Challenging Legal Issues Confronting VAT Regimes

By Walter Hellerstein and Jon Sedon

Walter Hellerstein is the Francis Shackelford Professor of Taxation at the University of Georgia School of Law. Jon Sedon is a manager in the state and local tax practice of KPMG LLP’s Washington National Tax office. The authors would like to thank Alain Charlet, Danny Cisterna, Edel Flynn, Arthur Kerrigan, and Rainer Nowak for helpful comments on an earlier draft of this article. All errors or omissions are the authors’ own.

KPMG’s Washington National Tax office is conducting an initiative to inform the debate over a VAT as a tax reform option in the United States. A key part of this project is Views on VAT, a series of Tax Notes articles on the VAT regimes in foreign countries, comparison of VAT and U.S. retail sales taxes, VAT administration and compliance issues, how a U.S. national VAT would be administered, and other issues related to VAT.

Although this article marks the final installment of the Views on VAT series, KPMG plans to publish periodic updates that will focus on VAT developments and practical applications.

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In our final installment of this series of articles designed to familiarize American tax professionals with VATs, we turn to VAT controversies. Controversies can and do arise over virtually every aspect of VAT regimes, including the determination of what activities fall within the scope of the VAT; the delineation of exempt and zero-rated supplies; the characterization of supplies and determination of where they are provided — issues that are often intertwined; the treatment of composite supplies; the apportionment of input taxes to taxable and non-taxable supplies; the classification of services and goods; the treatment of mixed supplies; the taxation of financial transactions; and the treatment of cross-border transactions.

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1For purposes of this discussion, by “VAT” and “VAT regimes” we mean to include VATs that are denominated goods and services taxes, like the VATs in Australia, Canada, and New Zealand.


3See, e.g., Kandaswala v. The Queen, [2004] C.T.C. 659 (holding that paan leaves that are chewed to aid digestion and employed in Hindu religious ceremonies are not zero-rated “food for the purpose of human consumption” within the meaning of Canadian GST); see generally Alan Schenk and Oliver Oldman, Value Added Tax: A Comparative Approach, 269-278 (2007) (describing extensive litigation over EU VAT exemptions, including exemptions for medical care and education).

4See, e.g., Case C-270/09, MacDonald Resorts Ltd. v. The Commissioners for Her Majesty’s Revenue & Customs, 2010 O.J. 267, Doc 2010-26792 (sale of points by the supplier of timeshare usage rights constitutes sale of services associated with the letting of immovable property, taxable at location of property, rather than supplies of a club membership, taxable at the club’s establishment, and, for purposes of determining the place of supply, they are classified when the customer converts the points into use; and in the context of normal commercial operations). The RBS case is discussed infra at text accompanying notes 78-79. Among other things, RBS demonstrates that the “first thing to say about the EU VAT is that there is no EU VAT.” Walter Hellerstein and Timothy Gillis, “The VAT in the European Union,” Tax Notes, Apr. 26, 2010, p. 461, Doc 2010-7537, 2010 TNT 79-8.

exempt supplies⁶; and the scope of activities falling within special VAT provisions.⁷ In our brief foray into the extensive body of case law, we thought it would be useful to focus on a few areas of current controversy that raise fundamental issues confronting contemporary VAT regimes: treatment of single-entity or branch-to-branch transactions, judicial restraints on VAT structure planning, and treatment of customer loyalty rewards programs.

A. Branch-to-Branch Issues

Does VAT apply to transactions within a single legal entity, that is, to branch-to-branch or interbranch transactions? At first glance — and even at the end of the day⁸ — one might say that this is a silly question for the simple reason that there cannot be a "transaction" for VAT purposes within a single legal entity. Nevertheless, on further consideration, this question turns out not to be so silly and, indeed, is an important question on which existing VAT regimes are not in full agreement and one that is likely to be a source of continuing debate.⁹ We therefore think the question is worth examining.

1. The nature and significance of the issue. Although to many tax lawyers the very notion of an intraentity transaction with tax consequences may seem to be a contradiction in terms — after all, one cannot contract with oneself — a moment's reflection reveals that the notion is not as counterintuitive as it may seem, at least if one relaxes the concept of transaction. In the U.S. federal income tax context, one need look no further than the branch profits tax¹⁰ to realize that governments can easily deem transactions to occur within a single legal entity even though the transaction (as commonly understood) did not occur.¹¹ In the U.S. state retail sales and use tax context, when a manufacturer uses property it produces in its own business, a number of states treat the use as taxable, as if the manufacturer had purchased the property for its own use.¹²

Most VATs, moreover, have traditionally taxed some intraentity transactions, or so-called selfsupplies.¹³ Typical examples of taxable self-supplies arise in connection with a business entity's conversion of assets to personal use¹⁴ or "to prevent the distortion of competition or VAT abuse in cases where persons engaging in exempt transactions can avoid VAT by vertically integrating their operations instead of purchasing property or services from outside vendors."¹⁵ Under those circumstances, VAT may treat "certain self-consumption of property and services by an exempt organization as a deemed sale of property and services by it in a taxable transaction."¹⁶ Nevertheless, with limited exceptions, "most countries take the view that there cannot be a domestic transaction within a single legal entity as far as direct taxes and VAT are concerned."¹⁷

When we turn to the cross-border issues, however, the problems of branch-to-branch transactions (or deemed transactions) become more significant and there is less consensus on how to treat them. There is generally no problem for cross-border

¹⁰Section 884.
¹¹Under the BPT, a tax is imposed on a deemed dividend — the "dividend equivalent amount," which in substance is the amount of a foreign corporation's U.S. earnings and profits that is presumed, under specified criteria, to have been transferred within the corporate structure outside the United States. The tax is imposed on the actual dividend that presumably would have been paid to accomplish the same result if the U.S. branch of the foreign corporation had been organized instead as a U.S. subsidiary of the foreign corporation.
¹³Schenk and Oldman, supra note 3, at 259-260, 314, 344.
¹⁶Id.
branch-to-branch supplies of goods. All imported goods, whether supplied by another branch of the same legal entity or by an unrelated third party, are normally taxed on import at the border.\textsuperscript{18}

The problem arises in connection with services and intangible property.\textsuperscript{19} Unlike goods, services and intangibles cannot effectively be stopped (and taxed) at the border, and as a consequence special rules need to be (and are being\textsuperscript{20}) developed to address the problem of applying VAT to international trade in services and intangibles.\textsuperscript{21} That problem is obviously not limited to branch-to-branch transactions involving services and intangibles — the focus of the instant discussion. Nevertheless, branch-to-branch transactions do create special concerns in that context, particularly for taxable services provided to a branch of an entity that provides exempt services (such as financial institutions). As explained by the Department of Finance Canada:

Since businesses that make exempt supplies (e.g., financial institutions that supply financial services) are not entitled to recover GST/HST [goods and services tax/harmonized sales tax] paid on inputs used to make their exempt supplies, there would be an incentive for these businesses to import services and intangibles to avoid paying the irrecoverable GST/HST.\textsuperscript{22}

It is precisely that scenario — the cross-border branch-to-branch provision of services by an entity whose supplies are exempt — that has been the basis of VAT litigation.

Finally, to facilitate understanding of the essential nature of the legal controversy discussed below, it may be worth reiterating that conceptually, as we suggested at the outset, one does not (or cannot) actually “provide services to oneself.” As the Tax Court of Canada observed in a case discussed below: “If one enjoys philosophical conundrums, one might ask if the brain renders a service to the hand or the hand renders a service to the brain. The simple fact is that parts of a single organism, whether concrete or abstract, do not render services to each other.”\textsuperscript{23} But having said that, regardless of philosophical musings, the key legal question is whether the law has deemed those “nonevents” to be considered as “events” (the supply of services) under whatever criteria the law may have established for treating those nonevents as events for tax purposes.

2. The EU VAT and FCE Bank. In Ministero dell’Economia e delle Finanze, Agenzia delle Entrate v. FCE Bank plc,\textsuperscript{24} the European Court of Justice considered whether services provided by a bank established in the United Kingdom (FCE) to its Italian branch (FCE IT) were subject to VAT in Italy. FCE provided supplies of services to FCE IT in the form of consultancy, management, staff training, data processing, and the supply and management of application software. FCE IT treated the supplies as taxable, self-assessing the tax under the reverse charge mechanism,\textsuperscript{25} on the basis of the costs of the supplies allocated to it on the internal accounts of FCE. FCE subsequently sought a refund of the VAT\textsuperscript{26} on the grounds that no VAT was due on supplies between two branches of a single “taxable person.”\textsuperscript{27}

Among the questions Italy’s Supreme Court of Cassation referred to the ECJ was the following:

\textsuperscript{18}Id. at 713; see, e.g., Recast Sixth VAT Directive, supra note 14, at arts., 1(d), 30, 60, 70 (subjecting imports to VAT on “entry into the Community” with “chargeable event” occurring “when the goods are imported”). In practice, VAT is therefore collected by customs at the border or by the post office when goods enter by post, unless they are taxed on a self-assessment basis by registered traders (for example, reverse charge). See Schenk and Oldman, supra note 3, at 202-203.

\textsuperscript{19}Some jurisdictions (for example, Canada) consider services and intangibles to be separate categories of supplies; in other jurisdictions (for example, the EU member states), the supply of services (which is defined broadly as “any transaction that does not constitute a supply of goods,” Recast Sixth VAT Directive, supra note 14, art. 24(1)) embraces intangibles.


\textsuperscript{25}Under the reverse charge mechanism, registered business purchasers, which are subject to control and audit by taxing authorities at destination, self-assess the VAT. See Hellerstein and Gillis, supra note 4, at 466.

\textsuperscript{26}With the benefit of hindsight, that may have been the key point. The plaintiff was FCE Bank plc, not FCE IT; if FCE IT had borne the burden of the VAT, one might have thought that it would have brought the action in its own name (assuming arguendo that it could do so).

\textsuperscript{27}Under EU law, a taxable person is “any person who independently carries out, in any place, any economic activity.” Recast Sixth VAT Directive, supra note 14, art. 9(1). For purposes of this discussion, we deliberately avoid the use of terminology (even though it appears in the ECJ’s opinion) that may be confusing to American readers, including the use of the term “entity” to describe what American lawyers would consider to be a branch of a single entity.
Must ... the Sixth Directive[28] be interpreted as meaning that the branch of a company established in another State (belonging to the European Union or otherwise), which has the characteristics of a production unit, be regarded as an independent person ... with consequent liability for VAT in relation to supplies of services effected by the parent company?29

In answering that question, the ECJ focused on the meaning of the term “taxable person,” because the EU VAT applies to the supply of services within a member state only when effected by a taxable person.30 Observing that a taxable person is one who “independently” carries out an economic activity,31 the ECJ found that the key question was “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.”32

FCE IT flunked that test. The branch did not bear any of the risks associated with the bank’s operation, which were borne entirely by FCE “as a legal person.”33 That FCE and FCE IT may have agreed to share costs was irrelevant34 because the agreement was not negotiated between “independent” parties. Accordingly, the ECJ 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.”35

As Alain Charlet and Dimitra Koulouri have observed, it is possible to read FCE as leaving open the possibility that a branch could be a taxable person, and branch-to-branch supplies therefore subject to VAT, if it could be demonstrated that the branch itself (rather than the legal entity as a whole) bore the economic risk arising from its business. Under those circumstances, the branch would arguably satisfy the underlying criteria that the ECJ employed in FCE in reasoning that FCE was not a taxable person. Despite that possibility, the court’s categorical language concluding that a branch that “is not a legal entity distinct from the company of which it forms part ... should not be treated as a taxable person by reason of the costs imputed to it”36 may plausibly be read as authority for the proposition that no interbranch transactions are supplies for EU VAT purposes. Only future case law will determine which interpretation of FCE is correct.

3. The Canadian GST and State Farm. In State Farm,37 the Tax Court of Canada considered whether expenses of an insurance company’s U.S. headquarters allocated to its Canadian branch were subject to the Canadian GST. State Farm Mutual Auto Insurance Co. and its wholly owned subsidiary, State Farm Fire & Casualty Co. (collectively State Farm), were engaged in the automobile, fire, and casualty insurance business throughout the United States and in three Canadian provinces. The Canadian operation was carried on by a Canadian regional office (CRO), which constituted a permanent establishment.

In contrast to the EU VAT, Canada’s GST explicitly applies to supplies between branches. Section 220 of the Canadian Excise Tax Act (which embodies the GST) provided in pertinent part:

Where a person carries on a business through a permanent establishment of the person in Canada and through another permanent establishment outside Canada,

(a) any transfer of personal property or rendering of a service by one permanent establishment to the other permanent establishment shall be deemed to be a supply of the property or service;

(b) in respect of that supply, the permanent establishments shall be deemed to be separate persons who deal with each other at arm’s length;

(c) the value of the consideration for that supply shall be deemed to be the fair market value of the supply at the time the property is so transferred or the service is so rendered; and

(d) the consideration for that supply shall be deemed to have become due and to have been paid, by the permanent establishment (in this paragraph referred to as

29 Since 1977 the EU’s Sixth VAT Directive has established the legal framework for the common EU VAT. It has been amended many times since and was “recast” effective January 1, 2007, for “reasons of clarity and rationalization.” Recast Sixth VAT Directive, supra note 14, at 1. See generally Hellerstein and Gillis, supra note 4, at 462-465.
30 FCE Bank, C-210/04, para. 20.
31 Recast Sixth VAT Directive, supra note 14, art. 2(1).
33 Id. at para. 35.
34 Id. at para. 36.
35 Id. at para. 37.
36 Id. at para. 41.
37 State Farm, 2003 G.T.C. 632. Although that decision has effectively been overturned by remedial legislation, see infra text accompanying notes 46-49, it nevertheless provides an instructive window into the controversy over the treatment of branch-to-branch supplies.
“the recipient”) to which the property was transferred or the service was rendered, to the other permanent establishment at the end of the taxation year of the recipient in which the property was transferred or the service was rendered.\(^{38}\)

Although State Farm had allocated some of its head office expenses in Bloomington, Ill., to its CRO in Scarborough, Ontario, the Canadian Tax Court rejected the government’s position that those were taxable supplies under section 220 for several reasons. First, the court found that the statute did not create a taxable supply in Canada merely because the taxpayer had allocated an expense to Canada for income tax purposes. The only “fiction” created by the statute was that the two PEs of a single legal entity\(^{39}\) were to be treated as “separate arm’s-length persons” and “if there is a rendering of a service,” there is “deemed to be a supply of the service.”\(^{40}\)

That was as far as the “statutory fiction” went: “No statutory fiction is created in section 220 that deems an accounting allocation of a portion of a head office expense to be evidence of the rendering of a service or that the amount so allocated is equal to the fair market value of the service.”\(^{41}\) Whether a service was in fact rendered by the head office to the CRO and what the FMV, if any, was of that service were to be determined “independently of any deeming provision.”\(^{42}\)

Second, the government failed to plead or prove facts to establish the statutory basis for the assessments. The court was “unable to see in the evidence that any management or administrative services were rendered by the head office to the CRO.”\(^{43}\)

Third, even if services had been rendered to the CRO by headquarters (and assuming further that the FMV of those services was reflected in the expense allocations for income tax purposes), the court concluded that services would not have been subject to assessment as the provision of taxable services from one branch to another because the services in question were financial services,\(^{44}\) which Canada, like most countries with a VAT, exempts.\(^{45}\)

4. The aftermath of State Farm and the future of branch-to-branch under VATs. State Farm posed two challenges to the Canadian approach to branch-to-branch supplies. First, by refusing to interpret the statute as creating a deemed supply based on an entity’s internal expense allocations, at least without actual proof that those supplies were in fact provided by the foreign branch, and by demanding proof of the FMV of the supplies, apart from the accounting allocations, the decision undermined the basic mechanism that Canada had provided for subjecting branch-to-branch supplies to tax, or, at a minimum, made administration of that provision considerably more difficult, because of the proof requirements. Second, by characterizing the management or administrative services in question as exempt financial services, the decision threatened to undermine the branch-to-branch transfer of what were generally thought to be taxable supplies (administrative services) between branches of exempt financial institutions.

To address those challenges, the Canadian government made changes to the GST. Regarding the basic approach to cross-border branch-to-branch taxation of taxable services provided by entities other than financial institutions, the government amended section 220\(^{46}\) “to clarify the longstanding policy that self-assessment of tax . . . applies to taxable imports of services and intangibles that occur between separate branches of the same person.”\(^{47}\)

In substance, the amendments to section 220 make it clear that income tax allocations of the “internal use” of some “support resources” such as labor provided by employees, services provided by third parties, and intangibles purchased or internally

39Technically, of two corporations (State Farm Mutual Auto Insurance Co. and its wholly owned subsidiary, State Farm Fire & Casualty Co.), but as noted above, for purposes of this discussion we are treating them as one (State Farm).
40State Farm, 2003 G.T.C. 632, at para. 30 (emphasis in original).
41Id. at para. 31.
42Id.
43Id. at para. 80.
created are subject to Canadian GST/HST on the basis of permitted allocations.48

The impact of those amendments is illustrated by the following example from the Canada Revenue Agency:

Higher Trades Learning Inc. is a US-based company that qualifies as a vocational school. It has a branch in Canada and offers courses in Canada that are exempt. The company’s head office acquires consulting services that provide advice on how to teach courses and keep the company up to date on the latest technological changes in certain trades. Some of the consulting services acquired in the US by the head office are used in the Canadian branch, the cost of these services is allocated to the Canadian branch. The amount that is allocated to the Canadian branch is an allowable deduction under the [Income Tax Act] for calculating the company’s income tax.

[Under the amendments to section 220], Higher Trades Learning is deemed to have rendered a service to itself, to be the recipient of a supply made outside Canada for use in Canada. The consideration for the deemed supply is deemed to be the fair market value of the internal use.49

For financial institutions, the Canadian government proposed changes to the GST, which were adopted in 2010 with retroactive effect as far back as 2005,50 providing special rules for cross-border branch-to-branch supplies for those institutions and specifying that some services (including management and administrative services) were not exempt financial services.51 The changes to the branch-to-branch rules were analogous to those for nonfinancial institutions and specified how financial institutions should determine the appropriate portion of internally provided supplies that should be treated as imported into Canada and, consequently, subject to self-assessment. As in the case of nonfinancial institutions, the GST/HST-deemed supplies are based on income tax expense allocations, with an election for a simplified method for determining the appropriate value of the imported supplies based on an internal charge that is generally an amount that is treated — for income tax purposes — both as income in a particular country other than Canada and as a deduction from income in Canada.52

Although most of the discussion of branch-to-branch issues (including the foregoing) is directed to inbound services and to the requirement for a company to account for tax when a branch “imports” the service from another of its branches (for example, its headquarters), it is worth keeping in mind the flip side of the issue, namely the treatment of outbound services. In that context, the provision of the outbound service is generally viewed as an export in the suppliers’ country and is therefore zero rated, meaning that the supplier can claim input tax credits for that service. For example, if a Canadian financial institution acquires data services for use in its financial activities, it generally would not be allowed to claim an input tax credit for any GST paid on the acquisition of those services. However, if some of those services are for use by the Canadian financial institution’s branch in the United States, the Canadian financial institution could claim an input tax credit for the GST paid on those services used by the U.S. branch.53 Accordingly, viewing cross-border branch-to-branch transactions as supplies does not always result in an increased tax burden. In some cases, it can actually relieve a tax burden. Indeed, in Canada’s case it ensures that Canadian financial institution branches

48Id. at 15. Those cost allocations are not only amounts permitted in fact but also amounts that would be permitted if the Income Tax Act applied to the person. Id. For an illuminating discussion of the potential role of transfer pricing principles for VAT/GST regimes, see Alain Charlet and David Holmes, “Determining the Place of Taxation of Transactions Under VAT/GST: Can Transfer Pricing Principles Help?” 2010 Int’l VAT Monitor 428, 431 (Nov./Dec. 2010).


50See supra note 47.

51Excise Tax Act, supra note 38, at c. E-15, ss. 123(1), 217.1. See Canada Revenue Agency, GST/HST Technical Information Bulletin B-105: Changes to the Definition of Financial Service (Feb. 2011), available at http://www.cra-arc.gc.ca/E/pub/gm/b-105/b-105-e.pdf. Arguably, the new rules applicable to financial institutions do not really change the character of the underlying supply from being exempt if it is a financial service. What they do in some cases (in which related parties are involved predominantly) is to require the affected financial institution that “imports” services to look through the consideration for the otherwise exempt financial services and determine what part of the consideration represents something that should be taxed in Canada (for example, administrative components). That is referred to as “loading” in the rules. See Danny Cisterna and Jason Riche, “Why Is Everybody Always Picking on Me?: A Snapshot of the Evolution and Current State of Affairs Concerning the Goods and Services Tax and the Financial Services Sector in Canada,” at 57-63 (paper presented at the 2007 Canadian Institute of Chartered Accountants Commodity Tax Symposium).

52Excise Tax Act, supra note 38, at ss. 217.1, 218.01; see also Canadian Department of Finance, News Release 2009-088 (Backgrounder), available at http://www.fin.gc.ca/rl05/data/05-079_2-eng.asp.

53Excise Tax Act, supra note 38, at s. 132(4) attempts to accomplish that goal but it is subject to the same shortcomings that the Tax Court of Canada in State Farm identified in section 220 of the Act before its amendment.
in the United States are not at a competitive disadvantage because of the GST.

With Canada having fixed the problem created by State Farm regarding branch-to-branch supplies, the question remains whether the basic approach reflected in FCE or the approach adopted by Canada is likely to prevail in the future. While the EU collectively represents 27 member states (all of whose VATs are subject to the ECJ’s pronouncements interpreting the EU directive), Canada is by no means alone in its approach to branch-to-branch supplies. Indeed, Australia, New Zealand, South Africa, Switzerland, and other countries “normally treat cross-border inter-branch transactions as supplies for VAT purposes.”54 Because many of those countries are members of the OECD, perhaps the answer will emerge from the OECD’s International V A T/GST Guidelines55 on that happy day when the guidelines emerge in final form.

B. Judicial Restraints on VAT Planning

1. Overview. If you mention tax planning, most listeners will assume that you are talking about income tax planning.56 However, tax planning is alive and well in the VAT context, as reflected in a number of recent cases before the ECJ addressing tax-motivated VAT structures. What restraints have courts placed on VAT planning? To state the question in a slightly different way, what principles have courts developed and applied to determine whether one should respect the VAT consequences that would follow from the formalities of the transaction that the taxpayer has structured when there is reason to believe that the structure of the transaction was motivated in whole or in part by a desire to reduce the VAT and may have lacked economic substance? Like the questions raised by branch-to-branch issues, VAT planning raises issues that are fundamental to all VAT regimes, and we therefore think the issue is appropriate for consideration here. We should make it clear from the outset that our focus is limited to transactions that meet the literal requirements of the law and that we do not address questions of tax evasion or fraud (for example, missing trader fraud, carousel fraud, falsely reporting sales, etc.).57

Courts in both the United States and Europe long ago recognized that a taxpayer may arrange its affairs to pay the lowest tax possible.58 However, judicial doctrine disallowing the tax consequences of some transactions designed to reduce tax liability developed earlier in the United States.59 European courts, for whatever reason, were somewhat slower to adopt similar doctrines. The first case in which the ECJ applied the “abuse of law” doctrine to indirect tax planning was decided in 2000,60 but it was not applied in the VAT context until 2006.61 Since 2006 the ECJ has decided several cases applying — and refining — the abuse of law, or abusive practices, doctrine.62

The VAT planning stakes are high. VAT planning, when it survives judicial scrutiny, can result in significant tax savings. By the same token, the disallowance of tax benefits based on the abuse of law doctrine can result in significant tax costs. Moreover, the risks in VAT planning — like the

54Charlet and Koulouri, supra note 17, at 715.
56As authority for that proposition — although, we confess, not “peer reviewed” — we cite our Google search for “tax planning,” which produced income tax references for nine of the first 10 hits, with one reference to estate taxation. A more thorough experiment would have cataloged all 23.6 million references to tax planning that Google identified.
58See Helvering v. Gregory, 69 F.2d 809 (2d Cir. 1934) (observing that “any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one’s taxes”). In a strikingly similar observation, the House of Lords wrote that “every man is entitled if he can to order his affairs so that the tax attaching . . . is less than it otherwise would be.” IRC v. Duke of Westminster, [1936] AC 1, 19 TC 490, HL.
59Helvering, 69 F.2d 809. In the United States, Helvering is “almost universally identified as the first major case applying a precursor of the modern economic substance doctrine.” Leandra Lederman, “W(h)ither Economic Substance,” 95 Iowa L. Rev. 389 (2010). In her article, Lederman provides a thorough history of the economic substance doctrine and a thoughtful critique of its application.
60Joep Swinkels, “Halifax Day: Abuse of Law in European VAT,” 2006 Int’l VAT Monitor 173 (May/June 2006) (discussing Case C-110/99, Emsland-Stärke GmbH v. Hauptzollamt Hamburg-Jonas). Emsland-Stärke involved refunds of agricultural levies on potato and wheat starch. The business exported the products from Germany and received a refund of the levies previously paid, and then imported those same products back into Germany. The import duties were less than the export refund, resulting in a net benefit to the business. The ECJ determined that that transaction could constitute an abuse of rights.
62We use “abuse of law” and “abusive practices” interchangeably.
stake — are high, because, as the ensuing discussion reveals, there is considerable uncertainty surrounding the scope of the abuse of law doctrine, which is still in the early stages of its development.

2. The EU VAT and Abusive Practices.

a. Halifax plc.

In Halifax plc, the ECJ addressed a financial institution’s plan to reduce its VAT liability by having its wholly owned nonfinancial institution subsidiaries engage in transactions on its behalf. Halifax, a bank, intended to build call centers on real property it owned in a number of locations. Because Halifax was a financial institution offering primarily VAT-exempt services, its recovery of the input tax it paid was limited to the percentage of taxable transactions in which it engaged. For the period at issue, Halifax was entitled to recover only about 5 percent of its input VAT. Accordingly, if Halifax directly hired contractors to build the call centers, it would have had to absorb approximately 95 percent of the VAT paid to the contractors.

Rather than directly hire the contractors, Halifax engaged in several transactions, summarized as follows. Halifax first loaned money to a wholly owned property development subsidiary (S1). S1 used the funds to purchase the real estate where the call centers were to be located and to pay another Halifax wholly owned subsidiary (S2) to carry out construction work on the call center properties. Later, S2 hired third-party contractors to construct the call centers. The net result of the transactions was (1) no VAT liability for Halifax (as the loan is exempt from the VAT); (2) a refund claim for S1, on the basis of its input VAT paid on its purchase of taxable services from S2; and (3) offsetting input and output VAT for S2, on the basis of S2’s provision of taxable services to S1 and purchase of taxable services from the third-party contractors. The taxing authorities in the United Kingdom and Ireland denied S1’s refund claim, allowing an input credit in the amount that Halifax would have been credited if it had directly engaged the third-party contractors.

The U.K. Supreme Court referred several questions to the ECJ. In its initial question of interest here, the national court asked:

whether the Sixth Directive must be interpreted as meaning that a taxable person has no right to deduct input VAT where the transactions on which that right is based constitute an abusive practice.

The ECJ first said that EU law “could not be relied upon for abusive or fraudulent ends.” After citing non-VAT cases for the proposition that EU law “cannot be extended to cover abusive practices,” the court concluded that the “principle of prohibiting abusive practices also applies to the sphere of VAT.” However, the ECJ recognized that when a taxpayer is faced with two transactions, the taxpayer is not required to choose the one that involves paying the highest amount of tax. In light of those considerations, the court articulated the following principles governing abusive practices under the VAT:

For it to be found that an abusive practice exists, it is necessary, first, that the transactions concerned, notwithstanding formal application of the conditions laid down by the relevant provisions of the Sixth Directive and of national legislation transposing it, result in the accrual of a tax advantage the grant of which would be contrary to the purpose of those provisions. Second, it must also be apparent from a number of objective factors that the essential aim of the transactions concerned is to obtain a tax advantage.

The national court further considered “under what conditions VAT may be recovered where an abusive practice has been found to exist.” The ECJ concluded that “the transactions involved must be redefined so as to re-establish the situation that would have prevailed in the absence of the transactions constituting that abusive practice.”

The Halifax case in essence promulgated a two-part test to determine whether an abusive practice exists: (1) The transactions must result in a tax advantage that would be contrary to the purpose of VAT law, and (2) the essential aim of the transaction must be to obtain a tax advantage. If an abusive practice exists, the remedy is to apply the VAT to the transactions as if no abusive practice had existed. Two cases decided by the ECJ on the same day as it decided Halifax implicated the abusive practices doctrine, but added nothing of substance to the analysis in Halifax. Several cases handed down after Halifax have refined the abusive practices doctrine.

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66Id. at para. 68.
67Id. at para. 69.
68Id. at para. 70.
69Id. at para. 86.
70Id. at para. 87.
71Id. at para. 99.
b. Part Service Srl. In Part Service Srl,\textsuperscript{73} the ECJ considered the splitting of motor vehicle leases into taxable and nontaxable components provided by two related parties. The taxpayers were involved primarily in motor vehicle leasing. Rather than treat their leases to consumers as a single transaction, one party contracted with the customer to provide use of a vehicle in exchange for lease payments (a transaction subject to VAT), while a related party contracted with the customer to provide credit and insurance (transactions not subject to VAT). The Italian government challenged the transactions, concluding that although there were multiple agreements, together they constituted a single taxable transaction.

The Italian Supreme Court of Cassation referred two questions to the ECJ. First, the Italian court asked whether the abuse of rights doctrine — described in Halifax to require that the essential aim of the transaction be the securing of a tax advantage — should be interpreted to require that the sole aim of the transaction be to obtain a tax benefit.\textsuperscript{74} The ECJ concluded that the finding of an abusive practice requires only that the "principal aim" of the transaction or transactions be the accrual of a tax advantage.\textsuperscript{75}

The second question referred by the Italian Supreme Court of Cassation was, "in essence, whether, for the purposes of the application of VAT, transactions such as those at issue in the dispute in the main proceedings can be considered to be an abusive practice."\textsuperscript{76} The ECJ discussed the abusive practices test and concluded that it was for the Italian court to determine whether the transactions constituted an abusive practice, although the ECJ strongly implied that the transactions could be construed as abusive.\textsuperscript{77}

c. RBS Deutschland Holdings GmbH. In RBS Deutschland Holdings GmbH,\textsuperscript{78} the ECJ discussed a taxpayer’s supply of rental cars, which, because of a difference in the laws of two member states, resulted in an input tax credit but no output tax due. The taxpayer, established in Germany, acquired cars in the United Kingdom (on which it paid VAT) that it then leased to a third party. Under U.K. law, the supply of rental cars was treated as a supply of services made in Germany, and thus incurred no U.K. VAT. However, under German law, the supply of rental cars was treated as supplies of goods made in the United Kingdom and therefore incurred no German VAT. The result was that the taxpayer claimed an input tax credit in the United Kingdom for its purchase of the cars, with no corresponding output tax on its rentals of cars.

Scotland’s Court of Session referred several questions to the ECJ, including whether the transaction could be considered an abusive practice. The ECJ found that the transactions occurred between two legally unconnected parties, were not artificial, and were carried out in the context of normal business operations.\textsuperscript{79} Under those facts, the ECJ concluded that the abusive practices doctrine did not apply.

d. Weald Leasing Ltd. In Weald Leasing Ltd,\textsuperscript{80} the ECJ addressed an insurance company’s plan to reduce its VAT liability by having a related party purchase and lease assets to a third party, which later subleased the assets to the insurance company. Two related insurance companies wanted to acquire equipment. However, like the financial institution in Halifax, the insurance companies’ VAT recovery rates were very low (approximately 1 percent). If they had purchased the equipment outright, they immediately would have incurred substantial VAT, almost none of which would have been recoverable. Accordingly, the insurance companies had a related

\textsuperscript{72}Id. at para. 62. The ECJ noted that the lease transaction “considered in isolation, therefore seems to be economically unprofitable, so that the viability of the business cannot be ensured solely by means of contracts concluded with the customers,” and that the result “would appear to be contrary to the objective of Article 11A(1) of the Sixth Directive, namely the taxation of everything which constitutes consideration received or to be received from the customer.” Id. at paras. 57 and 60.
\textsuperscript{73}Case C-277/09, The Commissioners for Her Majesty’s Revenue and Customs v. RBS Deutschland Holdings GmbH, Doc 2010-27192 (E.C.J. 2010).
\textsuperscript{74}Id. at para. 50.
\textsuperscript{75}Case C-103/09, The Commissioners for Her Majesty’s Revenue and Customs v. Weald Leasing Ltd., Doc 2010-27187 (E.C.J. 2010).
leasing company purchase the equipment and lease it to a third party. The leasing company took an input tax credit for the entire amount of VAT paid on its equipment purchases. The third party then subleased the equipment to the insurance companies. Although the input tax credit for VAT paid by the insurance companies was limited, the nonrecoverable VAT was not incurred all at once but rather was spread out over the term of the lease, thereby deferring the insurance companies’ payment of nonrecoverable VAT. The U.K. government disallowed the leasing company’s input tax credit.

The U.K. Supreme Court referred several questions to the ECJ, including whether the transactions constituted an abusive practice. The Court determined — much as it did in Part Service — that it was the national court’s responsibility to determine whether an abusive practice existed. However, the ECJ provided some potentially useful guidance. For example, the ECJ said:

A taxable person cannot be criticised for choosing a leasing transaction which procures him an advantage consisting, as is apparent from the decision making the reference, in spreading the payment of his tax liability, rather than a purchase transaction which does not procure him any such advantage, provided that the VAT on that leasing transaction is duly and fully paid.

The ECJ then noted that the correct VAT on the leasing transactions had been paid. Further, there was no guarantee that the leasing transactions would cause less VAT to be paid than if the asset had been purchased. The ECJ concluded that the leasing structure would not lead to a tax advantage contrary to VAT objectives if (1) “the contractual terms of those transactions, particularly those concerned with setting the level of rentals, correspond to arm’s length terms,” and (2) “the involvement of an intermediate third party company in those transactions is not such as to preclude the application of those provisions.”

One could read Weald Leasing to suggest that VAT planning that defers rather than avoids, payment of VAT does not constitute an abusive practice, as long as prices are at arm’s length. To American observers at least, that could be taking an unjustifiably narrow view of the scope of judicial restraints on tax planning. After all, the goal of tax planning is often deferral rather than outright avoidance; much of the U.S. case law striking down tax planning schemes as lacking business purpose or economic substance is, in fact, addressed to schemes designed with deferral rather than avoidance in mind; and from an economic standpoint, the difference between deferral and avoidance disappears, if one’s time horizons are long enough. It is, however, too early in the evolution of the ECJ’s VAT avoidance doctrine to say with confidence that VAT planning to obtain deferral is an acceptable practice, as long as the other contractual provisions reflect economic reality.

C. Customer Loyalty Rewards Programs

1. Overview. Customer loyalty rewards programs provide a challenge for VATs, as they do for retail sales taxes. Customer loyalty rewards programs take a wide variety of forms, from the simple punch card issued by the local ice cream shop to frequent flyer miles and credit card rewards points. Although they differ in their details, those programs usually share two essential features: (1) the customer is awarded a point (or mile, or similar unit of measure) on making a purchase, usually tied to the amount of the purchase, and (2) on accumulating a specific number of points, the customer may redeem them for something of value, either from the retailer issuing the points or from a third party. Accordingly, customer loyalty rewards programs typically involve some or all of the following parties:

- Customer — the party who purchases the goods or services to earn the points.
- Retailer — the party that sells the goods or services to the customer and transfers awards points to the customer in connection with the purchase.
- Operator — the party that operates the customer loyalty rewards program on behalf of the retailer.
- Redeemer — the party that redeems the points from the customer in exchange for a product or service.

In some cases, a single entity may perform one or more of the functions described above, as when Retailer or Operator also acts as Redeemer.
Customer loyalty rewards programs also typically involve some or all of the following transactions:

- Customer’s payment of consideration to Retailer for goods or services and the award of points.
- Retailer’s payment of consideration to Operator for the service of operating the customer loyalty rewards program.
- Operator’s payment of consideration to Redeemer for redeeming the goods or services from Customers for points.
- Customer’s “payment” of points to Redeemer for goods or services.

Those transactions can be illustrated by Figure 1.

2. Loyalty Management and Baxi Group. The ECJ considered two companion cases involving customer loyalty rewards programs under the EU VAT in *Loyalty Management UK Ltd. and Baxi Group Ltd.*[^88] The cases involved how to characterize payments made by operators to redeemers and by retailers to operators. As will become clear, one of the central issues in the cases was whether the VAT charged on the payments could be treated by the party making the payments (and paying the VAT) as deductible input tax. The resolution of that issue depended in part on whether, or the extent to which, the VAT was paid (a) as consideration for goods and services “used for the purposes of the taxed transactions of the taxable person”[^89] and was therefore deductible, or (b) as “third-party consideration” for the benefit of customers as payment for the loyalty rewards they received from the redeemer and was therefore nondeductible.

a. Loyalty Management — the proceedings below. Loyalty Management UK (LMUK) operated a loyalty rewards program involving all the parties and transactions reflected in Figure 1. Under the scheme operated by LMUK, customers purchasing goods and services from retailers earned points that they could redeem for goods and services from redeemers. Under the scheme, retailers paid the operator a specified sum of money for each point issued, as well as an annual fee for marketing, developing, and promoting the scheme. LMUK paid the redeemers a fixed amount of money for each point redeemed, and the redeemers charged LMUK VAT on this amount.

The difficulty of VAT issues raised is reflected in the course of decisions before reaching the ECJ. When LMUK sought to deduct VAT paid to the redeemers as input tax, the revenue commissioners

[^88]: Joined cases C-53/09 and C-55/09, Commissioners for Her Majesty’s Revenue and Customs v. Loyalty Mgmt. UK Ltd. and Baxi Group Ltd., Doc 2010-21927 (E.C.J. 2010).

took the position that the charge in question was not deductible because it constituted third-party consideration for the benefit of customers for the supply of their loyalty rewards from the redeemers rather than payment for the benefit of the operator. On challenge of that position by the operator, the VAT and Duties Tribunal agreed with the operator that the supplies of goods made to customers by the redeemers in return for points constituted a supply of services to the operator and that the VAT on the supply was deductible by the operator. On appeal of that ruling by the revenue commissioners, the High Court of Justice of England and Wales reversed, holding that the fee paid to the redeemers by the operators was third-party consideration paid by the operator for the loyalty rewards provided to customers, thus the operator was not entitled to deduct VAT paid to the redeemers. The court further found, in the alternative, that in cases in which the rewards to customers consisted of goods, if redeemers supplied those goods to the operator, it followed that the operator was liable for output tax on the deemed onward supply of those same goods to customers. That decision was in turn reversed by the Court of Appeal (England and Wales), which held that the charge the operator paid to the redeemers was consideration for a service provided to the operator, which was entitled to deduct the VAT payable on that charge.

On the case’s further appeal to the House of Lords, that body stayed the proceedings and asked the ECJ to determine whether the payments by the operator to the redeemers were (a) consideration solely for the supply of services by the operator to redeemers, (b) consideration solely for the supply of goods and/or services by the redeemers to the customers, or (c) consideration in part for the supply of services by the redeemers to the operator and in part for the supply of goods and/or services by the redeemer to the customers. If the answer was (c), the further question was raised as to how to apportion the payment between the two supplies.

b. Baxi Group — the proceedings below. The facts of the companion case (Baxi Group) involved a group of companies that manufactured boilers and related heating products. The group set up a customer loyalty rewards program for its customers, namely installers of boilers, to encourage them to purchase the Baxi Group’s products. Under the scheme, the boiler installers (customers) received points they could redeem for loyalty rewards (goods and services, although the case involved rewards only in the form of goods) when they purchased the Baxi Group’s (retailer’s) products. Baxi Group subcontracted the operation of the loyalty rewards program to @1, which managed the program, including marketing and the purchase and sale of rewards. Hence, for purposes of our terminology, @1 would be characterized as the operator/redeemer, which distinguishes Baxi Group from Loyalty Management, in which the operator and the redeemer were separate entities. Under the arrangement in Baxi Group, the retailer paid the operator/redeemer an amount equal to the retail sales price of the loyalty awards provided to customers, as well as charges for specific services. The operator/redeemer charged VAT to the retailer on all those payments. The transactions are illustrated in Figure 2.

As in Loyalty Management, the difficulty of VAT issues raised in Baxi Group is reflected in the course of decisions before reaching the ECJ. When the retailer sought to deduct as input tax the VAT paid on the amounts charged by the operator/redeemer, the revenue commissioners took the position that the retail sales price paid by the retailer to the operator/redeemer was consideration for two separate supplies: (1) services provided by the operator/redeemer to the retailer, for which the retailer was entitled to deduct VAT, and (2) third-party consideration for supplies of goods by the operator/redeemer to customers for which the retailer could not deduct VAT. On appeal by the retailer to the VAT and Duties Tribunal, the tribunal held that the operator/redeemer was supplying loyalty rewards to the retailer, which then supplied them to customers without consideration. The retailer was therefore entitled to deduct the VAT invoiced by the operator/redeemer, but was obliged to account for the output VAT chargeable on the subsequent transfer of the goods to customers (purchased with points). On further appeal by the retailer to the High Court of Justice of England and Wales, that court held that the operator/redeemer had supplied the loyalty rewards to customers, not to the retailer, but that the operator/redeemer also supplied services to the retailer that included the supply of the rewards.

90Id.

91Although it may be more accurate to characterize the Baxi Group as a wholesaler, if one views the installer-purchaser as acquiring the boilers for resale, for ease of discussion (and without affecting the underlying analysis), it retains the designation of retailer to facilitate discussion of the two cases using the same terminology. A more neutral (but less recognizable) term for “retailer” would be “sponsor,” that is, any seller, whether retailer or wholesaler, that underwrites a customer loyalty program to encourage its sales.

92Loyalty Mgmt. UK Ltd. and Baxi Group Ltd., C-53/09 and C-55/09.
goods to customers. Because the price paid by the retailer constituted the consideration for the supply of that service, the retailer was therefore entitled to treat the entire VAT invoiced by the operator/redeemer as deductible input tax. On further appeal by the revenue commissioners to the Court of Appeal (England and Wales), the court reaffirmed the holding that the retailer was entitled to recover VAT on its entire payment to the operator/redeemer on essentially the same grounds.

In the case’s appeal by the revenue commissioners, the House of Lords (as in Loyalty Management) stayed the proceedings and asked the ECJ to determine whether the payments by the retailer to the operator/redeemer were (a) consideration solely for the supply of services by the operator/redeemer to the retailer, (b) consideration solely as third-party consideration for the supply of goods by the operator/redeemer to customers, (c) consideration in part for the supply of services by the operator/redeemer to the retailer and in part for the supply of goods by the operator/redeemer to customers, or (d) consideration for supplies of advertising and marketing services and reward goods by the operator/redeemer to the retailer. If the answer was (c), the further question as to how to apportion the payment between the two supplies was raised.

c. The ECJ’s decision. In approaching the question of how to characterize the payments by the operator to the redeemers in Loyalty Management and by the retailer to the operator/redeemer in Baxi Group, the ECJ rejected one characterization of the loyalty rewards scheme that would have influenced the outcome, namely treating the customers’ initial payment for the merchandise in which they earned points as consideration for whatever goods and services they might receive in the future from redeemers. If that characterization had prevailed, it would have been logical to conclude that all consideration paid to the redeemers in Loyalty Management and to operator/redeemer in Baxi Group was for the services provided to the operator in Loyalty Management and to the retailer in Baxi Group, because, under that view, consideration for the goods and services provided to the customers had already been paid in full by the customers themselves. In that case, all the VAT paid would have been a deductible input tax because it would have been in consideration for services “used for the purposes of the taxed transactions of the taxable person,”93 and not third-party consideration.

The reason for the ECJ’s rejection of that theory was stare decisis. In Kuwait Petroleum,94 an oil company awarded fuel purchasers points that they could redeem for goods. The court dismissed the oil company’s argument that the price paid by the fuel purchasers contained an element representing the

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93 Recast Sixth VAT Directive, supra note 14, art. 168.
value of the goods supplied in exchange for the points because the fuel purchaser had to pay the same retail price, whether or not he took the points. Instead, the court held that the sale of fuel giving rise to the points and the transfer of the goods in exchange for the points were two separate transactions.

Accordingly, in analyzing the transactions in Loyalty Management and Baxi Group, the court proceeded from the premise that the sale of goods or services giving rise to the points and the exchange of loyalty rewards for the points were two separate transactions. As a practical matter, the former transaction simply dropped out of the picture, and the question was how to attribute the consideration among the various remaining alternatives identified above in the House of Lords' requests for rulings to the ECJ.

Within that analytical framework, there was no serious dispute about the fact that the redeemers in Loyalty Management had supplied goods and services to customers in exchange for points and that operator/redeemer in Baxi Group had supplied goods to customers in exchange for points. The ECJ further concluded, based on the facts described above, that the consideration paid was inextricably linked to the exchange of points for the supply of goods and services to customers. In short, it concluded that this constituted third-party consideration for which any VAT paid would not constitute deductible input tax.

At the same time, the ECJ recognized in Loyalty Management that there was arguably a basis for finding that a portion of the consideration was a payment for services provided by the redeemer to the operator and that in Baxi Group a portion of the consideration constituted payment for services provided by the operator/redeemer to the retailer. Any VAT paid on that consideration would constitute deductible input tax.

In Loyalty Management, the allocation of the consideration between the bundled supplies was not clear, and the ECJ left it to the national court to sort out the bundling issue. In Baxi Group, by contrast, the purchase price of the goods constituted the consideration for the supply of the loyalty rewards to the customers, whereas the difference between the retail sales price paid by the retailer and the purchase price paid by the operator/redeemer to acquire the loyalty awards, namely the operator/redeemer's profit margin, constituted the consideration for the services that the operator/redeemer provided to the retailer.

D. Conclusion

If our brief foray into VAT controversies accomplishes nothing else, it reveals that they can be as intellectually challenging and technically demanding as tax controversies in other contexts. It should therefore put to rest the view in some quarters that VAT issues need not command sustained attention because they are simply matters of cash flow. Finally, if there is a common theme that links all three issues we addressed — branch-to-branch issues, abuse-of-law issues, and issues raised by customer loyalty rewards — it may well be the central role that the inability to recover input VAT played in each context (whether because of exemptions or third-party consideration). This conclusion is hardly surprising because, at least from a business perspective, the VAT only hurts enough to pay lawyers when it sticks.