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TAXABLE PERSONS AND THE "PRIVATE LIFE" OF COMPANIES

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Over the years a number of eminent commentators have praised the European Court for its rulings in the sphere of value added tax,[2] in particular its willingness to be guided by the basic principles and scheme of the tax in interpreting provisions whose drafting sometimes leaves much to be desired. Although I too belong to that school of thought, I would like to look at a line of cases which - although arguably all correct in their result - give rise to some concern. The cases also illustrate the somewhat unsatisfactory situation pertaining at present in which the Court, often with the benefit of written observations from no more than one or two Member States, is called upon to clarify on a case-by-case basis points of general importance which should really be dealt with in the legislation itself.

Prior to its ruling in *Polysar*[3] the Court had consistently construed the concept of taxable person in Article 4 of the Sixth VAT Directive broadly.[4] Although, I

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2 See, for example, 'Tax Law: Rules or Principles', text of the 1996 IFS Annual Lecture given by John Avery Jones, published in *Fiscal Studies* (1996) vol 17 No 3, pp. 63-89.

3 Case C-60/90 *Polysar Investments Netherlands v Inspecteur der Invoerrechten en Accijnzen* [1991] ECR I-3111.

4 See, for example, the judgment in Case C-186/89 *Van Tiem v Staatssecretaris van Financïen* [1990] ECR I-4363 and in Case 235/85 *Commission v Netherlands* [1987] ECR 1471.

suspect, not recognised at the time, the *Polysar* ruling marked the start of a retreat from that position. The ruling seemed innocuous enough in itself. Polysar was a wholly owned subsidiary of a Canadian group incorporated in the Netherlands to act as the purely passive holding company of the group's various trading subsidiaries in Europe. In their written observations to the Court the French and Netherlands Governments and the Commission contended that Polysar was not a taxable person. Their view was accepted by the Advocate General and by the Court, which held:

> "The mere acquisition of financial holdings in other undertakings does not amount to the exploitation of property for the purpose of obtaining income therefrom on a continuing basis because any dividend yielded by that holding is merely the result of ownership of the property.
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> 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, without prejudice to the rights held by the holding company as shareholder."[5]

It is perhaps interesting, in the light of more recent rulings, to mention briefly the submissions made by the French Government and the Commission in the case. The French Government distinguished between companies which received (a) dividends, interest and management fees; (b) dividends and interest; and (c) dividends alone. The first two categories of company fell within the scope of VAT, the receipt of interest on loans constituting consideration for an exempt supply falling within the scope of the tax. A company receiving only dividends was not a taxable person because dividends did not constitute the consideration for the provision of services - they merely amounted to a profit share. For its part the Commission considered that there was an intermediate category of company between the purely passive company and the company providing services to its subsidiaries, namely a holding company which also carries on investment activities connected with the holding of shares in other companies. The Commission considered such a company to be a taxable person but exclusively in respect of the services exempted under Article 13B(d)(5) of the Directive (share transactions).

Thus, whereas the French Government's analysis was based on the absence of any supplies for consideration, the Commission and especially the Court based their reasoning on the notion that purely passive equity investment fell outside the scope of the tax, a theme that has since been developed in later cases.

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5 Paragraphs 13 and 14 of the judgment.

The next chapter in the story is the Court's ruling in *Sofitam*.[6] The issue in this case was rather different. Unlike Polysar, Sofitam was an active holding company which, in addition to receiving dividends from its subsidiaries, provided taxable services to them. The issue in the case was whether the dividends which it received were to be excluded from the denominator of the input tax fraction under Article 19(1) of the Sixth Directive. That provision lays down the general rule for calculating the deductible proportion of input VAT on purchases used partly for supplies not giving rise to the right of deduction. The proportion is arrived at by applying to the total input tax a fraction having as its numerator turnover giving rise to the right of deduction and as its denominator total turnover. The effect of including the dividends received by Sofitam in the denominator of the fraction was to reduce the deductible proportion of its input tax.

The French Government considered that, although - as it had argued in *Polysar* - dividends did not constitute consideration for a supply of services and hence fell outside the scope of the tax, they nevertheless had to be included in Sofitam's total turnover figure in the denominator of the input tax fraction in order to preserve fiscal neutrality. The Court took the opposite view. The result, although not beyond debate, is defensible. What is perhaps more surprising is the Court's reasoning. Referring to the *Polysar* ruling, the Court concluded that, since dividends did not constitute consideration for any economic activity within the meaning of the Directive, the receipt of dividends did not fall within the scope of the tax. Consequently dividends received from the holding of participations were alien to the deduction system.[7] The court's ruling broadly followed the views expressed by the Commission.

Thus in *Sofitam* the Court extended the *Polysar* ruling to the calculation of the deduction entitlement of an active holding company. The *Polysar* case was perhaps of limited significance. If, as the French Government argued, dividends do not constitute consideration for a supply of services, Polysar would not have had any deduction entitlement under the Sixth Directive even if it had been a taxable person (although it is not clear that that would have been the case under the Netherlands legislation). However, the exclusion of dividends from the fraction in Article 19(1) on the ground that they do not constitute consideration for an economic activity is more problematic. There are certainly circumstances in which income from transactions outside the scope of VAT must be taken into account in the calculation of input tax. A taxable person may incur input tax on goods and services used for both inside-the-scope and outside-the-scope supplies.

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[6] Case C-333/91 *Sofitam v Ministre chargé du Budget* [1993] ECR I-3513.

[7] See paragraph 13 of the judgment.

To adapt an example taken from the case law,[8] if a body such as the Apple and Pear Development Council incurred input tax on goods or services used for the purposes of both the taxable contractual services which it provided to growers and the services financed by compulsory levies (held by the Court not to constitute the supply of services for consideration), it would be necessary to arrive at an appropriate apportionment of input tax. In the absence of a more precise method applied pursuant to Article 17(5), the compulsory levies would have to be included in the denominator of the fraction in Article 19(1). The analysis in *Sofitam* would therefore appear to demand a distinction between passive income which does not affect input tax recovery (e.g., income falling outside the scope because it does not involve an economic activity) and other outside-the-scope income which does (e.g., non-passive income linked - but not directly linked - to a supply of goods or services).

It is submitted that the same result could have been achieved by a much simpler route. In order to limit Sofitam's dividend income the Court could have excluded it from the calculation in Article 19(1) on the basis of Article 19(2). That provision, which proceeds from the premise that incidental financial income does not entail the use of business resources, excludes such income from the denominator of the input tax fraction in order to prevent a distortion of the calculation. Thus dividends, whether they are to be regarded as consideration for an exempt supply or, as the French Government in my view correctly argued, an outside-the-scope profit share (dividends being distinguishable from interest involving an ascertainable consideration), they would in principle enter into the input tax calculation but, where the general rule in Article 19(1) is applied, would be excluded as incidental income. Such an analysis would have involved only a minor change to the French rules instead of raising fundamental conceptual questions.

The *Polysar* ruling was raised again by the Commission in *BLP*, a reference from the United Kingdom courts.[9] BLP sought deduction of input tax on fees for services connected with the sale of shares in a subsidiary company. It was assumed by the parties to the national proceedings that the share sale was an exempt transaction. However, the Commission for the sake of completeness raised the point that the *Polysar* ruling might be construed to the effect that the share sale by BLP was to be regarded as carried out in its non-taxable capacity as a holding company, i.e., that it fell outside the scope of the tax. In the event the Court wisely decided to brush the issue under the carpet, responding to the case as put to it by the national Court.

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[8] Case 102/86 *Apple and Pear Development Council* [1988] ECR 1443.

[9] Case C-4/94 *BLP v Commissioners of Customs & Excise* [1995] ECR I-983.

The story continued this year with *Wellcome Trust*[10] and *Régie.*[11] The *Régie* case is of particular interest. The Régie dauphinoise was involved principally in managing let property as agent of the owners and in acting as manager of condominiums. As such, it received advances from the co-owners and lessees. With the agreement of its clients it invested those sums for its own account with financial institutions. The issue was whether the interest received by the Régie on the treasury placements was to be included in the denominator of the input tax fraction.

Although the French Government and even the Régie considered that the interest fell within the scope of the tax, the Commission, referring to *Polysar* and *Sofitam*, argued that the investments did not constitute an economic activity. By a rather tortuous line of logic, which Advocate General Lenz valiantly attempts to summarise in his Opinion,[12] the Commission argued that there was a requirement of a direct link between the service provided and the consideration received and hence between the service provided and the recipient of the service. That was the case where clients' funds were invested for their account. In the present case the Régie had invested the funds for its own account, with the result that the Régie was at the same time the supplier of services and the recipient of such services. In such circumstances the placement of funds did not constitute a supply of services made in the framework of the property management business. It therefore acted as an ordinary individual administering his investments; in the Commission's view there was therefore no economic activity within the meaning of the Directive.

The Court declined to follow the Commission's line of reasoning - although it seems to have been influenced by the Commission's general approach of placing limits on the scope of the tax. Distinguishing *Sofitam*, it observed that, unlike the receipt of dividends by a holding company, interest received by a property management company on placements made for its own account of sums paid by co-owners or lessees could not be excluded from the scope of VAT, since the interest did not simply arise from ownership of the asset but was the consideration for placing capital at the disposal of a third party, namely the financial institutions.[13] The Court then added:

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[10] Case C-155/94 *Wellcome Trust Ltd v Commissioners of Customs & Excise*, judgment of 20th June 1996.

[11] Case C-306/94 *Régie dauphinoise - Cabinet A Forest SARL v Ministre du Budget,* judgment of 11th July 1996.

[12] See paragraph 14 *et seq* of the Opinion.

[13] See paragraph 17 of the judgment.

> "It is true that services such as placements made with banks by the manager of a condominium would not be subject to VAT if supplied by a person not acting as a taxable person. However, in the case at issue in the main proceedings, the receipt, by such a manager, of the interest resulting from the placement of monies received from clients in the course of managing their properties constitutes the direct, permanent and necessary extension of the taxable activity, so that the manager is acting as a taxable person in making such an investment."

After concluding that the treasury operations fell within the scope of the tax, it considered whether they constituted incidental financial transactions within the meaning of Article 19(2). The Court held as follows:

> "The purpose of excluding incidental financial transactions from the denominator of the fraction used to calculate the deductible proportion in accordance with Article 19 of the Sixth Directive is to comply with the objective of complete neutrality guaranteed by the common system of VAT. As the Advocate General has observed at point 39 of his Opinion, if all receipts from a taxable person's financial transactions linked to a taxable activity were to be included in that denominator, even where the creation of such receipts did not entail the use of goods or services subject to VAT or, at least, entailed only their very limited use, calculation of the deduction would be distorted.
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> However, placements by property management companies are the consequence of advances to them by co-owners and lessees for whom they manage their properties. With the consent of their clients, those companies are able to place these monies for their own account with financial institutions. That is why, as the Court has pointed out at paragraph 18 of this judgment, the receipt of interest from those placements constitutes the direct, permanent and necessary extension of the taxable activity of property management companies. Such placements cannot therefore be characterised as incidental financial transactions within the meaning of Article 19(2) of the Sixth Directive. To take them into account in order to calculate the deductible proportion would not be such as to affect the neutrality of the system of value added tax."

The result, although debatable, is certainly defensible. What is interesting is the Court's reasoning, in particular with respect to the scope of the tax. The Court appears to have extended the notion of passive investment falling outside the scope of VAT from dividends to interest, distinguishing between passive debt investment and debt investment forming a direct extension of a taxable person's activity. How the "direct extension" test will apply in practice is unclear. In particular it is unclear where the line is to be drawn between purely passive investment and investment linked to the economic activity. Would, for example, the normal treasury operations of a more typical trading company constitute a direct extension of its activities falling within the scope of the tax? If so, would short-term or medium-term investments be covered?

A further point is that, curiously, the Court applied the same test for the purpose of defining the scope of the tax as it did for the purpose of defining the term "incidental financial transactions" in Article 19(2). Since according to *Sofitam* only transactions falling within the scope of the tax enter into the fraction in Article 19(1), it is difficult to see what purpose is served by Article 19(2) since financial transactions not forming a direct extension of the taxable person's economic activity would fall outside the scope of the tax and hence be excluded from the fraction anyway.

There is perhaps no reason in principle why a company should not have a "private life". On that view the scope of VAT should be limited to its trading activities - like a private individual it can engage in passive investment beyond the reach of the VAT system. Hitherto the cases have been concerned with dividends or interest which would in any event have been either exempt or outside the scope of the tax. That may however not always be the case. Loans to non-EC residents, if they were to fall within the scope of the tax, would be zero-rated (i.e., exempt with refund of tax), and there may even be implications for the option to tax financial transactions depending on the extent to which the company's private life spills over into its business affairs. There would moreover seem to be scope for applying the same principle to other types of supplies. If a company buys a work of art as an investment and then sells it, would the otherwise taxable sale not fall outside the scope of the tax? Would it matter if and where it was displayed? Some might argue that such an approach is justified from the standpoint of the theory of the tax. It is, however, important to be aware of the general dangers involved in eating into the scope of the tax, and it is submitted that the Court should be cautious about taking this approach too far.

Another view might be that a trading company or company in a trading group ultimately has a business motive for everything it does. Unlike investment by a private individual or non-trading entity, investment by a company, e.g., in the form of long-term loans to associated companies, involves the use of business funds as part of a business strategy. Indeed, whether the profits of a subsidiary company are extracted as dividends, interest or management charges may in any event largely be determined by direct tax considerations. Apart from such conceptual considerations, the case law seems to add an unnecessary practical complication. A proper treatment of input tax could surely have been achieved more simply by means of the deduction rules in Article 17 et seq. Certainly that is true of the cases so far decided. Polysar had no right of deduction because dividends do not constitute consideration for a supply of goods or services. Sofitam's dividends could have been excluded from the input tax calculation for the same reason or because they constituted incidental financial income. Régie's interest income, as the ascertainable consideration for the making available of business funds, would fall within the scope of the tax and then fall to be tested against the criteria for incidental financial income in Article 19(2). The Court would have then avoided the task now facing it of tracing the limits of a corporate "private life".