the CJEU for a preliminary ruling. In short, this includes the following:

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 recovery right of the French fixed establishment;
   b) the pro rata recovery right of the UK head office; or
   c) a combined recovery right?
   The CJEU was also asked to take the French option-to-tax into account.

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 CJEU assumed that the UK head office and the French fixed establishment are a single taxpayer for VAT purposes. The internal activities ('cost recharges') of the French fixed establishment to the UK head office are therefore not relevant for VAT purposes. When determining the VAT recovery right on costs incurred by the French fixed establishment, account must be taken of the taxpayer's external turnover, including the turnover of the foreign head office.

The CJEU therefore ruled that it is wrong to determine the recovery right for cost category 1 and 2 solely on the basis of the external activities of the French fixed establishment. This would not correspond to the ultimate use of the costs because category 1 costs involve mixed use by the UK head office. The ultimate use of the category 2 costs lies with both the UK head office and the French fixed establishment.

The VAT Directive provides that the recovery on mixed-use costs is determined on the basis of the total turnover generated by the taxpayer. For cost category 1, however, the CJEU only examined a part of the UK head office's turnover. This concerns the part of the (taxed and exempt) turnover of the UK head office, for which the costs of the French branch are used. Turnover generated by the UK head office on activities not related to the costs of the French fixed establishment should not be included in the recovery calculation. Effectively this results in a partial pro rata.

The CJEU ruled that for cost category 2 the pro rata recovery rate must be determined on the basis of the turnover of both the French fixed establishment and the UK head office. On the basis of the CJEU's judgment, it is not clear whether the total French and UK turnover should be included in the pro rata calculation or only that part of the turnover for which the French branch incurred the costs.

The CJEU applies a double test when qualifying the turnover of the UK head office. The UK head office turnover is in the first instance only regarded as turnover with a right to recover input VAT if this turnover would give a right to recover VAT under the UK VAT rules. Moreover, the UK turnover should also give rise to a right to recover VAT under the French VAT rules, taking the option-to-tax into account. This double test applies to both cost category 1 and 2.

In this case, the CJEU qualifies the impact of the Le Crédit Lyonnais judgment (case no. C-388/12) in which it ruled that a French head office was not allowed to include turnover originating from foreign fixed establishments in the pro rata recovery calculation. In

practice, this raised the question whether a pro rata recovery calculation is always geographically constrained. This does not appear to be the case and should be approached more casuistically. The CJEU concluded that the Le Crédit Lyonnais judgment does not rule out the turnover of foreign branches being taken into account when determining the recovery right. The CJEU 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 the Morgan Stanley case.

Practical consequences

The CJEU judgment differs from Dutch practice on a number of points. In order to determine the VAT recovery of costs of a taxpayer with establishments in more than one country, the CJEU seeks to reconcile the cross-border use of those costs. From the perspective that this leads to a recovery that is more in line with the use of the costs, this is positive, but it also makes the recovery calculation more complex. The standard practice in the Netherlands is that a local pro rata recovery right is determined, which is applied to all local mixed-use costs. On the basis of Dutch policy, the turnover of a taxpayer's foreign establishments is (also) of importance when determining the recovery right if the local costs are (also) used for the foreign establishments' turnover. Following the Le Crédit Lyonnais case, a cross-border pro rata at the entity level was often rejected in practice, however. The CJEU has now expressly kept this possibility open.

If costs are only mixed used for part of the turnover, the CJEU appears to be of the opinion that a partial pro rata must be determined in accordance with this mixed use. In this respect, (part of) the foreign turnover may be a contributory factor. What is new is that the CJEU bases this on the VAT Directive's general provisions concerning the recovery of VAT on mixed-use costs, which prescribe that a total turnover must be calculated on a pro rata basis, and not on the special recovery rules concerning actual use and sector pro rata, which can optionally be implemented by Member States. The CJEU's description is so broad that it may be necessary to extend this line to other situations. The position of the Dutch tax authorities not to allow any partial pro rata may need to be put into perspective.

Another important point of attention is the use of a double test. This could seriously limit the recovery of VAT in cross-border situations. This double test is not currently used in Dutch practice, and in many other countries, because it does not follow literally from the text of the VAT Directive. For the purposes of the recovery right, it will then not only be relevant in which Member State the costs are incurred, but also where the turnover is generated. It is unclear what the effect will be if not two but three or more countries are involved.

If a taxpayer has branches in several countries, a proportion of a potential recovery limitation in this respect can probably be avoided by directly incurring the costs in the country of the establishment where the costs are used locally. If in the Morgan Stanley case the costs had been incurred directly in the United Kingdom, where turnover was

generated from local customers, no double test would have been involved. 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 EU VAT Implementing Regulation applying as of July 1, 2011 stipulates that, as a starting point, the nature of services and their use must serve as the basis for determining the establishment that should be regarded as the customer. Cost category 1 possibly occurs less frequently, as they can be considered to have been purchased by the UK head office.

Incidentally, the CJEU pays no attention to the situation where the head office and/or a fixed establishment is part of a fiscal unity. The Skandia (C-7/13) case is relevant here. Furthermore, the impact of non-EU branches is not addressed.

In both practice and case law we notice that more attention is being paid to the manner in which the right to recover VAT must be calculated. This applies in a wider sense to more than just head office-fixed establishment situations. It is therefore advisable to examine the manner in which the recovery right is determined and, where necessary, perform 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 judgment. Feel free to contact one of these tax advisors or your regular contact for more information.

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