SALE OF A SUBSIDIARY: HOLDING COMPANIES *CAN* DEDUCT VAT ON COSTS

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Although a holding company supplying management services to its subsidiary is a taxable entity for VAT purposes, a holding company that sells off a subsidiary is not making a VAT-relevant supply. This is the outcome of a recent case before the High Court of the Netherlands.[2] According to the Dutch Court, the sale of a participation interest by a holding company is neither exempt nor taxable, but falls outside the scope of VAT. Costs relating to such a sale cannot be directly linked to specific taxable activities of the holding company. However, they can be linked to the holding company's business as a whole. Consequently, the nature of the holding company's economic activities as a whole determine deductibility.

The Dutch Court's judgment is quite remarkable. Until now *communis opinio* seemed to imply that VAT incurred when selling shares could not be recovered. Unfortunately, the Dutch High Court did not exactly provide an accessible 'users' guide' to the VAT status of holding companies and the sale of shares. Although the outcome of the case is clear, the reasoning of the Dutch judicial authority is shrouded in mystery. Below, the writer will try to reconstruct the train of thought followed by the Dutch Court.

The Case

The Court's decision related to a Dutch holding company (the 'Holding Company') owning 50% of the shares in another Dutch private limited liability company (the 'BV'). Apart from being a major shareholder, the Holding

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Company provided the BV with various management services.[3] The Holding Company received management fees in return for those management services. In 1998 the Holding Company sold its interest in the BV to a third party. A merchant bank supervised the transaction, charging a fee that included Dutch VAT. The Holding Company deducted the VAT, but that deduction was not accepted by the Dutch VAT authorities. Judicial proceedings followed, first before the District Court of The Hague, which rejected the deduction, and then before the Dutch High Court. This Court rendered its decision on 14th March 2003.

Findings of the Dutch High Court

First, the Dutch High Court referred to the case law of the European Court. The European Court had clearly decided that the acquisition, holding and sale of a holding of shares all fell outside the scope of VAT. There were only two exceptions to this rule:

(i) The sale of shares as part of a commercial share-dealing activity[4];

(ii) 'VAT involvement'[5]; i.e. activities carried out as part of a direct or indirect involvement in the management of shareholdings. These activities are VAT relevant in so far as they entail carrying out transactions for consideration.

In the case in hand the sale of shares was clearly not carried out as a commercial share-dealing activity. The question remained whether the sale of shares fell under category (ii), VAT involvement.

It was clear that the management-for-consideration supplied by the Holding Company and paid for by its subsidiary did constitute a VAT-relevant activity. As a result, the Holding Company was to be considered a VAT taxable entity. Thus far, nothing was new. But then the Dutch Court considered the sale of shares. Did the sale also qualify as VAT involvement, thus constituting a VAT relevant, albeit exempt, transaction? Here the Court referred to the European Court case law on dividends. Dividends do not qualify as consideration for any activity and fall outside the scope of VAT. The Dutch Court likened dividends to

3 These services were not further substantiated.

4 Case C-155/94, *Wellcome Trust Ltd v Commissioners of Customs and Excise*, [1996], ECR I-03013.

5 Term introduced by author.

the proceeds of sale, neither of which is VAT relevant, and concluded that the sale of shares thus remained outside the scope of VAT.

After this remarkable conclusion, the High Court addressed the main issue: the deductibility of VAT on costs relating to the sale of the shares in the BV. According to the Dutch Court, those costs related to the Holding Company's participation in the BV and more specifically to the sale of the shareholding. The Dutch Court concluded that the costs were part of the Holding Company's general costs. The costs had a direct and immediate link with the Holding Company's business as a whole. The deductibility of the costs, therefore, depended on the composition of that general output. The High Court referred the case to a lower court in order to complete the pro rata calculations and determine the activities of the Holding Company before the sale of the shares.

Direct or Indirect Involvement

The European Court has consistently drawn a distinction between direct and indirect involvement. Apparently, direct involvement refers to a situation in which a holding company 'does the work' itself. For example, it assists its subsidiary, provides advice or is actively involved in the management. Indirect involvement occurs when a holding company uses a third party to carry out the work.[6] For instance, it hires a lawyer to assist its subsidiary with legal issues.

A further distinction must be made between involvement *with* or *without* economic activities. Each holding company is involved in the management of its subsidiaries to some extent. Such involvement does not necessarily imply the existence of VAT–relevant activities. This issue was first elucidated in the Opinion of Advocate General Van Gerven in *Polysar*[7]:

> 'The question remains whether liability to tax may be inferred from the other activities of a holding company. The national court has pointed out that Polysar's activities are concerned solely with the holding of shares in subsidiary companies. It seems to me that such activities, which are undertaken in the exercise of shareholders' rights, do not constitute economic activities within the meaning of the directive. The exercise of those rights includes, for instance, participation in the general meeting of the subsidiary's shareholders, the exercise of the right to vote at the meeting and the possibility of influencing company policy thereby and,

6 See also: Yves Bernaerts, *Holding Companies put to the VAT Test* ECTJ 6/2 [2002] 165.

7 [1991] ECR I-3111 at 3126, paragraph 6., see also: Christian Amand *VAT: Deductibility on the Costs of Issuing New Shares*, EC Tax Journal, Volume 5, 2001, Issue 3.

> where appropriate, involvement in the decision appointing the company's directors or officers and/or apportioning the subsidiary's profits, as well as the receipt of any dividends declared by the subsidiary or the exercise of shareholders' preferential rights or options.
>
> In addition to the aforesaid activities which a holding company carries on as a shareholder in other companies, there are activities which, like any other company, it carries on through its organs and which, in so far as they are conducted within the company (in its relations with the shareholders and the company's organs) also cannot be regarded as economic activities, within the meaning of the Sixth Directive. Those activities include the administration of the holding company, the making up of the annual accounts, the organisation of the general meeting, the decision to spend the holding company's profits and to declare (and possibly pay out) dividends. Nor, in my view, is there any question of economic activities independently carried on within the meaning of Article 4(1) of the Sixth Directive in the case of activities which the holding company, or persons acting in its name, carries out in its capacity as director or officer of a subsidiary company. A director or officer of the company does not act on his own behalf but only binds the (subsidiary) company whose instrument he is; in other words, where he acts in the exercise of his duties under the company instruments, there is no question of his acting independently. In that regard, his actions must be equated with those of an employee who, as Article 4(4) of the Sixth Directive expressly states, does not act independently.'

It is thus clear that a holding company can have a high level of involvement, while still remaining outside the scope of VAT. However, VAT becomes relevant when the involvement entails carrying out activities for consideration as mentioned in Article 2(1) of the Sixth Directive. 'For consideration' means for payment. In the famous organ-grinder case[8] the European Court held that a supply of services only qualified 'for consideration' if a legal relationship existed between the provider of the service and the recipient pursuant to which there is reciprocal performance. In such a case the remuneration received by the provider constitutes the value actually given in return for the service supplied to the recipient.

8 Case C-16/93 *Tolsma v Inspecteur der Omzetbelasting Leeuwarden* [1994] ECR I-743.

Involvement and Consideration

According to the European Court, dividends cannot be regarded as remuneration for any economic activity. There is no direct link between the receipt of dividends and any activity of the shareholder. The amount of dividends depends partly on unknown factors[9] and entitlement to dividends is merely a function of shareholding. Dividends represent, by their very nature, the return on investment in a company and are merely the result of that property.[10] As a result, the receipt of dividends does not fall within the scope of value added tax.[11] In the words of the European Court[12]:

> 'It follows that involvement of that kind in the management of subsidiaries must be regarded as an economic activity within the meaning of Article 4(2) of the Sixth Directive in so far as it entails carrying out transactions which are subject to VAT by virtue of Article 2 of that directive, …'

Nevertheless, if the receipt of dividends paid by those subsidiaries to the holding company thus involving itself in their management is to fall within the scope of VAT, a further requirement is that the dividends are capable of being regarded as consideration for the economic activity in question, which presupposes that there is a direct link between the activity carried out and the consideration received:

> 'In that regard, the Court has held that, since the receipt of dividends is not the consideration for any economic activity, it does not fall within the scope of VAT.'

'Economic activity' and 'activity carried out' refer to the involvement in the management of subsidiaries. There must be a direct link between such involvement and payments received. Without a direct link, the involvement remains outside the scope of VAT.

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9 Such as (i) the existence of distributable profits, (ii) the specifics of the shares held (and not the specifics of the shareholder), Case C-142/99 *Floridienne and Berginvest v Belgian State* [2000] ECR I-9567, paragraph 22.

10 Case C-60/90 *Polysar* [1991] ECR I-3111, paragraph 13.

11 Case C-16/00, *Cibo Participations SA v Directeur regional des impôts du Nord-Pas-de-Calais* [2001] ECR I-6663.

12 Case C-142/99, *Floridienne and Berginvest v Belgian State* [2000] ECR I-9567, paragraphs 19-21.

From dividends, the Dutch High Court moved on to revenues realised on the sale of shares. Like dividends, revenues of this kind could not be regarded as payment for any 'involvement' on the part of the holding company. Indeed, there was no reciprocal performance between the activities of the holding company and any payment made by its subsidiary. In fact, the subsidiary made no payment at all. There was no payment, no consideration, no direct link, no relevant involvement and no relevant economic activity. The Dutch Court did not bother to refer this question to the European Court as these conclusions were beyond a reasonable doubt.

It appears that the Dutch Court explains the 'VAT involvement doctrine' as follows:

- Involvement is only relevant for VAT purposes insofar as it entails carrying out transactions for consideration.

- These transactions (services) must be supplied to the subsidiary, as only involvement in the management of the subsidiary can be VAT relevant.

- The subsidiary must pay for the transactions, creating a direct link between the involvement activities carried out by the holding company and the amounts it received.

This reasoning seems to imply that a sale of shares is only VAT relevant if the holding company receives a separate payment from its subsidiary for setting up the sale of shares of the subsidiary.

Shareholder's Rights and Economic Activities

According to the Dutch Court, VAT involvement does not include hiving off shares. Not all involvement is VAT involvement and therefore subject to tax. Between the lines, the European Court also addressed this issue in *Polysar*[13] and later case law:

> '… the Court held that it is otherwise where the holding is accompanied by direct or indirect involvement in the management of the companies in which the holding has been acquired,[14] *without prejudice to the rights held by the holding company as a shareholder.* '[15]

13 *Polysar*, paragraph 14.

14 Italics by the author.

15 Case C-142/99, *Floridienne and Berginvest v Belgian State* [2000] ECR I-9567, paragraph 18.

The 'without prejudice' clause seems to imply that not all involvement is VAT relevant, as sometimes a shareholder is only exercising its shareholder's rights. In other words, some activities imply involvement, but are primarily the result of a shareholder exercising its rights arising from its participation. Perhaps this category includes selling shares as well as attending a shareholders' meeting.

Cost Deduction

According to the Dutch High Court, the merchant banking costs incurred by the Holding Company could not be directly linked to a specific VAT-relevant output activity. Of course, there was a direct link with the sale of shares, but this sale fell outside the scope of VAT. The Dutch Court held that the banking costs related to the shareholding participation and more specifically to the *sale* of that participation. The Court then referred to the European Court's judgment in the *Cibo Case*[16]. Applying paragraphs 27-35 of the judgment in *Cibo*, the Dutch Court concluded that the costs were part of the Holding Company's general costs. As such, they were a component of the price of all the Holding Company's VAT-relevant activities. The costs had a direct and immediate link to the Holding Company's business as a whole. The deductibility of the costs, therefore, depended on the composition of that general output prior to the sale of the shares.
A full deduction would be available for the Holding Company, if it only performed taxable activities. A partial deduction would be available if both taxable and exempt activities were carried out (pro-rata calculation). The Dutch Court stressed again that the sale of shares was outside the scope of VAT and did not affect any pro-rata calculation. Only the activities carried out by the Holding Company prior to the sale of shares were relevant.

Forget BLP?

The Dutch High Court did not refer to the European Court's decision in *BLP*.[17] The generally accepted interpretation of *BLP* is that a holding company that sells off shares in its subsidiary is making an exempt supply, provided that the holding company was involved in the management of that subsidiary. However, close reading of the decision reveals that the European Court did not address the VAT

16 Case C-16/00, *Cibo Participations SA v Directeur régional des impôts du Nord-Pas-de-Calais* [2001].

17 Case C-4/94 *BLP Group v Commissioners of Customs & Excise* [1995] ECR I-00983.

status of the sale at all. The referring (UK) court had already decided that the sale was VAT exempt as is apparent from this extract from reference:

> '… where a taxable person ('A') supplies services to another taxable person ('B'), and those services are used by B for an exempt transaction (sale of shares) …'[18]

Apparently, the European Court took the UK qualification for granted. It only addressed the issue whether costs relating to an exempt activity of that nature could be deducted. In the instant case the Dutch Court did not overlook *BLP*, but ignored it intentionally.

Conclusions

The Dutch High Court has opened a promising new chapter in the never-ending story on VAT and holding companies involved in the management of their subsidiaries. The sale of subsidiaries falls outside the scope of VAT, provided that the selling holding company is not involved in commercial share dealing. The sale revenues received by the holding company do not constitute remuneration for management activities performed. In fact, the revenues are not paid by the subsidiary nor can they be linked to any activity of the holding company. As a result, the sale does not qualify as VAT involvement, and is therefore VAT irrelevant.

In the writer's view the Dutch Court has provided a plausible interpretation of the VAT-involvement doctrine of the European Court. Time will tell whether this interpretation is accepted by other courts in Europe or even by the European Court itself. In any event, the situation in the Netherlands is now clear. The decision of the High Court surely offers Dutch holding companies ample VAT savings when they sell off participation interests.

18 *BLP* paragraph 11.