

The concept of “Grouping” for VAT purposes

Abstract

The EU VAT Directive¹ specifically provides for VAT grouping, in that Member States may regard any persons established in their territory who, while legally independent, are closely bound to one another by financial, economic and organizational links, as a single taxable person for VAT purposes. Member States wishing to exercise that option must consult the VAT Committee and may adopt any measures needed to prevent tax evasion or avoidance arising from group registration.

The main advantage of VAT grouping is that the members of the group act as a single entity in respect of their transactions with third parties and, therefore, the arrangement reduces their direct and indirect VAT costs. On the other hand, VAT grouping entails a specific application of the entire VAT legislation and case law, in that it gives precedence to economic substance over legal form.

Sixteen Member States, i.e. Austria, Belgium, Cyprus, Denmark, Estonia, Finland, Germany, Hungary, Ireland, the Netherlands, Romania, Czech Republic, Slovakia, Spain, Sweden and the United Kingdom have already introduced VAT grouping into their national legislation.

The fairly wide interest of the Member States and the European Commission in VAT grouping gives rise to the question of whether it can be expected that all Member States will soon have adopted such arrangement in their national legislation based on a common approach.

¹ Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax

The purpose of this work is twofold. Firstly, it outlines the potential benefits of national VAT grouping arrangements, as well as the features of their design. Secondly, it provides an overview of the Italian VAT legislation in order to point out that Italy has not introduced yet a system of group registration in line with the provision of VAT Directive, since the Italian VAT grouping arrangement is relevant exclusively from a procedural point of view.

More in detail, it has been highlighted that the right to deduct input tax is aimed at ensuring that the VAT system is neutral for taxable persons. Suppliers of goods and services charge VAT on their output transactions and deduct VAT on their input transactions, settling the balance with the Treasury. Thus, in the course of the processes of production and distribution of goods and services, the suppliers collect the VAT from their customers on behalf of the Treasury and generally do not bear the burden of the tax – the ultimate burden is on the final consumer.

However, this neutrality principle does not always operate as intended, with the result that taxable persons incur VAT costs. In this context, two categories of VAT costs can be distinguished: direct and indirect VAT costs.

Direct VAT costs arise from restrictions on the right to deduct input tax on the ground that the goods or services concerned are used for the purpose of carrying out exempt transactions or on the ground that the VAT on specific goods and services has categorically been excluded from deduction. Indirect VAT costs come in the form of the burden on taxable persons of having to finance amounts of VAT and comply with administrative obligations imposed under the VAT legislation.

Without VAT grouping, each member of the group incurs these costs separately. With VAT grouping, however, these costs are neutralized, at least in part. Therefore, VAT grouping facilitates the concept of neutrality that is typical for the VAT system. It does not grant any additional advantages to the taxable persons that form part of a VAT group but, instead, simply eliminates unfair disadvantages.

In this scenario, it has been pointed out in the first chapter that essentially, group registration has the effect that several independent but connected taxable persons virtually merge into a single taxable person for VAT purposes. In that respect, group registration gives precedence to economic substance over legal form.

Group registration not only implies that supplies of goods and services exchanged between the members of the group are outside the scope of VAT, as regards taxable persons with a partial or no right to deduct input tax, but it also means that the right to deduct input tax is determined on the basis of the tax regime applicable to the transactions of the entire group with third parties.

Thus, VAT grouping neutralizes VAT costs incurred on intra-group transactions: restrictions on the right of deduction and exemptions without the right of deduction are not applicable to intra-group transactions.

Group registration also reduces the costs of financing the VAT because a considerable amount of time can pass between the time the taxable person pays the VAT to its suppliers and the time he receives the amount of VAT from the tax authorities, in particular where, for the tax period, the amount of deductible input tax is larger than the amount of output VAT due and the balance (“excess input tax”) must be refunded by the authorities. By the same

token, where he accounts for VAT on an accrual basis, the taxable person must also finance the VAT if his customers are very slow in settling their debts: a considerable amount of time can pass between the time the taxable person must remit the VAT invoiced to his customers to the tax authorities, and the time he receives that amount from his customers. Group registration prevents the taxable person from having to finance the amounts of VAT in respect of intra-group transactions.

Moreover, group registration has the advantage that, where some members of the group must pay a net amount of VAT to the authorities, whilst others have a VAT claim on the authorities (excess input tax), the latter do not have to go through a lengthy refund procedure.

VAT claims of certain members of the group are simply credited against VAT debts of other members, and the group only remits the positive balance to the authorities.

The saving is equal to the loss of purchasing power and opportunity costs (equity capital) or interest (debt capital) during the period between the time of payment of VAT by a taxable person and the refund of that VAT by the tax authorities.

Finally, VAT grouping reduces the taxable person's costs arising from compliance with the administrative obligations imposed under the VAT legislation. VAT grouping neutralizes the administrative costs that normally would be borne by each member of the group separately. Intra-group transactions are not invoiced and can be processed in the current account. Only one VAT return for the group is submitted, again reducing administrative costs.

Group registration enables groups of companies, who only have a partial or no right to deduct input tax, to organize their activities more efficiently without being burdened by irrecoverable VAT.

Furthermore, Group registration has a number of beneficial effects for the government, in that it:

- (i) safeguards the collection of the VAT debts of the members of the group, if, as is the case in most Member States, VAT grouping is accompanied by a joint and several liability of the individual members of the group for payment of the VAT debts of the other members;
- (ii) may prevent abusive practices in the form of artificially splitting up medium-sized and large companies into small companies, whose turnover remains below the registration threshold in order to benefit from the VAT exemption for small businesses. It may also prevent taxable persons engaged in exempt activities or non-taxable persons from setting up a VAT-saving scheme aimed at spreading and reducing the burden of non-deductible VAT on large investments by setting up a fully controlled intermediate entity between itself and the supplier;
- (iii) enables the tax authorities to operate more efficiently because they need to process fewer VAT returns and manage fewer files. Centralization of the files of independent but connected companies leads to a better insight for the authorities into the activities of those companies and more efficient auditing procedures. The time saved enables the authorities to carry out more in-depth VAT audits, which contributes to their efforts to combat VAT avoidance and evasion. In addition, regardless of where they are established, the connected companies are

audited by the same inspector(s), which increases the uniformity and transparency of the tax policy.

Several Member States have decided not to introduce group registration because they fear that the arrangement may have a significant negative impact on their VAT revenue. The question is whether this fear is justified. In this respect, it has been highlighted that in the short run, introduction of group registration will have a negative impact on the budget. VAT revenue on intra-group transactions which, in the absence of group registration, would have contributed to the net tax revenue on the ground of restrictions on the right to deduct input tax and exemptions is lost if the parties concerned form part of a VAT group. However, in practice, this loss of revenue is limited because, in the absence of group registration, taxable persons will find other means to minimize their VAT costs.

On the other hand, in the long run, the impact of VAT grouping on the budget will be positive and significant. Firstly, group registration enables taxable persons engaged in exempt activities to outsource services to connected service providers without incurring VAT costs. Existing and new companies can specialize in specific services and the other members of the group can outsource those activities to these specialized companies, which will enable the latter to realize economies of scale leading to a reduction of the cost. Secondly, group registration may prevent VAT avoidance and reduction schemes. Thirdly, the joint and several liability of the members of a group for payment of the debts of the entire group reduces the risk of non-collection of the VAT debts of its members.

Finally, VAT grouping reduces VAT avoidance and evasion because more in-depth VAT audits can be carried out.

These financial consequences should be weighed against each other. Rejecting VAT grouping without carrying out this exercise is jumping to conclusions.

That being said, it has been also pointed out that Art. 11 is concise and the VAT Directive does not contain any other provisions specifically relating to VAT groups, which means, on the one hand, that VAT groups are to be treated as ordinary taxable persons and, thus, have the same rights and obligations. On the other hand, it seems to be up to the Member States to lay down more detailed rules governing the national VAT grouping arrangements.

That supposedly broad discretionary power of the Member States has caused a wide divergence between the national VAT grouping arrangements. Those differences give rise to a number of problems. Not least, group registration has become a source of tax competition between the Member States, which means that it has a potential impact on the functioning of the internal market and on the basic principles of the Community VAT system. According to the European Commission, it is therefore essential to ensure that the Member States apply these arrangements more uniformly.

Against this background, the Commission, as the guardian and initiator of Community legislation, has published its views on a number of essential elements of VAT grouping, which are to be harmonized either by means of amendment of the VAT Directive or on the basis of an agreement between the Member States.

In particular, the Commission has clarified the original objectives of VAT Grouping, maintaining that apart from administrative simplification, compulsory group registration has the effect of combating abusive practices, such as splitting up a business into several separate businesses in order to benefit from a special scheme for small businesses. To the extent that group registration is based on this objective, that ground seems to have lost relevance because, under case law of the Court of Justice of the European Communities (European Court of Justice, ECJ), Member States have the power to combat abusive practices in general.

Moreover, group registration even seems to have become a source of abuse itself. In 2006, a second paragraph was added to the initial text of Art. 11, which enables Member States to prevent group registration from having unintended consequences by adopting any measures aimed at preventing related tax evasion or avoidance.

Several Member States have used that power by adopting specific anti-avoidance rules, especially relating to scenarios in which invoices are channelled through branches.

The Commission takes the view that Art. 11 must be interpreted in the light of what it labels as the “original objectives”. However, there are many other reasons justifying the existence of group registration.

In the second chapter, the wide variety of the VAT Grouping arrangements that currently exist in the various Member States has been analyzed on the basis of the available information. In this respect, it has been pointed out that from the perspective of Community law, the national arrangements must stay within the boundaries laid down by Art. 11 of the

VAT Directive, but that common legal basis has given rise to a diversity of national arrangements, which have different effects on the businesses and authorities concerned.

In the third chapter, Italian VAT legislation has been examined, in order to underline the circumstance that Italy has not introduced yet a system of group registration in compliance with the provision of VAT Directive, since the Italian VAT grouping arrangement is relevant exclusively from a procedural point of view.

More in detail, according to article 73 of Presidential Decree no. 633/1972 and Ministerial Decree 13 December 1979, upon the making of a proper election, an Italian company and its 50 per cent owned subsidiaries may elect to opt for VAT grouping arrangement.

In such a case, the group parent may offset the group member's VAT credits against its respective VAT obligations (including VAT carryforwards).

The group parent is legally obligated to pay the net tax owed by "VAT grouping". Each group member is jointly and severally liable to pay its share of the tax should the parent default and is obligated to reimburse the parent for its share of the consolidated tax liability.

The parent and subsidiaries must provide security for the VAT taxes offset upon consolidation. Should they fail to do so, they must pay the amount of the offset VAT.

Based on the above, it appears evident that according to Italian VAT legislation relating to VAT Grouping, the essential effect of this arrangement does not occur to the extent that it does not giving rise to a single taxable

person and the connected entities continue to be treated as separate taxable persons.

In line with these considerations, in the fourth chapter, have been highlighted some criteria that Italian Government should adopt in implementing a national VAT Grouping arrangement in compliance with the provision of VAT Directive, and furthermore, an analysis is made of, in our view, the two most important issues that have an impact on VAT grouping, i.e. the aspects concerning (i) tax liability of the members' group and (ii) the right to deduct input tax for VAT grouping.

With specific regard to the first aspect listed sub point (i) above, it has been stressed the circumstance that, in line with the provisions set forth by various Member States, also under Italian legislation, the creation of a "single taxable person" should be accompanied by a joint and several liability of its members for payment of the VAT debts of the group that have arisen during their membership. This liability should imply that each member of the group could be forced to pay the total amount of VAT due by the other members. Where a particular member should pay the VAT debts of the other members, the tax authorities could no longer demand payment of the debt from the member to which it must be attributed. Whether or not and if so, to what extent, the paying member could recover the amount paid from the other members depends on the civil law of the Member State concerned.

Finally, with respect to the second aspect listed sub point (ii) above, first of all it has been confirmed that treating the group as a (single) taxable person also means that in the relationship with *third parties*, all supplies of goods and services made by any of the group members are deemed to be made by the group, and supplies of goods and services made by third parties to the

members of the group are deemed to be made to the group, and that transactions between the individual members of the group must be treated as internal supplies, so that they are not subject to VAT, unless the internal supply is treated as a deemed supply.

Based on the above, it has been pointed out that similarly, the right to deduct input VAT is to be exercised by the VAT group as a whole, and is determined on the basis of the transactions of the group as such with third parties. In this context, the circumstance that a taxable person joins or leaves the group may have the effect that previous deductions relating to capital goods must be adjusted. Where the activities of the group are partly subject to VAT and partly exempt, the proportion of the deductible VAT must be determined on the basis of the normal rules. More in detail, reference has to be made to article 173 et seq. of VAT Directive and article 19 of Presidential Decree no. 633/1972, according to which the general rule is the deductible proportion rule (the “pro rata”). In this respect, it also has been clarified that Member States have the option to replace the pro rata by a system of direct attribution, i.e. the rate of deduction in respect of goods and services used for the purposes of making both taxed and exempt supplies may be based on actual use of the goods and services, underlying that, in our view, the latter system may be convenient whether Italian Government grants the faculty to opt, at level Group, for the separation of the activities provided for by article 36 of Presidential Decree no. 633/1972.