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FINANCING ACTIVITIES AND VAT

A UNICE DISCUSSION PAPER

Introduction

According to the Sixth Directive, the supply of goods and services effected for consideration within the territory of the EU by a taxable person is in principle subject to value-added tax (hereafter VAT). In article 13 of the Sixth Directive, a limited number of supplies are exempt from VAT without the right to deduct input VAT. Financial services such as transactions in shares and/or granting of loans are examples of exempt supplies without the right to deduct input VAT. The exemption of financial services and the blocking of input VAT sometimes creates distortions and does not always achieve neutrality, one of the aims of the Sixth directive.

Financing and VAT

As mentioned, according to article 13 of the Sixth Directive, transactions (including negotiation) in shares, granting of loans, negotiation of credit guarantees, payments and currency transactions are exempt from VAT. This implies that the majority of the activities of a bank within the EU is exempt from VAT and that such a bank cannot deduct the input VAT incurred on investments and expenses which thus form part of its VAT exempt activities. However, enterprises that supply goods and/or services that are subject to VAT, can also be confronted with a similar blocking of input VAT.

Supply of goods and blocking of input VAT

If an enterprise, with as its core business the supply of goods, is expanding and carries on business in other countries, the enterprise is "forced" (due to legal and income tax issues) to establish its business in the various countries in separate foreign legal entities. By setting up such a structure of enterprises for its taxable business purpose (=selling goods) the enterprise will be confronted with blocking of input VAT due to unintended but "compulsory" issues such as transactions in shares and financing activities such as granting loans, hedges etc.

The structure of a holding company, shareholding and subsidiaries means that the enterprise becomes involved in transactions such as the issuance of new shares, shareholdings in its subsidiaries, the transfer of shares if complete enterprises are sold, the dividend payments etc. As a consequence, input VAT incurred on the costs related to the afore-mentioned activities may be blocked.

In addition, if an enterprise needs cash, finance can be raised by issuing shares or borrowing money. If shares are issued, some Member States are of the opinion that input VAT should be blocked as it is a VAT-exempt activity. However, if money is raised via borrowing, the enterprise does not supply a service and no blocking takes place.

Besides this, the provision of capital by granting loans, receiving interest, etc., within the group will also trigger the blocking of input tax.

VAT is in principle a neutral tax. Hence, an enterprise involved in taxable activities should not be confronted with the blocking of input VAT. Furthermore, VAT should also be neutral in terms of influencing behaviour – the different treatment of (i) capital raised through a share issue and (ii) capital raised through borrowing money runs contrary to this principle. Legislation needs to focus on the intended purpose of the finance – if it is to raise capital to finance taxable activities then the VAT should, in principal, be recoverable. There is a need to eliminate the present distortive effect.

In UNICE's view, the Sixth Directive should make a distinction between a financial investment and a business investment. With a financial investment, the shares are held as an investment to gain value or dividends. In case of a business investment, the shares are held for the business purposes of the shareholder because of the interest in the underlying business of the company.

In drawing the line between the two types of investment UNICE recommends a single EU threshold not exceeding 25 per cent of the capital of the company, a threshold similar to the EU parent/subsidiary directive. The rationale for the threshold is that larger shareholdings above the threshold can reasonably be deemed to be held for the business purposes of the shareholder because they reflect his interest in the underlying business of the company.

Linked to this, UNICE proposes that, in the case of a business investment, the deductibility of all input VAT incurred on costs related to shares and all financing activities between the shareholder and the company in which the shares are held should be calculated pro rata to the shareholding. UNICE also proposes that the VAT incurred on costs of raising capital by issuing shares should be treated in the same way, namely following the pro rata shareholding of the enterprise involved.

UNICE is of the opinion that, with the above-mentioned introduction of the distinction between finance investment and business investment and the allocation of the incurred input VAT to the pro rata shareholding, both mentioned neutrality issues will be solved.

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