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# ABBEY NATIONAL – VAT ON COSTS WHEN TRANSFERRING A TOTALITY OF ASSETS

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In the Abbey National case[2], the European Court of Justice set forth guidelines for the deduction of VAT on costs incurred by a taxable person transferring a totality of assets. From a VAT point of view, the transfer of a totality of assets (or a part thereof) is a peculiar phenomenon. Normally, supplies are either VAT taxed or VAT exempt. When transferring a totality of assets, however, no taxation or exemption applies. Instead, supplies are *ignored*[3]. As a result, there is no VAT relevant transaction to which the costs can be linked. Deductibility is then dubious.

Looking for the closest link, the European Court has now decided that the costs have a direct and immediate link with *all* economic activities of the seller. A right to deduct therefore depends upon the whole of the transferor's output.

## The Case

The decision of the High Court relates to the deductibility of costs incurred by Abbey National Plc (hereinafter: 'Abbey National'), a UK-based bank and insurance concern.

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2 Court of Justice of the European Communities, Case C-408/98, (*Abbey National plc v Commissioners of Customs & Excise*).

3 Provided that Article 5(8) of the Sixth Directive has been incorporated in the national legislation.

Abbey National owned all the shares of Scottish Mutual Assurance plc (hereinafter: 'Scottish Mutual'). Scottish Mutual conducted an insurance business and operated a commercial property-letting business. In the course of the latter business, Scottish Mutual had obtained a 125-year lease in Atholl House, apparently an office building in Aberdeen. Scottish Mutual had rented out Atholl House on a 40-year (sub)lease. That sublease was subject to VAT. In 1993 Scottish Mutual sold its interest in the Atholl House lease, with the sub-tenancy, to a third party. That third party continued the VAT taxed sublease. As a result of that transfer Scottish Mutual incurred professional fees, including VAT. That VAT was claimed back through the VAT return of Abbey National. The Commissioners of Customs and Excise now raised an assessment for the VAT claimed back. According to the Commissioners, the transfer of Atholl House was a transfer of a going concern and as such not a taxable supply to which any input VAT could be attributed.

Finally, the English High Court decided that the transfer was indeed the transfer of a going concern. The High Court further noticed that the deductibility of costs relating to those transactions was unclear and raised questions in the Court of Justice in order to obtain some clarity on this subject.

Prior to addressing the specific questions raised by the English High Court, I will give some general remarks on the special regime for the transfer of a totality of assets, codified in Article 5(8) of the Sixth Directive.

## Legal Background

The special regime of Article 5(8) of the Sixth Directive aims at facilitating the transfer of an entire business or a separate business unit by means of a transfer of assets. Normally, the sale of a business through an asset transaction attracts VAT. The purchaser must pay VAT and can generally claim it back afterwards.[4] As a result, the purchaser is confronted with a loss of liquidity, making the transaction less attractive for him. Invoicing can also be an issue, taking into account the sheer quantity of the assets sold. Under the special regime of Article 5(8) of the Sixth Directive, Member States may now consider that where a totality of assets or a part thereof is transferred, no taxable event has taken place and the recipient is to be treated as the successor to the transferor.[5] In other words, VAT complications are avoided by ignoring the transaction.

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4 Provided that taxed activities are performed.

5 Article 6(5) of the Sixth Directive gives a similar provision for the supply of services.

## Defining Totality

Meanwhile, the scope of a 'totality of assets' is not entirely clear. In the Sixth Directive this concept is not further elucidated. According to Advocate General Jacobs regarding the present Abbey National case, the transfer of a 'totality' refers to the transfer of a business in its entirety, by means of a transfer of its assets rather than the shares. In his view a part of a totality implies a part of a business capable of separate operation. In this respect, the Advocate General refers to the VAT legislation of the United Kingdom on this topic.[6] Under UK legislation, where a person transfers a business or part of a business as a going concern, the transfer is neither regarded as a supply of goods nor as a supply of services.

Another definition of 'totality' is provided by the High Court of the Netherlands, that defines 'totality' as a set of assets destined to be used together. When transferred those assets remain closely linked by their joint destination.[7] Despite this somewhat broader definition, the use of the special regime in the Netherlands is in practice restricted to the transfer of (part of) a business.

In the present case, the transfer of a leased building apparently falls under the regime for the transfer of a totality of assets as implemented by the UK. This seems a little peculiar, how can only one asset constitute a 'totality'? Unfortunately, the European Court was not asked to give its opinion on this subject. The question remains whether the UK legislation is in conformity with the wording of the Sixth Directive.

## Rules for Deduction of VAT

The Abbey National case evolves around the right to deduct input VAT. In general, the right to deduct VAT is dependant upon the activities to which the costs have a direct and immediate link.[8] This implies that such expenditures should be part of the costs of the output transactions which utilise the goods and services acquired.[9]

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6 More specifically, Regulation 5(1) of the VAT (Special Provisions) Order (SI 1995 No 1268).

7 The Supreme Court (*Hoge Raad*), 9 February 1992, no. 27 897.

8 Court of Justice of the European Communities, Case C-4/94, (*BLP Group v Commissioners of Customs & Excise*).

9 Court of Justice of the European Communities, Case C-98/98, (*Midland v Commissioners of Customs & Excise*).

Problems arise when costs cannot be linked with specific output activities. For instance, investments are made for contemplated taxed activities. At the end of the day those activities are not carried out. According to the European Court of Justice, VAT on such investments can nevertheless be deducted, provided that not carrying out the planned activities is a result of circumstances beyond the control of the taxable person.[10]

It is also possible that costs unexpectedly arise after completion of specific output activities. In general, such costs are not part of the costs components of the output transaction. Take for instance the situation in which the output activities trigger legal claims. In order to deal with those claims, legal costs are incurred. In the *Midland* case[11] the European Court of Justice made it clear that such legal costs were the consequence of the output transaction carried out. The costs lacked, however, a direct and immediate link with those activities as they were not part of the cost components of the taxable transaction.[12] Nonetheless, the costs were part of the general costs of the taxable person. As such, the costs were a component of the price of all output activities of the taxable person. The costs had a direct and immediate link with the taxable person's business as a whole. The deductibility of the costs, therefore, depended on the composition of that general output.

Finally we come to the Abbey National case. The costs incurred here also lack a direct and immediate link with a specific VAT relevant output activity. In fact there is a related output transaction, the transfer of the business, but this transaction is *ignored* for VAT purposes. The deductibility of costs is therefore unclear. To end this uncertainty, the UK High Court asked the European Court of Justice for guidance.

## Questions Raised by the UK High Court

In order to get a better understanding of the VAT treatment of costs relating to the transfer of a business, the UK High Court submitted three questions to the European Court.

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10 Court of Justice of the European Communities, Case C-37/95, (*Ghent Coal v Belgian State*).

11 See note 9.

12 According to the Court this reasoning cannot be followed if the taxable person can *prove* that the costs are part of the costs components of that transaction.

First, the UK Court asked whether the right to deduct was determined by the activities carried out by the party acquiring the business. In other words, does deductibility exist if the recipient of the business assets performs taxed activities.

Second, the UK Court asked whether deductibility was determined by the VAT consequences of the transfer of the business assets in the hypothetical situation that the special regime of Article 5(8) did not apply. In other words, if without Article 5(8) the transaction would have been taxed, would this also imply deductibility under the regime of Article 5(8).

Thirdly, the UK Court asked whether the right to deduct was determined by the business activity of the transferor prior to the actual transfer of the business assets. In other words, could VAT be deducted if the transferred business itself generated VAT taxed activities.

**Findings of the European Court**

The European Court deemed it necessary to examine whether a direct and immediate link existed between the costs incurred and one or more taxable output transactions performed by the transferor. According to the Court, the activities of the acquiring party could not possibly affect the deductibility of VAT for the transferor. A clear negative response to the first question of the UK Court, therefore.

The European Court further upheld that no comparison could be made with the hypothetical situation in which the special regime did not apply. The fact was that the special regime *did* apply. This lead inevitably to a special regime for the VAT on costs. The European Court therefore rejected the solution proposed by the UK Court in the second question.

Looking for direct and immediate links, the European Court concluded that there were no such links between the costs incurred and one or more specific output transactions of the transferor. The transferor incurred the costs after termination of the business activities.[13] As a result, the latter costs could not form part of the costs of the business transactions carried out previously. The European Court saw, however, a link between the costs and the whole economic activity of the transferor prior to the transfer of the business. According to the Court, the costs must be regarded as part of the economic activity of the business as a whole before the transfer. The costs were part of the transferor's overheads and as such were cost components of the products of the business. As a result, costs could be deducted if

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13 That is after the sale of the business assets.

all economic activities of the transferor (prior to the transfer) were VAT taxed. If both taxed and exempt activities were carried out, the transferor could only deduct that proportion of the VAT which was attributable to the former transactions.

The Court followed a somewhat peculiar reasoning in order to defend the link between the costs and the whole of the transferor's economic activity. According to the Court, those costs should be regarded as part of the economic activity of the transferor, because:

> "Any other interpretation of Article 17 of the Sixth Directive would be contrary to the principle that the VAT system must be completely neutral as regards the tax burden on all the economic activities provided that they themselves are subject to VAT (...). An arbitrary distinction would thus be drawn between expenditure incurred for the purposes of a business before it actually operated and that incurred during its operation, on the one hand, and on the other hand, the expenditure incurred in order to terminate its operation."

The Court made one exception to the rules set forth above. If the costs incurred had a direct and immediate link with a *part* of the economic activities of the transferor, the VAT status of this part of the economic activities determined the deductibility. Apparently, the Court is referring to the situation of Scottish Mutual prior to the transfer of Atholl House. Scottish Mutual was conducting an (exempt) insurance business and a separate property letting business. Costs made for the transfer of Atholl House should be linked only to the property letting business. The separate insurance business should not affect the deductibility of VAT. According to the Court, in this case the national court should investigate whether the costs could indeed be linked with *part* of the economic activities of the transferor.

## Conclusion

With its decision in the Abbey National case, the European Court has provided clear guidance on the deductibility of VAT on costs for the 'ignored' transfer of a totality of assets. The right to deduct is determined by the total of the economic activities of the transferor prior to the transfer. If the costs are clearly linked to an independent part of the economic activities of the transferor, this part of the economic activities determines the deductibility.

Unfortunately, the Court did not address the scope of the concept of 'totality of assets'. The question remains, therefore, whether this 'totality' is similar to a 'business'. Does the transfer of a business always imply the transfer of a totality even if only a few assets are transferred? It would be helpful if the Court could also shed some light on that question.