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Can Spanish Taxpayers Still Rely on the FCE Bank Principle?

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Raise your hand if you have any certainty of when recharges of costs between a branch and its head office fall outside the scope of VAT. Some time ago, we would have been pretty confident to regard such intra-entity 'services'[1] – i.e., transactions between a branch and its head office – as falling outside the scope of VAT in the absence of any VAT grouping structure. However, this does not seem to be the view of the Spanish Tax Authorities (STA) as we explore below.

Let us depict the context. It is settled case law that services between these two establishments are outside the scope of VAT since the branch is not independent of its head office.[2] In support of this interpretation, Article 9 of the VAT Directive states that a taxable person shall mean "*any person who, independently, carries out in any place any economic activity, whatever the purpose or results of that activity*".

A branch is most of the time (if not all the time) not carrying out its activity 'independently' from the head office so that both establishments constitute one single taxable person for VAT purposes (known as the 'unity of the taxable person'). Put in another way, a branch is the 'extension' of its head office, no matter the geographical location of these establishments. As a result, any flow of service between a branch and its head office is disregarded for VAT purposes. This interpretation is entirely consistent with the idea that one 'VAT person' cannot be split into more 'persons' simply because it has established itself through one or more branches. Legally, also, it would not make much sense to have one legal entity being split into various 'VAT persons' because it chose a certain commercial model of organisation.

That said, this interpretation is somewhat called into question by the VAT grouping judgments from the Court of Justice of the European Union (CJEU) in *Skandia*[3] and *Danske Bank*,[4] which seem to conclude that VAT grouping snaps up the link between a branch and its head office, resulting in the two establishments being treated, oddly perhaps, as two separate persons for VAT purposes. In the authors' view, however, such interpretation is not set in stone yet[5] but in any event, the conclusion reached in those decisions is not relevant in scenarios where there is no VAT grouping in place (indeed, absent any VAT group, the authority should and still is *FCE Bank*).

Against this background, the Spanish Tax Authorities (STA) have taken a tougher stand on the orthodox principle of unity of the taxable person. Based on a decision from the Spanish Central Tax Court, the STA considers that the Spanish branches of EU banks and insurance companies are in fact 'independent' and, therefore, any services provided by an overseas head office and received

by a Spanish branch fall within the scope of VAT (and mostly subject to VAT). Given the limited right of the input tax deduction for businesses in those sectors, such aggressive interpretation by the STA has the potential of having a material impact on businesses' bottom line.

We briefly explore some of the key CJEU judgments on this issue and we consider the recent developments in Spain. The authors argue that this new interpretation from the STA is likely to result in years of litigation, probably up to the CJEU, creating unwelcome legal risks for current branch structures.

Quick overview of key CJEU judgments[6]

The bedrock principle of unity of the taxable person was set out in *FCE Bank*.[7] The facts can be summarised as follows. FCE IT is a subordinate entity, resident in Italy, of FCE Bank, a company established in the United Kingdom, whose business activities include the supply of financial services exempt from VAT. FCE IT receives services such as consultancy, management, staff training, data processing, software, etc. from FCE Bank. The question arose whether these services were subject to VAT in Italy under the reverse charge mechanism.

In order "*to establish whether such a legal relationship exists between a non-resident company and one of its branches so that the supplies made may be subject to VAT, it is necessary to determine whether FCE IT carries out an independent economic activity. It is necessary in that regard to determine whether a branch such as FCE IT may be regarded as being an independent bank, in particular, that it bears the economic risk arising from its business.*"[8] The CJEU went on "*as a branch, FCE IT does not have any endowment capital. Consequently, the risk associated with the economic activity lies wholly with the FCE Bank. Consequently, FCE IT is dependent upon that company and, with it, constitutes a single taxable person.*"[9]

The CJEU concluded that "*a fixed establishment, which is not a legal entity distinct from the company of which it forms part, established in another Member State and to which the company supplies services, should not be treated as a taxable person by reason of the costs imputed to it in respect of those supplies.*" Therefore, FCE IT had no reverse charge obligation in Italy.

Although the conclusion reached by *FCE Bank* seems clear – i.e., there is no legal relationship between a branch and its head office so that any supply of service between the two establishments is in principle outside the scope of VAT –, the Court left the door open for a branch to be regarded as 'independent'. If a branch bears the economic risk, the CJEU suggests that the branch can be independent of its head office and, it seems, this could be assessed by reference to its capital requirements.

In the authors' view, the approach from the CJEU is unfortunate for two reasons. First, it creates (unnecessary) legal uncertainty in genuine commercial settings in relation to an otherwise very clear principle of the unity of the taxable person, and second, it does not provide clear guidance as to which criteria should be applied to assess a (theoretical) "non-dependence" of a branch. If one has to consider capital requirements, it seems to us that a branch has no decision-making power (in most cases, if not all) as regards its capital since the head office is the only establishment deciding how much capital to allocate to the branch and for what purposes.

It is worth highlighting the Advocate General's opinion in *FCE Bank* in which AG Léger stated that "*the fact that the [Directive] contains several provisions expressly setting out the circumstances in which supplies of services effected by a taxable person for its own professional or*

private purposes are to be treated as supplies of services for consideration tends to confirm, in my view, that outside of those specific cases such supplies are not chargeable to VAT".[10] This interpretation, – which underpins the idea that there is no supply for VAT purposes as regards intra-entity flows since they were not intended to be caught in the VAT net by the legislator -, is a helpful reminder that the VAT law should not be extended to ring-fence transactions that are not intended to be caught in the first place.

A few years later, the CJEU upheld the *FCE Bank* doctrine in its *Skandia* decision.[11] The CJEU, referring to *FCE Bank*, set out that "*as a branch of [Skandia America Corporation], Skandia [SE] does not operate independently and does not itself bear the economic risks arising from the exercise of its activity. In addition, as a branch, according to the national legislation, it does not have any capital of its own and its assets belong to SAC. Consequently, Skandia [SE] is dependent on SAC and cannot, therefore, itself be characterised as a taxable person within the meaning of Article 9 of the VAT Directive.*"[12]

This statement from the Court is important for two reasons. First, it upholds the decision of *FCE Bank* that a branch cannot be seen as operating independently since it cannot bear the economic risks arising from the exercise of its activity. Second, the CJEU points out that "*in addition*" the branch does not have capital of its own which necessarily creates a dependency on its head office. In the authors' view, the use of the words "in addition" perhaps suggests that the CJEU regards the capital requirements as being a helpful indicator rather than a decisive criterion as to whether there is dependency vis-à-vis the head office. That said, the judgment does not go much further in providing any concrete criterion to be applied by the taxpayer in order to assess a potential non-dependency of the branch.[13]

In *Morgan Stanley*, the CJEU further pointed out "*with regard to a company whose principal establishment is located in a Member State and whose branch is registered in another Member State, it is apparent from the case law of the Court that the principal establishment and the branch constitute a single taxable person subject to VAT, unless it is established that the branch carries out an independent economic activity, which would be the case inter alia if it were to bear the economic risk arising from its business*". [14] Sadly enough, the CJEU did not specify in which scenario and under which criteria a branch could be seen as bearing the economic risk associated with its activities.

In conclusion, the principle of unity of the taxable person laid down in *FCE Bank* should remain the default legal principle in genuine commercial arrangements. This means that a branch should be regarded as dependent on its head office and constitute a natural extension of the same legal person. If a branch "bears the economic risks" associated with its activities, it is theoretically possible to regard the branch as independent in light of CJEU's judgments. That said, the judgments from the CJEU have not set out in which scenario this situation could arise. In our experience, it is unlikely to be a realistic interpretation of normal commercial arrangements within group companies as the head office either provides the necessary capital to its branches (and is remunerated for it) or, potentially, acts as a guarantor for an amount agreed between the relevant stakeholders. The head office is the only establishment that, directly or indirectly, bears the economic risks associated with the activities.

A singular approach taken in Spain

We thought that the principle of unity of the taxable person was firmly established in the EU

since *FCE Bank*, particularly outside any VAT grouping arrangements. However, in January 2020,[15] the Spanish Central Tax Court issued a resolution (confirmed by the Spanish National Court) which broke up with the principle of unity established in *FCE Bank*. The Tax Court concluded that a branch of a foreign head office that takes over the insurance activities of a subsidiary can be considered an independent taxable person from its head office. This resulted in the allocation of expenses made by the head office to the branch to fall in the scope of VAT, even though the branch was not a member of any VAT group.

The facts that led to this decision were very specific, however. The transfer of activities took place without any commercial change occurring post-transfer in respect of the risk assumption, decision making and employee responsibilities. In other words, the branch was carrying out the same functions and activities as the subsidiary used to, without the transfer being driven by commercial or regulatory requirements. We understand that the transfer of activities aimed at gaining a VAT advantage resulting from the branch structure, which sharply contrasts with genuine commercial arrangements (which constitute the vast majority of corporate structures).

In its resolution, the Spanish Central Tax Court referred to both *FCE Bank* and *Skandia* judgments and elaborated a complex analysis of the facts by reference to those decisions. The Tax Court considered, for example, how and why the funds were attributed to the branch for transfer pricing and regulatory reasons.[16] The Tax Court also referred to the theory of 'independency of the branch', which mirrored the conclusion reached by the CJEU in *Skandia* (despite the facts not involving any VAT group). The Tax Court seems therefore to have developed criteria to assess the non-dependency of a branch in such a context by reference to capital requirements as set out in *FCE Bank*.

The legal interpretation put forward by the Tax Court[17] is quite specific to arrangements that have a tax-driven motivation. In the authors' view, this line of interpretation cannot be applied to genuine commercial arrangements as it would create unacceptable legal challenges to the concept of the taxable person and aggravate the competitiveness of the EU financial and insurance sector compared to its US counterparts.[18] Therefore, we thought – naively – that the resolution from the Tax Court would constitute an isolated 'incident' with no application to arrangements outside tax avoidance or tax fraud.

However, over the last year, we have seen a surge in VAT assessments issued by the STA against financial and insurance businesses in relation to the VAT liability of transactions taking place between branches and their head office. These assessments are raised outside any specific tax avoidance or fraud context but rather rely on the general principle arising from the resolution of the Spanish Tax Court that a branch can be independent. This has resulted in significant amounts of money being claimed by the STA in a highly questionable alignment with the fundamental principle laid down in *FCE Bank*.

Businesses should be free to decide whatever form of organisation they decide to operate within as long as it satisfies commercial, and more importantly, regulatory imperatives. This can be illustrated as follows. Within the EU, a bank registered in a member state can operate in other member states through branches (and only branches, not subsidiaries) without meeting concrete regulatory requirements in each member state where the bank operates (this is the well-known 'Passporting for Credit Institutions'). That is, being granted a banking licence authorisation in one member state opens up the possibility of a credit institution being able to passport throughout the rest of the EU without the need to establish a subsidiary in another member state. From a

regulatory perspective (note that we are dealing with a regulated market!), a branch is considered to be part of the same entity as the head office and that is why the licence granted to a head office also benefits its branches. In our opinion, the fact that the passport is granted to the head office (that is, the branch needs the head office's licence to operate in a specific market) cannot be a more relevant indication of dependency. In fact, if the branch cannot access the mentioned licence to operate, the branch would not be able to operate in the local market on its own.

It is undisputed that a head office can have a fixed establishment (as per the VAT directive and case law) which necessarily involves a degree of autonomy at the level of the fixed establishment, otherwise, it would not be a fixed establishment (!). However, the STA seems to be developing a contrived interpretation whereby the degree of autonomy that a branch enjoys – which, again, is an inherent characteristic of a branch – results in the 'independency' of a such branch. This interpretation does not only go far beyond CJEU case law, but it also overlooks regulatory imperatives at play in the financial sector in the context of which branches cannot assume the economic risks related to their activities.

In the authors' view, businesses need to articulate the autonomy of the branch in a way that merely satisfies the criteria of a fixed establishment as set out in the law. In other words, one should demonstrate that a branch operates within the framework of autonomy that is expected from an establishment that meets the criteria for a fixed establishment. As regards the assumption of risks, it seems to us that the regulatory framework should be a key area to support the position. In any case, the general rule should be that a branch is not independent of the head office, since the CJEU has not concluded otherwise.

If this matter ends up before the CJEU in the coming years, we can only hope that the Court will close the matter by clearly articulating that an exception to the principle of unity of the taxable person can be conceived in case of avoidance and/or fraud. In the meantime, Spanish businesses should be encouraged to rely on *FCE Bank* and the legal principle of unity of the taxable person.

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[1] We use the term 'service' in its generic meaning; sometimes it constitutes a service for VAT purposes, sometimes it doesn't, as this article demonstrates.

[2] CJEU, FCE Bank, C-210/04, 23 March 2006.

[3] CJEU, Skandia America Corporation, C-7/13, 17 September 2014.

[4] CJEU, Danske Bank, C-812/19, 11 March 2021.

[5] In this regard: Philippe Gamito, "Danske Bank: Will EU VAT Grouping Survive to Reverse Skandia?" [2021] 32 International VAT monitor (issue 4), 213 – 218. We also note the difficulties resulting from UK VAT grouping in a post-Brexit context and whether it should be treated in the same way as an EU VAT grouping under Article 11 of the VAT Directive.

[6] The authors have selected specific judgments but please note that there are other judgments from the CJEU on this issue. See inter alia Credit Lyonnais (c-388/11).

[7] CJEU, FCE Bank, C-210/04, 23 March 2006.

[8] FCE Bank, para. 35.

[9] FCE Bank, para. 37.

[10] AG Opinion in FCE Bank, para. 60.

[11] CJEU, Skandia America Corporation, C-7/13, 17 September 2014.

[12] Skandia America Corporation, para. 26.

[13] We note the recent Opinion from AG Kokott in relation to director fees (see AG in TP, C-288/22) and the various criteria she applied to determine whether the director was acting independently (i.e., liability, influence on remuneration, risk). Although a read-across is possible to some extent, the issue of directors' fees is directly linked to Article 10 of the VAT Directive, which differs from the issue of intra-entity supplies in our view.

[14] CJEU, Morgan Stanley, C-165/17, 24 January 2019, para. 35.

[15] Num. 00/05047/2016/00/00, 23 January 2020.

[16] The risk assumption from the branch side is linked to the fact that the branch disposes of capital that protects it from potential losses in the market. From the substantive regulations, regulating the exercise of the insurance activity results in the necessary provision of funds that ensure the solvency of the entities. These funds are determined by the volume of activity of the entities, considering, logically, the activity carried out by each of them in the territories in which they operate including, among others, Spain.

[17] Resolution, whose content has been already applied by the Spanish General Directorate of Taxes in ruling V0144-23.

[18] The current EU VAT landscape is already complicated in light of Skandia and Danske Bank as well as the fact that financial and insurance businesses can no longer make use of the cost-sharing exemption.

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