tax notes international

Volume 69, Number 11 ■ March 18, 2013

ECJ Advocate General Issues Opinion in French VAT Case

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Reprinted from *Tax Notes Int'l*, March 18, 2013, p. 1012

COUNTRY DIGEST

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Advocate General Cruz Villalón of the European Court of Justice on February 28 issued his opinion in *Crédit Lyonnais* (C-388/11), a French case on the VAT treatment of income from foreign branches. (The opinion has not been published in English.)

The French Administrative Supreme Court had submitted a reference for a preliminary ruling by the ECJ in the *Crédit Lyonnais* case, asking several questions about the calculation of the VAT-deductible proportion of the bank's income tax liability and the inclusion of its overseas branches' turnover in light of the interpretation of the neutrality principle.

Case Background

Following a tax audit covering the period from January 1, 1988, to December 31, 1989, the company Le Crédit Lyonnais (LCL), which is headquartered in France, has been reassessed for VAT and payroll tax on the basis that it wrongly took into account the amount of interest on loans to its branches in other EU member states or in third countries in the VAT-deductible proportion of its taxable income referred to in article 212 of Annex II of the French Tax Code.

The Administrative Court of Appeal of Paris on December 8, 2006, held that LCL's branches in other member states were themselves subject to VAT and had already calculated their revenues to determine their own deductible proportion of VAT. The court also held that the operations performed by LCL's branches in third countries could not be taken into consideration for purposes of LCL's VAT deduction because these branches could either be VAT exempt or subject to other rules.

LCL appealed the court's decision before the Administrative Supreme Court on February 21, 2007, and on July 11, 2011, that court suspended the proceedings and referred the following questions to the ECJ:

- As they apply to the rules on the territorial scope of VAT, can articles 17(2) and (5) and 19 of Sixth VAT Directive 77/388/EEC be interpreted as meaning that in calculating the deductible proportion for which they provide, the principal establishment of an EU resident company must take into account the income of each of its branches in another member state and, correspondingly, those branches must take into account the parent company's aggregate income falling within the scope of VAT?
- Does the same requirement apply for branches established outside the European Union, particularly in light of the right to deduct provided by article 17(3)(a) and (c) for banking and financial operations referred to in article 13B(d)(1) to (5) of the directive, which are carried out for the benefit of customers established outside the EU?
- Might the answer to the first two questions vary from one member state to another, depending on the options made available by the last subparagraph of article 17(5) of the directive, particularly regarding the establishment of different sectors of business?
- If the answer to either of the first questions is yes:
  - — is it appropriate to limit the application of that kind of deductible proportion to the calculation of deductible VAT charged on expenses incurred by the principal establishment for the benefit of foreign branches; and
  - — must income obtained abroad be taken into account in accordance with the rules applicable in the member state of the branch or in the member state of the principal establishment?

In essence, the referring court asked the ECJ whether (first and second questions), and if so, to what extent (third and fourth questions), the Sixth VAT Directive requires member states to apply the ''worldwide VAT deductible proportion'' — that is, the deductible proportion of VAT (as provided by articles 17, paragraph 5, and 19 of the directive) of the headquarters of a company established in a member state — by taking into account for purposes of its tax obligations in that member state, the turnover of its branches established in other member states or in third countries (and vice versa).

In the context of this case, LCL essentially argued that the principle of neutrality inherent in the common system of VAT established by the Sixth VAT Directive provides for the full recognition of the worldwide VAT-deductible proportion.

In essence, LCL argued that the application of the case law in *FCE Bank* (C-210/04) indicates, in principle, a loss of the right to deduct VAT on goods and services acquired upstream by the headquarters of a company each time those goods and services are used for the purposes of taxable transactions carried on downstream by the branches of that company that are established in other member states. Indeed, if the headquarters cannot invoice the goods and services provided to the branches, then according to *FCE Bank* case law, the branches cannot deduct the VAT paid in advance by the headquarters company for which they are liable on their downstream taxable transactions. Only the VAT incurred by the branches themselves in their own member state of establishment could thus be deducted.

LCL concluded that in order to prevent the nondeductibility of VAT, which is contrary to the principle of VAT neutrality, a company whose headquarters performs both taxable transactions and transactions that are not eligible for deduction should, under article 17, paragraph 5 of the Sixth VAT Directive, be able to take into account all the transactions conducted by the headquarters in its member state of establishment when computing its deductible proportion of VAT on costs relating to its taxable transactions.

Advocate General's Opinion

In his February 28 opinion, the advocate general said the *FCE Bank* case law shows that if: (a) a company that has its principal place of business in a member state (FCE Bank) and a branch in another member state (FCE IT) that does not perform any independent economic activity, and (b) the headquarters provides goods or services to the branch in the other member state, the two companies are a single taxpayer in their reciprocal relationship. Therefore, any services provided by the headquarters to the branch cannot be described as ''services for consideration'' within the meaning of article 2 of the Sixth VAT Directive and are not subject to VAT in the member state of the branch.

Indeed, according to ECJ case law, a service is subject to VAT only if there is a legal relationship between the provider and the recipient. However, such a legal relationship cannot exist between the headquarters and its branch if the branch does not perform an independent economic activity.

However, in *FCE Bank*, the ECJ determined only that the operations performed by the headquarters with its various branches should be considered as internal operations. Thus, even if the judgment in *FCE Bank* excludes the possibility of deducting VAT on the expenditures made by a headquarters company established in a member state when the goods or services are used for the operations of its branches in other member states, it does not provide a response — expressed or implied — to the main question raised in *Crédit Lyonnais*, namely, whether such a company must take into account both the turnover of the headquarters and the turnover of its branches in order to calculate its deductible proportion of VAT within the meaning of articles 17, paragraph 5, and 19 of the Sixth VAT Directive.

Contrary to LCL's claim, it cannot be argued that the exclusion of the branches' turnover could lead to a breach of equal treatment (itself contrary to the principle of neutrality) between companies, depending on whether:

- the companies have branches only in their member state of establishment;
- they have branches in other member states; or
- they have both branches and subsidiaries.

A company that has its headquarters and branches in a single member state is not in the same situation as a company with branches in other member states. The former is taxable in only one member state and therefore falls within the territorial scope of that member state's VAT legislation, while the latter is taxable in all the member states where it has a branch and falls within the territorial scope of each of those member states' VAT legislation.

Moreover, a company with branches is not in the same situation as a company with subsidiaries. As the ECJ has already pointed out, legal independent entities that are closely linked on the financial, economic, and organizational fronts can be considered as a single taxable person only when they are established in the territory of a single member state, in accordance with article 4, paragraph 4 of the Sixth VAT Directive.

Finally, the ECJ has also already emphasized that taxable companies are free to choose the organizational structures and transactional terms they consider to be the most appropriate for their business and for limiting their tax burdens, which includes the setting up and allocation of group expenses.

Therefore, in answer to the first question asked by the referring court, the advocate general said articles 17, paragraphs 2 and 5, and 19 of the Sixth VAT Directive must be interpreted as meaning that member states are not required to provide that the turnover of a company's branches in other member states be taken into account in the calculation of company's VAT-deductible proportion.

In answer to the second question, the advocate general said that its answer to the first question relating to branches established in other member states also applies to branches established in third countries.

Given the answers to the first two questions, it was not necessary to answer the third and fourth questions. ◆

♦ *Sophie Borenstein, partner, Reed Smith, Paris*