Cost sharing exemptions

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Abstract The cost-sharing exemption applied in the field of VAT is losing its relevance rapidly as it is becoming clear that it cannot be applied in many sectors of the economy after all.

Keywords Cost sharing exemption · Aviva Group case · DNB Banka

In a world where global trade is dependent on endless organisational networks, it is common for many businesses to come together, cooperate and pool resources. This contractual cooperation gives businesses certain advantages that are not obtainable by them acting on their own. There is no single way of engaging in such cooperation. Businesses can cooperate in different ways such as pooling certain assets, pooling money (by cash pooling or cost pooling), or pooling personnel.¹ They can also share risks or form new business together by way of a joint venture, a partnership or a European Economic Interest Group (EEIG).² Any such contractual agreement has quite an impact in determining the identity of a taxable person for the purposes of value added tax (VAT) as the linking of individual businesses with each other or the creation of a new business might be treated as one single taxable person for the purposes of VAT.³ The idea that, under certain conditions, a group of individual businesses can

¹ Doesum/Kesteren/Norder [3], p. 144.

² Doesum/Kesteren/Norder [3], p. 144.

³ Case C-23/98 *Staatssecretaris van Financiën v J. Heerma*, EU:C:2000:46; Case C-162/07 *Ampliscientifica Srl, Amplifin SpA v Ministero dell'Economia e delle Finanze, Agenzia delle Entrate*, EU:C:2008:301; Case C-480/10 *European Commission v Kingdom of Sweden*, EU:C:2013:263; Case C-274/15 *European Commission v Grand Duchy of Luxembourg*, EU:C:2017:333.

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be treated as one taxable person can be traced back to the German *Organschaft* which embodies the idea that substance should prevail over legal form and that businesses that are technically independent but practically related should be treated as one.⁴ One of the consequences of treating participants of a VAT group as a single taxable person is that transactions between those participants are disregarded for VAT purposes.⁵

Under the European Union VAT Directive (henceforth ‘VAT Directive’),⁶ the general principle is that all supplies of goods or services made by taxable persons for consideration are taxed. However, there are a few exceptions to this general principle under which certain supplies are exempted from VAT. One of the exemptions is provided for in Article 132(1)(f) of the VAT Directive which deals with cost sharing agreements. Under this Article, instead of cost sharing agreements, the term ‘independent groups of persons’ (IGP) has been used. This provision exempts the supply of services by IGP, the members which are carrying out an activity that is exempt from VAT or in relation to which they are not taxable persons, for the purpose of rendering their members the services directly necessary for the exercise of that activity, where those groups merely claim from their members exact reimbursement of their share of the joint expenses, provided that such exemption is not likely to cause distortion of competition. This exemption is more clearly illustrated below:⁷

*costs = exact reimbursement of their share of the joint expenses

** service = directly necessary for the exercise of the exempt/non-taxable activity

⁴Amand [2], p. 238.

⁵Vyncke [5], p. 339.

⁶Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax [2006] OJ L 347/1.

⁷European Commission [4], p. 3.

The basic purpose of this exemption is to allow economic operators to use a cost sharing group to pool the acquisition of services and to re-distribute the costs for these services exempt from VAT, from the group to its members.⁸ In other words, its rationale is to create an exemption from VAT in order to avoid any entity offering certain services from being required to pay this tax when it has found it necessary to cooperate with other entities by means of common structure set up to undertake activities essential to the provisions of those services.⁹

In order to apply the exemption under Article 132(1)(f), the following conditions have to be met:¹⁰

1. there must be an entity ‘independent group’ supplying services to persons who are members of it. This exemption is applicable only if the group has at least two members;¹¹
2. the exemption only applies to services to the members (either to one or several members). Hence, any service from the members to the independent group falls outside the scope of Article 132(1)(f) of VAT Directive.
3. the services supplied by the group must be ‘directly necessary’ for the exercise of the members’ exempt or non-taxable downstream activities;
4. the services supplied by the IGP must be rewarded at cost ‘exact reimbursement’ and so the group must not make a profit out of the exempt services supplied to its members; and
5. the exemption from VAT of the supplies must not be likely to cause distortion of competition.

Although these conditions look quite straightforward, the application and scope of this exemption has been a source of considerable debate ever since its inception. Recently, the European Court of Justice considered a number of significant questions in respect of the cost sharing exemption which go to the very heart of how the exemption is to be applied and understood. In infraction proceedings against Luxembourg,¹² where, contrary to Article 132(1)(f) of the VAT Directive, Luxembourg VAT law allowed exemption of a taxed activity within a certain ceiling, the Court of Justice clarified that services rendered by IGPs’ to members who also carry out taxable activities may qualify for that exemption, but only in so far as those services are directly necessary for those members’ exempt activities or activities in relation to which they are not taxable persons.

In another set of infringement proceedings, this time against Germany,¹³ the Court of Justice, considered the scope of application of Article 132(1)(f) of the VAT Directive in the light of the issue of whether restricting the exemption to a limited number of professions was permissible or not, and held that such an exclusion was not allowed. The European Court of Justice dismissed Germany’s argument that the exemption was restricted to IGPs whose members exercise a professional activity in

⁸European Commission [4], p. 2.

⁹Case C-407/07 *Stichting Centraal Begeleidingsorgaan voor de Intercollegiale Toetsing v Staatssecretaris van Financiën*, EU:C:2008:713.

¹⁰*Doesum/Kesteren/Norder* [3], p. 273.

¹¹Case C-348/87 *Stichting Uitvoering Financiële Acties v Staatssecretaris van Financiën*, EU:C:1989:246.

¹²Case C-274/15 *European Commission V Grand Duchy of Luxembourg*, EU:C:2017:333.

¹³Case C-616/15 *European Commission V Federal Republic of Germany*, EU:C:2017:721.

the health sector only and observed that the VAT Directive envisages other exempt transactions in the public interest, such as transactions related to welfare and social security, education, sport and culture. Additionally, while considering the scope of justification required to restrict the exemption on the ground of causing distortion of competition, the European Court of Justice further held that the said restriction could not be applied in a general manner resulting in the exclusion of other services.

In two further cases,¹⁴ the European Court of Justice again dealt with the scope of Article 132(1)(f) of the VAT Directive when it was called upon to deal with its stipulation that there must be no distortion of competition and the question of whether a Member State had an obligation to transpose more than the mere wording of the exemption into its national law.

In the case of *Aviva Group*, the referring court enquired about the possible use of the exemption by a Polish group company of the Aviva Group. Aviva Group, which engages in providing insurance services, was considering the setting up of a series of shared-service centres in certain Member States and of pursuing that activity in the form of an EEIG. The idea was that these centres would supply services directly necessary for the exercise of insurance activities by members of the group (*i.e.*, the EEIG). Regarding the issue of whether such activities would be exempt under the cost sharing exemption, the referring court requested clarification of the criteria for determining that there had been no distortion of competition. Further, it also enquired whether Member States must set out specific criteria in their legislation with respect to this condition. In its final query, the referring court asked whether a cross-border situation would lead to different conclusions. The European Court of Justice, in answering the questions referred, made a comparison between the exemptions provided under Chap. 2 and Chap. 3 of the VAT Directive, respectively. It relied upon a contextual interpretation method and held that Chap. 2 of the VAT Directive deals solely with exemptions on activities performed in public interest. As a result, services provided by IGPs whose members carry out economic activity in the area of insurance, which does not constitute an activity in the public interest, were not entitled to seek exemptions under Article 132(1)(f) in Chap. 2 of the VAT Directive. *Vide* this judgment the European Court of Justice excluded businesses supplying insurance services from the scope of VAT exemption provided under Article 132(1)(f) of VAT Directive.

Similarly in the case of *DNB Banka*, the referring court sought guidance from the European Court of Justice on the concept of an IGP under Article 132(1)(f) of the VAT Directive, on whether the exemption could be combined with a transfer pricing-related margin, and on whether the exemption could be used in a cross-border situation. DNB Group consists of several entities active in the area of financial services. One of these entities is DNB Banka (Latvia), a subsidiary of DNB NORD (Denmark) which itself is a subsidiary of DNB Bank (Norway). DNB NORD (Denmark) is also the parent company of DNB IT (Denmark). In this case, DNB Banka (Latvia) entered into contracts with DNB NORD (Denmark) and DNB IT (Denmark) for the provision of financial management services and information technology management services respectively. DNB Bank (Norway) in agreement with DNB Banka (Latvia), also concluded a contract with Microsoft Ireland Operations Ltd. relating to the pur-

¹⁴Case C-605/15 *Minister Finansów v Aviva Towarzystwo Ubezpieczeń na Życie S.A. w Warszawie*, EU:C:2017:718; Case C-326/15 *'DNB BANKA' AS v Valsts ienemumu dienests*, EU:C:2017:719.

chase of Microsoft products and licences. The costs of the licences were allocated by DNB Bank (Norway) to the members of the DNB Group, and consequently DNB Banka (Latvia), received invoices issued by DNB Bank (Norway) regarding the software licences. DNB Banka (Latvia) was later subject to a tax inspection where it maintained that the aforementioned transactions were exempt from VAT by virtue of the cost sharing VAT exemption and requested the Latvian tax authority to correct the VAT declarations accordingly. Subsequently, the referring court raised the above-mentioned question to the European Court of Justice. The Court of Justice in deciding the issue first looked at the exact wording of the exemption rule, noting that merely the exempt activity of the members of an IGP was mentioned; and that, as Article 135(1)(d) (located in Chap. 3 of the VAT Directive) exempts financial services, an IGP whose members carry on an economic activity in the area of financial services would not be excluded from the exemption according to a literal interpretation of the rule. However, in finally adjudicating the issue, the European Court of Justice without giving any reasons, did not rely upon a textual interpretation and just as in the case of *Aviva*, used the contextual interpretation method and finally held that in order to avail of the exemption under Article 132, the supply of a service should contribute directly to the exercise of activities in the public interest, and as services provided by IGPs whose members carry on an economic activity in the area of financial services do not constitute an activity in the public interest, they are thus not entitled to the VAT exemption referred to in Article 132(1)(f) of VAT Directive.

In both of these recent judgements, the European Court of Justice made it clear that the exemption provided under Article 132 of the VAT Directive covers only IGPs whose members carry on activities in the public interest and not any other activities. Further, according to the European Court of Justice's interpretation, financial services which are not on the limiting list of activities under Article 132 of the VAT Directive, are precluded from the cost-sharing exemption under Article 132. This interpretation has created a dilemma among IGPs as according to it, only the supply of services by IGPs for the public interest will fall under the scope of the exemption. In other words, a new condition in addition to those already stipulated under Article 132(1)(f) of the VAT Directive for IGPs has been introduced which may create a tricky situation for the supply of services by IGPs related to immovable property or the supply of services involving non-taxable persons. With regard to the latter category of persons, it is unclear how these judgments must be interpreted. If the non-taxable member of a IGP is, for instance, a pure holding company belonging to a group of companies in the financial sector, it could be argued that such an entity is not directly involved in the making of (exempt) financial services itself. At the other hand, it might be argued that such a non-taxable person is incorporated in a financial institution and that an IGP that provides supplies to such an entity may not apply the cost sharing exemption on the supplies provided to that entity. If the latter reasoning is correct, a non-taxable entity belonging to a healthcare group is allowed to receive services provided under this exemption.

These rulings have definitely reshaped the landscape for financial institutions and have forced these institutions to review the impact of such rulings on their organisation and to consider alternatives in order to avoid a significant VAT burden. One of the alternatives can be the formation of a VAT group by group companies, which will allow entities within a VAT group to supply goods and services to other entities in

the VAT group without VAT. However, before considering such an alternative, entities have to consider the rules of individual Member States as not all Member States allow VAT grouping. One such Member State is France, the position of which is quite complex as, on the one hand, being one of the financial centres of the European Union, it caters to substantial financial institutions extensively involved in cost-sharing agreements, yet on the other hand it lacks a VAT grouping regime leaving both itself and financial institutions in a vulnerable situation. It will be interesting to observe how France reacts and acts in the light of the above judgments. Furthermore, to state that there is an easier way out for financial institutions in those Member States where a VAT grouping regime is available is also not entirely true as such Member States generally have complicated eligibility criteria, thereby leaving financial institutions with Hobson's choice. Another alternative which entities can consider is the formation of a consortium. Participants in a consortium are, under strict conditions, not regarded as providing a service to each other because they are basically only fulfilling their own obligations towards the consortium and are not providing a service and therefore can reduce their VAT burden. One case in which partners of a consortium shared their knowledge and other resources without charging each other for the common use of those resources is the *EDM* case.¹⁵

Another important topic which is worth discussing in light of these recent judgments is the method of interpretation applied by the European Court of Justice in these cases, as they have not only created unrest among financial institutions but have also initiated a debate on the application of interpretation methods. Over a period of time, the European Court of Justice has maintained that exemptions, being an exception to a general rule should be interpreted strictly,¹⁶ involving analysis of the text, the context, the purpose and the principle of effectiveness (although not so strictly that it virtually is impossible to apply¹⁷). What is interesting to know here is the sequence that has to be followed for the purposes of interpretation. It is a question that has been lingering in everyone's mind for quite some time now. Some clarification can be derived from Article 31 of the Vienna Convention on the Law of Treaties, which explains that once the textual interpretation is exhausted, contextual interpretation needs to be carried out.¹⁸ Therefore, the intent clearly is to derive a solution first by using textual interpretation and if that is not possible only then to consider other methods of interpretation. Traditionally the European Court of Justice has also followed such an approach and has been cautious in applying the contextual method directly as it could lead to errors or changes in the case law. However, despite appreciating the risks of applying the contextual method, the European Court of Justice has never felt bound to apply interpretative methods in a specific order, something which can be seen from its celebrated rulings in *Van Gend & Loos*¹⁹ and *Continental Can*.²⁰ Re-

¹⁵Case C-77/01 *Empresa de Desenvolvimento Mineiro, SA v. Fazenda Publica*, EU:C:2004:243.

¹⁶Case C-412/15 *TMD Gesellschaft für transfusionsmedizinische Dienste mbH v Finanzamt Kassel II - Hofgeismar*, EU:C:2016:738.

¹⁷*Doesum/Kesteren/Norder* [3], p. 274.

¹⁸*Amand* [1], p. 449.

¹⁹Case C-26/62 *NV Algemene Transport- en Expeditie Onderneming van Gend & Loos v Netherlands Inland Revenue Administration*, EU:C:1963:1.

²⁰Case C-6/72 *Europemballage Corporation and Continental Can Company Inc. v Commission of the European Communities*, EU:C:1973:22.

cently, this approach has also been seen in the cases of *DNB Banka* and *Aviva*, where the European Court of Justice applied only contextual interpretation without taking into account the wording and the purpose of VAT exemptions in general, which, if applied, would have probably resulted in more logical consequence in applying VAT exemption to financial services as well. Further, contrary to its normal practice in such cases, the European Court of Justice opted out of giving a proper explanation of its avoidance of other interpretation methods and directly adopted the contextual method. This approach by the European Court of Justice has raised certain questions regarding its method of choosing interpretive methods that could be regarded as being arbitrary or excessively innovative or restrictive. An interpretation as restrictive as that of the Court to the scope of exemption accorded to IGP might defeat the objective of cost-sharing exemptions which is to prevent VAT from becoming a distortive factor when a group of persons find it necessary to cooperate.²¹ It is the smaller economic operators in the financial sector which often do not have the capacity to provide essential services from their own internal resources which will be most affected by the said interpretation as this will affect their capacity to sustain competitiveness. The exclusion of finance services will also affect end consumers as the cost of financial services will increase, which will again defeat the object of exemptions, which is to ensure control over unwanted rises in costs of services provided to end customers.

It will be worth monitoring the potential impact of these judgments on Member States and how they react to it. As the manner in which Article 132(1)(f) of the VAT Directive is applied at present varies from one Member State to another, there is a strong possibility that the latest view of the European Court of Justice may create more confusion and differences of opinion among Member States, which will eventually adversely affect financial institutions and end customers.

Another relatable topic which it is appropriate to touch upon here—and also quite a subject of debate in recent times—is the federative structure, something under constant discussion among economic operators involved in activities in the public interest and tax authorities. A federative structure is a modification of a normal IGP structure, where in addition to an IGP supplying services to its members, it also supplies the same to its member's member (in this situation the first IGP member is now the IGP for its own member). This can be explained better through the illustration below:

²¹ Doesum/Kesteren/Norder [3], p. 273.

The issue here is whether in such a situation, an exemption can be availed for services provided by first IGP to second IGP's member. There are still no concrete answers for this and we need to wait and see how different jurisdictions deal with this structure and eventually how the European Court of Justice perceives and interprets it.

The overall conclusion is that the cost-sharing exemption is losing its (assumed) relevance rapidly as, in the light of the above mentioned court cases, it is becoming clear that it cannot be applied in many sectors of the economy after all.

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