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## **BFH rules on organizational integration requirement and the need for a controlling company to be regarded as a taxable person for VAT grouping purposes**

VAT Group – organizational integration can exist even if the management boards of the controlling and the affiliated companies are not identical

Germany's Federal Tax Court (BFH) issued a decision on January 25, 2017, in a case involving the establishment of a VAT group. The BFH held that for a VAT group to be recognized, the parent company must have control over the management of the affiliated company and the parent must be taxable person in its own right.

### **Background**

Ten percent of the plaintiff, a German limited liability company (GmbH), was held by M and 90% of the company was held by her son S. By virtue of a contract, which was designated a "contract of employment for managing directors", S was appointed as the managing director of the GmbH with the sole right to represent the company. S did not receive a fixed monthly salary for these services and he had to comply with the instructions of the shareholders' meeting and V, the managing director of another GmbH, A-GmbH. The shares of A-GmbH and those of the plaintiff were contributed into a newly established GmbH, F-GmbH, whose purpose was to hold and manage the family participations. V, acting as the managing director of F-GmbH and having the sole right to represent the company, held 90% of the shares of F-GmbH and M held 10% of the share capital. Based on the findings in a tax audit, F-GmbH provided consultancy services to the plaintiff and to A-GmbH during the year at issue.

According to the findings of the Local Finance Court (FG), V had control over the company and S did not take care of the business, but left it "completely and without restriction" to V, who received a salary from the GmbH as an employee of the plaintiff.

The plaintiff considered that it was integrated into the VAT group of the controlling company, F-GmbH, and so it did not file a VAT return. After conducting a tax audit, the German tax authorities took the position that the plaintiff was not financially and organizationally integrated into F-GmbH and, therefore, it had to be treated as an independent taxpayer for VAT purposes.

### **Decision of the BFH**

The BFH concluded that the parties met the requirements to constitute a VAT group under German VAT law. To constitute a VAT group in Germany, the companies must be organizationally, financially and economically integrated.

### **Financial and economic integration**

Being financially and economically integrated means to hold a majority participation in the affiliated company and to cooperate with each other economically, resulting in a situation where the parent company has control over the subsidiary during the course of the current business. The BFH noted that F-GmbH held the majority of the voting rights in the plaintiff and so was able to influence the decision-making process. The plaintiff was thus financially integrated into F-GmbH. With regard to the economic integration of the plaintiff, the BFH pointed out that the situation as a whole is decisive and that the adoption of an organizational structure does not require that all three integrating factors be equally identifiable.

Organizational integration generally is achieved where personnel interdependence exists in the management board of the holding and the controlled entity; in particular, where the managing director of the holding company also is the managing director of the controlled entity. However, the BFH emphasized that – in exceptional cases – organizational integration can be achieved where the facts are such that the controlling company can intervene in the core area of the company's ongoing management. In this case, V acting as

the managing director of F-GmbH, was in a position to exercise control over the plaintiff.

Although S was appointed managing director of the plaintiff, the terms of the employment contract required that he follows the instructions given by the shareholders' meeting and the managing director of A-GmbH (i.e. V).

According to the findings of FG, it was V who actually managed the business of the plaintiff rather than the appointed managing director, S. Moreover, S generally agreed to the transactions undertaken by V to the extent such decisions concerned him. This was exactly the role S should play in the management of the plaintiff according to the contract of employment. Therefore, with regard to the VAT grouping requirements, there is sufficient substance of organizational integration.

#### **Independent commercial activity of controlling company**

The BFH referred to its previous decisions in cases with similar issues (decisions dated October 9, 2002 V R 64/99 and December 2, 2015 V R 67/14), which provided that the controlling company of a VAT group must qualify as a taxpayer on a stand-alone basis. The Senate states as far as EU law (see ECJ judgement as of April 9, 2013 C-85/11) would come to a different result, Article 4 (4) (2) of Directive 77/388 / EEC does not have direct effect and is not applicable.

#### **Comment**

In its decision, the BFH emphasized that organizational integration can exist even if the management boards of the companies are not identical, provided the control by the parent company is safeguarded by other effective organizational means. With respect to the requirement that the controlling company engage in its own business activities, the BFH has not changed its position even in view of the decision of the CJEU in *Commission v. Ireland* (C-85/11). As a result, it is expected that the requirement to be a taxable person on a stand-alone basis will give rise to more litigation.

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