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Case alert

Morgan Stanley & Co International plc

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Summary

This case – a referral to the Court of Justice of the European Union (CJEU) by the French courts – relates to the recovery of input VAT paid by the French branch of a UK business.

The French branch incurred input VAT on costs which were used exclusively by the UK head office establishment. It also incurred input tax on costs in relation to its general overheads. However, the French branch had 'opted to tax' its supplies of financial services in France – (an option not available here in the UK) and, consequently, the branch argued that, under the provisions of the VAT Directive, it was entitled to reclaim all of the above input tax.

The French tax authority had other ideas. It considered that, as the UK head office used the inputs predominantly to make exempt supplies of financial services in the UK, the French branch was only entitled to reclaim a proportion of the VAT incurred on general overheads. As far as the inputs that were wholly used by the UK head office were concerned, the tax authority considered that there was no entitlement to deduct due to the fact that the branch and the head office were components of the same legal entity.

Court of Justice of the European Union – Judgment

Articles 168 and 169 of the VAT Directive provide taxpayers with a right of deduction for VAT incurred on the purchase of goods and services. Provided that the taxpayer's outputs are themselves taxable. Article 168 allows for the recovery of input VAT incurred on supplies received from other taxable persons, on the acquisition of goods from other Member States and on the importation of goods from outside the European Union. Article 169 on the other hand provides a right of recovery where VAT is incurred that relates to transactions made in a different Member State that would be taxable if they were made in the taxpayer's Member State.

In this case, the UK based taxpayer has a French branch that is registered for VAT in France in relation to its taxable supplies of financial services (having opted to tax those services in France). Accordingly, the French branch only makes taxable supplies. The taxpayer took the view that under the provisions of Article 169, its supplies of financial services in the UK would have been taxable supplies had they been made in France and, as a result, it considered that it was entitled to a full deduction of the VAT incurred even though the costs in question were used exclusively by the UK head office in the making of exempt supplies.

The CJEU has issued its judgment and has said that, in the circumstances Article 169 must not be interpreted literally. The Court considers that to exercise the right of deduction granted by Article 169, the taxpayer's supplies must be taxable in both Member States. Accordingly, as the supply of financial services in the UK are exempt from VAT (with no option to tax available), this condition imposed by the Court is not met. The Court considers that an apportionment of the VAT incurred is required. Article 174 of the Directive provides taxpayers with a formula for calculating the apportionment based on the ratio of taxable turnover to total turnover. In this case, where there is a single entity with component elements established in different Member States, (ie a French branch and a UK head office), the Court suggests that relevant turnover of both the branch and the head office must be included in the formula.

Comment – the Court has recognised in this case that, when interpreted literally, Article 169 creates an anomaly which could lead to VAT being reclaimable in a situation where the head office makes VAT exempt supplies. There is nothing in Article 169 that dictates that the supplies have to be taxable in both Member States and, to some extent, one can sympathise with Morgan Stanley's position. Businesses with overseas branches need to understand the implications of this judgment.

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