German Federal Ministry of Finance publishes guidance on VAT grouping and the input VAT deduction of holdings

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In Brief

In 2015, the European Court of Justice (ECJ) handed down its judgment in "Larentia + Minerva and Marenave", in which it commented on certain aspects of VAT grouping and on the deduction of input VAT paid by holding companies for the acquisition of capital invested in their subsidiaries. At first, that judgment seemed to shake the German concept of VAT grouping to the core. In its wake, both VAT Senates of the Federal Fiscal Court (Bundesfinanzhof, or BFH) published a number of decisions dealing with various aspects of that judgment. They tried their best in those decisions to interpret the ECJ judgment conservatively so as to maintain the current VAT grouping system as far as possible. Nevertheless, they were forced to allow partnerships as affiliates in terms of VAT grouping. Aside from that, the ECJ had also strengthened the position of holdings with regard to their input VAT deduction.

Now the Federal Ministry of Finance (Bundesministerium der Finanzen, or BMF) has summarised its view in a decree amending the VAT Application Guidelines accordingly. The transitional period granted for VAT grouping with partnerships as affiliates, for example, is quite generous. Nevertheless, where the new rules may have an impact, the groups concerned should investigate the consequences as soon as possible.

VAT grouping

General matters

The BMF initially states that partnerships may be integrated in a VAT group "as a matter of exception", which apparently means that the corresponding provisions are to be interpreted strictly.

Up until now, where a limited partnership (Kommanditgesellschaft, or KG) held 100% of the shares in a limited liability company (Gesellschaft mit beschränkter Haftung, or GmbH) that acted as a general partner of the KG, the GmbH was deemed to be dependent in VAT terms. The amendment to the VAT Application Guidelines provides that it is sufficient if the KG is the majority shareholder of the GmbH. In such a case, the GmbH is in principle integrated in the KG's business as an affiliate for the purposes of the VAT group.

As before, and as was to be expected after the BFH decisions mentioned above, persons not considered taxpayers cannot take part in a VAT group – neither as head nor as an affiliate. Nevertheless, indirect financial integration, under the general conditions, may still be routed through affiliates that are not members of the VAT group, even where those affiliates are not taxpayers.

Financial integration

Proxy voting powers and vote pooling agreements are, for the sake of legal clarity, only relevant for the financial integration of a legal entity if they are stipulated exclusively in the articles of association (for instance in cases of a multiple voting right). The "integration with a right of direct action", as set out in the decree, suggests that the BMF will continue to applying the principle of subordination of the affiliate.

However, as regards partnerships, the head of the VAT group must be in a position to take direct action by means of direct and indirect financial integration. Here, it should be borne in mind that, according to German law, decisions in partnerships must in principle be made unanimously (regardless of whether that is actually true for each single case). For that reason, the decree requires that, apart from the head of the group itself, only persons that are themselves financially integrated into the VAT group head's business can be part of the VAT group. The BMF clarifies that even very small shareholdings of third parties in the partnership (even those not exceeding 0.1%, as in the example given by the BMF) prevent financial integration.

For other matters regarding financial integration, the BMF refers to the rules already in place.

Organisational integration

Some years ago, the BFH decided that organisational integration requires that the VAT group head must not merely be in a position to control the affiliate through its performance of managerial functions, it must also be able to enforce its will. It is not sufficient for the head merely to be able to prevent conflicting decision-making, for example, by means of a standoff. Rather, it must be in a position to implement any action it requires the affiliate to take. Previously, the BMF had held that preventing conflicting decisions was sufficient; now it has expressly adopted the opinion of the BFH.

In the event that no personal union of the boards of managers is in place for both the head and the affiliate (or at least a partial personal union which is sufficiently safeguarded by certain other measures for the purpose of the organisational integration), and where no employees are seconded to the affiliate's board of managers, the VAT Application Guidelines provide for a third way to implement organisational integration exceptionally, namely "institutionally safeguarded rights to take direct action in the core area of the affiliate's day-to-day management". Under certain additional conditions, this concept inter alia includes management policies and group policies – and (which is new) employment contracts. The latter amendment, however, seemingly does not refer to the concept of seconding employees as managers to the affiliate's board of directors, but to a very exceptional case recently decided on by the BFH, in which a manager was actually subordinated to the direction and guidance of a third person of the VAT group head's sphere.

As regards control agreements (for the purposes of section 291 of the Stock Companies Act) and integration in another company (for the purposes of sections 319 and 320 of the Stock Companies Act), the BMF has clarified that an organisational integration "must be assumed" in such cases. In the past, it was merely stipulated that, in such cases, organisational integration "may regularly be assumed". However, the BMF has further clarified that the control agreement must be entered in the trade register to become effective, which also means that the organisational integration is effective only from the time of that entry onwards.

The decree does not contain any particular requirements for the organisational integration of a partnership.

VAT grouping in insolvency cases

The BMF has also updated its view concerning the discontinuation of a VAT group in insolvency cases. According to the new rules, a VAT group ceases to exist as soon as insolvency proceedings are opened. The same applies to debtors in possession cases if a trustee has been appointed (for the purposes of sections 270 et seq. of the Insolvency Act). The VAT group ceases to exist even before the opening of insolvency proceedings where a preliminary insolvency administrator has been appointed either for the head or for the affiliate, where that administrator is granted decisive influence over the debtor, and where the head's control of the affiliate is no longer possible. The latter is the case particularly if the preliminary insolvency administrator, by means of a reservation of approval, is in a position to prevent the debtor from making any valid dispositions by legal transaction. All above provisions also apply if the same

administrator, trustee or preliminary administrator has been appointed for both the head and the affiliate.

Input VAT deduction of holdings

In its decree, the BMF also deals with the right to deduct input VAT paid on expenditures for the acquisition of capital for the purchase of company shares (as well as for the holding and sale of the shares). According to its decree, such a right does not exist if the acquired capital is disproportionate to the shares held in the economic sphere or if the setup, including the output transactions constituting the right to deduct input VAT, is deemed to be an abusive practice. The first statement seems to refer to a BFH decision in which input VAT deduction was disallowed because the acquired capital appeared not to be used exclusively for the purchase of shares in affiliates. In that case, it also remained unclear which input supplies were connected to output economic activities and which supplies had been purchased for other (non-economic) purposes. However, in the same decision, the BFH indicated that the deductible input VAT amount would, as a general rule, be restricted to the amount of the output VAT (but it left the matter open). However, such a view could potentially be incompatible with ECJ case-law. Moreover, the principles developed by the ECJ in the "Gemeente Borsele" case for instances of blatantly disproportionate supply and consideration do not currently seem to be directly applicable to holdings. As regards the "abusive practices" mentioned in the decree, the BMF refers to a BFH decision that merely deals with the general principles concerning abuse, tax evasion, etc, developed by the ECJ, which are generally applicable to all taxable persons. However, it remains to be seen whether or not the tax authorities will turn out to be quicker to assume abusive practices in the future.

The decree also makes some changes to the wording of the provision dealing with the conditions under which shares are held in the economic sphere and under which the holding of shares qualifies as economic activity (which has a direct impact on the input VAT deduction of expenditures connected with the acquisition of shares, etc). As before, a direct involvement in the management of the companies by means of taxable supplies is required. Formerly, the VAT Application Guidelines required that shares be held in the economic sphere "in so far as" that occurred "for the purposes" of direct involvement in the above sense. It remains open whether or not the new wording is intended to allow for the input VAT deduction only from the time supplies are actually carried out, which would probably not be in line with ECJ case-law.

Application of the decree

The provisions concerning VAT grouping with partnerships are binding only for supplies carried out after December 31st 2018. However, the decree provides that the tax authorities may not object to an earlier application, provided that, with respect to the scope of the group, the parties to the VAT group refer unanimously to that decree. In addition, these provisions cannot be applied for single transactions only. Another condition is that all relevant VAT assessments may still be amended.

The organisational integration amendments referring to standoff situations, etc, enter into force after December 31st 2018 as well. The same applies to those for proxy voting powers and vote pooling agreements, and, apparently, to those for KGs holding shares in their general partner GmbH.

The other amendments are applicable in all open cases.

Remarks

Taxable persons who are currently head of a VAT group or who could qualify as such in future (for example, because one of their affiliates is a partnership already qualifying for VAT grouping under the above conditions) should read the amendments carefully. There will be a need for changes in many cases, particularly with respect to organisational integration, for which it will no longer be sufficient merely to arrange for a standoff situation, for example, in order to prevent an affiliate from acting insubordinately. Please note that, in Germany, VAT groups neither come into existence nor cease to exist upon application – they do so when all

the conditions are met and when they are no longer met, respectively. After the transitional period has elapsed, the companies impacted by this decree will leave the VAT group immediately (or enter it, as the case may be). The decree does not provide a simplification rule for cases where a VAT group is unintentionally created or cancelled.

VAT grouping could also be subject to changes in future, since the BFH's conservative approach could, in future referrals to the ECJ, possibly prove inadequate – even though the ECJ has admitted that the national legislature has broad discretion to define its own rules regarding VAT grouping.

Sources

Bundesfinanzministerium (Federal Ministry of Finance), decree of 26 May 2017, available at www.bundesfinanzministerium.de (in German only)

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