Restricting VAT relating to foreign branches incompatible with EU law

Technical Indirect Tax

01 May 2015

Key Points

EU law allows VAT incurred relating to foreign operations to be deducted Changes announced in Budget 2015 would potentially restrict or deny that Apart from the technical issues, draft legislation is not in the interests of the UK

Background

UK VAT legislation allows VAT that has been incurred in making taxable supplies in the UK (input tax) to be deducted (regs 101 and 102). There is a similar provision (reg 103) allowing VAT relating to certain transactions undertaken outside the UK to be deducted. In his 2015 Budget, the Chancellor announced that there would be a change to UK VAT legislation that, in the words of the explanatory memorandum published afterwards, would not allow a partly exempt business to:

'…take into account supplies made from branches outside the UK when calculating how much input tax may be deducted'.

We consider that the proposed change is not compatible with EU law, in particular the clear wording of Principal VAT Directive article 169.

We have further pointed out that implementation of the changes potentially discourages businesses from managing and supporting their foreign branches from a UK hub because of the new VAT cost.

Why does HMRC consider that changes should be made?

The explanatory memorandum refers to the recent Court of Justice case involving *Crédit Lyonnais*. In that case, the court concluded that a partly exempt taxable person could not include the turnover of foreign branches in the amount of turnover used to determine the deductible proportion of input.

In our submission, we agree the court's interpretation and indeed point out that that view is supported by the House of Lords' judgment in the case of *Liverpool Institute for Performing Arts*.

However, we have also pointed out that, in para 21 of the Crédit Lyonnais judgment, the court noted:

'…no useful purpose would be served by ruling in detail on the calculation of the deductible proportions applicable to the branches of that company established outside that member state'.

We also noted that each of the three operative paragraphs of the judgment refer only to the inclusion of the *turnover* of foreign branches in the fraction used for determining the input tax that is deductible. We also note that the judgment is a response to a question about French legislation implementing a turnover-based partial exemption method. It is therefore of only limited assistance in deciding whether UK legislation needs to be changed.

Our technical analysis

We included with our letter to HMRC a short technical analysis of the position.

First, it needs to be recalled that the Court of Justice has repeatedly commented that the right to deduct is a fundamental part of the VAT system that, in principle, cannot be limited. Indeed, in *Crédit Lyonnais* the Court comments at para 27:

'The deduction system is meant to relieve the trader entirely of the burden of the VAT payable or paid in the course of all his economic activities. The common system of VAT consequently ensures complete neutrality of taxation of all economic activities, whatever their purpose or results, provided that they are themselves subject, in principle, to VAT…'

Next, we noted that the basic right to deduct VAT incurred on taxable supplies is set out in Principal VAT Directive article 168, but that article 169 extends an identical right in relation to certain supplies undertaken outside the UK. There is nothing in article 169 that suggests that it does not apply to VAT incurred in supporting foreign branches from the UK or any other EU member state. Indeed, since VAT is intended to be a destination system, it would be anomalous not to grant a deduction for such VAT.

We also noted that it is not possible to treat a foreign branch in the same way as, say, a separate foreign entity operating outside the UK that has no establishment in the UK. Such an entity would be entitled to reclaim VAT incurred in the UK (as long as it held the appropriate VAT invoices) using the refund procedure. However, that procedure cannot be used by a foreign branch that has a head office or indeed any other fellow branch established in the country of claim.

What is the impact of the change?

It is not entirely clear how the amendments would work, but it appears that UK input tax on overheads would be apportioned according to the recovery rate arising from the UK operations, only without regard to the activities in the foreign branches.

That of course could mean that a taxable person could benefit, say, if their UK external income arose from taxable activities in the UK but an EU branch they supported made fully exempt supplies elsewhere. That would seem clearly distortive in the context of the VAT system as a whole and not in line with the result the court was trying to achieve in *Crédit Lyonnais*. In the main, however, it seems likely that businesses organised in branches, such as financial services companies, would suffer additional costs.

As noted, those costs could create an additional burden for a business managing and supporting non-UK branches and this would have an impact on the UK's attractiveness as a base for European and global business.

Our suggestions for action

We suggested to HMRC that it would be appropriate to discuss the changes with representatives of the professions and industries affected. We suggested that it may be that the wording of the legislation does not properly express HMRC's intentions and that arguably one should infer from the *Crédit Lyonnais* case that regs 101 and 102 (but not 103) require a limited amendment dealing with the arbitrary inclusion of overseas branch turnover.

For example, reg 102 permits the adoption of a special method that allows VAT deductible under Principal VAT Directive articles 168 and 169 using a single method. However, in light of the judgment in *Crédit Lyonnais* such a method would not be permitted if the apportionment was being done using turnover.

Conclusion

Our submission has been made to HMRC and is available to view on the CIOT website.