UNICE
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VAT AND BUSINESS FINANCING :

A UNICE DISCUSSION PAPER

1. Introduction

The Sixth VAT Directive provides for the supply of goods and services by a taxable person to be subject to VAT. Certain supplies, such as financial services, are however exempt and the Directive causes the recovery of tax on purchases which have been used in the supply of the exempt services to be blocked.

This provision undoubtedly achieves the aim of the tax, which is to cause tax to be paid when final consumption takes place, when the end services are consumed by a non taxable person. However when tax is blocked at an intermediate point before final consumption, such blocking can be distortive and thus does not achieve neutrality which is one of the aims of the directive.

Such distortion is apparent when business financing is considered and uncertainty, something that is not in the interest of the efficient functioning of business in the European Union, has been introduced particularly by the interpretation of cases which have been considered by the European Court of Justice.

It is somewhat illogical for the VAT system to provide for the recovery of VAT paid by a business producing taxable supplies but to restrict that recovery because financing for such production comes from what is labelled in some Member States as a supply which is in principle exempt without recovery.

2. Raising capital

Whilst by no means the only ways of raising finance, a comparison between the treatment accorded to taking a loan from a bank and a company issuing its own shares or securities highlights the inconsistency and lack of neutrality in the current rules.

If a business takes a loan from a bank there is no direct impact on the ability of that business to recover VAT on goods and services used for the purposes of producing taxable supplies. In some countries however the supply of shares or securities is in principle an exempt transaction and carries with it the restriction of input tax. Even that is not immutable because if a business chooses to supply its shares or securities to parties established outside the EU, then the place of supply is taken out of the EU and input tax becomes recoverable again.

The VAT rules which allow such interpretation therefore contain serious anomalies which can affect decisions to be made when capital is being raised. More consistent treatment would be achieved if the issuance of shares were to be treated as a non supply which would not influence the right to deduction.
Again a company may seek to sell a branch or even a whole business but its method of disposal will impact on the amount of VAT it is able to credit. The straightforward sale of assets or a business as a going concern will not generally impact on the recovery of input tax. However if those assets or that business are share wrapped, (that is to say are held in a subsidiary company and disposal is by way of sale of the shares in the company), then input tax will be restricted, because such a sale is a supply which is exempt without the right of deduction of associated input tax.

3. Case law

Many of the problem faced by European business in this field are reflected in the decisions handed down by the European Court of Justice. Thus in the *Polysar* (case C60/90) the court ruled that the mere acquisition and holding of shares in a company which does not result in direct or indirect management in the target company could not be regarded as an economic activity within the meaning of the Sixth Directive. The theme was continued in the *Sofitam* (case C333/91) to take the receipt of dividends out of a partial exemption calculation, because the receipt of dividends is not considered as a economic activity. *Harnas & Helm* (case C80/95) confirmed the previous cases but extended it somewhat by amongst others indicating that where an investment was made in shares or bonds which resulted in direct or indirect management in the target company, then there was in existence an economic activity for the purposes of the Sixth Directive. Finally *BLP* (case C4/94) resulted in the denial of the recovery of input tax where shares in a subsidiary are sold to raise finance for the taxable business of the shareholding company.

These decisions have an essentially negative impact on business activity in the European Union because they provide the framework for tax to be taken from businesses in a situation where there is no true final consumption and in circumstances which do not so inhibit business in other countries, particularly the USA.

Finally it must be said on the positive side that the *INZO* (case C110/94) provides a ray of light for business by sanctioning deduction where no taxable supply was made.

4. The Member States

In addition to the negative impact outlined above it would appear that the rules applying to activities such as the raising of capital, the acquisition, holding and selling of shares and the collection of dividends and interest are interpreted in different ways. A particular bone of contention is the different way in which Member States handle the deduction of VAT where a company has an economic activity by virtue of its participation in the management of a subsidiary with some of them adopting an over restrictive attitude.

5. Financial Investment and Business Investment

In UNICE's view there is a key distinction to be made between financial investment and business investment.

In the former case, the mere passive holding of an investment solely for the receipt of income from a dividend stream or for capital growth, indicates that there is no economic activity within the terms of Article 4 of the Sixth VAT Directive, and in that event there is never any need for the shareholder to consider the entitlement to deduction available under Article 17.

In the latter case there should never be a problem with Article 4. However the way in which Article 17 is currently drafted taking account of the interpretation applied by Member States is unnecessarily restrictive, creates uncertainties, promotes the use of financial products which do not cause restriction of deduction thus losing neutrality, and gives a cost advantage in raising finance to businesses which are located outside the European Union.

6. Dividends and interest received

Dividends and interest can sometimes also lead to non deductible input VAT. If an enterprise is in principle entitled to deduct input VAT, the collection of dividends and interest should not have an impact on the right to deduct in order to maintain the neutrality of the VAT.

7. Conclusion

The Sixth VAT Directive needs modernising to remove the current provisions which penalise business when it raises finance in certain ways. Specifically there should be no restriction on the recovery of VAT as far as business investment goes:

- where a company issues its own shares,
- where a company acquires or sells shares in another company for the purposes of its taxable business,
- where dividends or interest are received, and
- where costs are incurred in an abortive acquisition or disposal of a company so long as the activity was undertaken for the purposes of a taxable business.

To avoid further uncertainty and uneven interpretation amongst the Member States it is suggested that the test for "business investment" could be in particular a percentage shareholding similar to that which is stipulated in Article 10.2 of the OECD Model Tax Convention on Income and

Capital. In Article 10.2 a reduced rate of withholding tax on dividends is available where there is a shareholding of no less than 25%.

This need not affect the current hurdle in Article 4 which has to be passed before a person can become a taxable person.

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