

ATOZ ALERT

Latest VAT Developments: VAT Impacts of Brexit for Luxembourg Financing Companies and VAT Deduction Right on Aborted Deal Costs

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2021 and Brexit bring VAT opportunities for Luxembourg companies performing financing or insurance activities with United Kingdom (“UK”) counterparts.

Furthermore, the Court of Justice of the European Union (“CJEU”) recently ruled that holding companies actively involved in the management of their subsidiaries can deduct input VAT on aborted deal costs under certain conditions.

Utmost attention should be paid to these developments which could require some actions in order to increase the VAT deduction right and to limit VAT leakages of Luxembourg holding and/or financing companies.

VAT Impact of Brexit for Luxembourg Financing and Insurance Companies

Following the withdrawal of the UK from the European Union (“EU”) as the result of Brexit, the UK has become a “third country”. The withdrawal has a positive impact nevertheless on Luxembourg companies performing financing activities with UK borrowers.

While financial and insurance services are VAT exempt with no VAT recovery right when provided to EU counterparts, the same services rendered to non-EU counterparts are also VAT exempt but grant a VAT deduction right. The following services are notably covered by the concept of “financial services”:

- the granting and the negotiation of credit;
- the negotiation of or any dealings in credit guarantees or any other security for money;
- transactions, including negotiation, concerning deposit and current accounts, payments, transfers, etc.;
- transactions, including negotiation, concerning currency, bank notes and coins used as legal tender;
- transactions, including negotiation in shares and interests in companies;
- etc.

1. Practical Example

Prior to 1 January 2021, the granting of interest-bearing loans by a Luxembourg company to UK borrowers was a VAT exempt activity not granting a VAT deduction right. Input VAT incurred by the Luxembourg financing company in relation to the UK interest income was not deductible.

As from 1 January 2021, Luxembourg financing companies are entitled to fully recover input VAT incurred on costs directly linked to their UK financing activities. Input VAT declared as due on services received from abroad, as well as VAT charged by Luxembourg service providers, is now deductible when linked to the UK financing activity.

2. Actions to be Taken

Luxembourg companies performing such non-EU VAT exempt financial or insurance activities will either have the obligation to modify their VAT registration format (from the simplified regime to the normal regime) or to register for Luxembourg VAT under the normal VAT regime.

It should be recalled that companies registered under the simplified regime have no VAT deduction right and actions must be taken towards the VAT authorities to change the VAT filing regime.

VAT Deduction Right of Holding Companies on Aborted Deal Costs: Update of the CJEU

In the Sonaecom¹ case, the CJEU recently confirmed that the input VAT on aborted deal costs incurred by a company with the view of acquiring shares could be deductible, provided that the company intended to provide VAT taxable management services to its subsidiaries on a recurrent basis.

1. Background

Sonaecom SGPS S.A. (hereinafter “**Sonaecom**”) is a holding company whose activity involved acquiring, holding and managing participations, as well as providing strategic management and coordination services to its subsidiaries operating in the telecommunications sector. In 2005, Sonaecom intended to acquire shares in the telecom operator Cabovisão but the acquisition ultimately did not materialise.

In the context of the intended acquisition, Sonaecom incurred:

- consultancy costs related to a market study requested with a view of acquiring the shares, and
- commissions related to the organisation and guarantee of the placement of a bond loan.

Sonaecom purchased these services with the intention to provide management services to Cabovisão after completion and fully deducted the input VAT incurred in relation to these costs, considering that they were linked to the future VAT taxable activity (i.e. intended management services to be provided to Cabovisão).

Since the acquisition of shares in Cabovisão did not take place, Sonaecom decided to use the funds from the bond to grant a loan to its parent company (Sonaecom SGPS).

The Portuguese VAT authorities denied Sonaecom the deduction of the input VAT on the consultancy services and the commissions by arguing that the acquisition of shares fell outside the scope of VAT and the granting of a loan was a VAT exempt activity with no VAT deduction right. Sonaecom decided to challenge this position and to bring action before the CJEU.

¹ CJEU, 12 November 2020, C-42/19, Sonaecom SGPS S.A.

2. Judgement of the CJEU

The CJEU considered that the fact that the consultancy costs were received by Sonaecom with the intention to acquire shares in Cabovisão and to provide management services to Cabovisão is sufficient to recognise a VAT deduction right on those costs. In this regard, the following considerations were additionally made by the CJEU:

- the fact that the acquisition did not take place is not precluding Sonaecom from a VAT deduction right, considering it had the intention of pursuing an economic activity including the involvement in the management by providing management services;
- the intention to provide VAT taxable management services should be supported by objective elements;
- the VAT deduction right could still be limited if the holding company (1) only provides VAT taxable management services to some of its subsidiaries (and not to all of them) or (2) performs a VAT exempt activity (e.g. EU financing).

With regard to the input VAT incurred in the framework of the placement of a bond loan, the CJEU ruled that this VAT should not be deductible because these services were ultimately used by Sonaecom to grant an interest-bearing loan to its parent company (VAT exempt activity with no VAT deduction right). In this regard, the fact that Sonaecom initially intended to use these services for the transaction is irrelevant as the actual use prevails over the initial intention.

3. Impact Assessment and Actions to be Taken

This CJEU case is a positive and welcomed development, given that it is in line with the previous case law on similar matters and it further outlines the framework of the VAT deduction right.

The CJEU confirms that a holding company is entitled to deduct input VAT on aborted deal costs incurred when it was the intention of the holding company to provide VAT taxable management services to its subsidiary (and when these management services were not provided due to the abortion of the transaction). Specific attention should be paid to keeping sufficient documentation (e.g. services agreements, deal reports, business plans, etc.) and factual elements supporting the intention to provide VAT taxable management services in the context of the contemplated acquisition of shares.

The actual use of the deal costs could nevertheless lead to a limitation of the VAT deduction if it appears ultimately that these costs have been effectively used for activities not granting a VAT deduction right (i.e. actual use to grant a loan instead of providing management services).

We strongly recommend that holding companies incurring deal costs in the framework of the acquisition of shares carefully review their VAT deduction methodology and the related overall VAT strategy.

While the VAT deduction right is a key element to monitor, utmost attention should also be paid to the VAT treatment applicable to commissions charged by brokers or by financial institutions for negotiating transactions in shares or for arranging financing. These services would be VAT exempt in Luxembourg (unlike in the Sonaecom case) and should not lead to a non-deductible VAT cost.

Do you have further questions?

We would be pleased to discuss the VAT deduction right of your companies performing financing activities with UK borrowers or to analyse the VAT deduction right of your Luxembourg holding companies and to review the related VAT deduction strategy.



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