Contribution to share capital and VAT 3/21/24

Whether a taxable person transfers a business or makes a contribution in kind in exchange for shares, this is typically treated as a transaction outside the scope of VAT. However, the Latvian VAT Act does not resolve this issue conclusively, and this assumption comes from a logical assessment of the rules that require adjustment to input VAT deduction. The latest case law of the Court of Justice of the European Union (CJEU) has weakened the impression that a contribution to share capital is always a supply outside the scope of VAT. This article explores a recent CJEU ruling.

Ruling C-241/23 (P. sp. z o.o.) of 8 May 2024 saw the CJEU mainly invoke article 73 of Council Directive 2006/112/EC on the common system of value added tax ('VAT directive') regarding ways to determine the taxable amount of a transaction. Here's the background.

Polish companies W and B contributed to the share capital of another Polish company, P, causing an increase. The two companies entered into several agreements with P to transfer their real estate and inject cash in exchange for shares in P. The agreements stated that the consideration for the contribution in kind to P's share capital was shares in P valued at their issue price of 35,287.19 zloty per share. The price was based on the market value of the real estate contributed (a third-party valuation). W and B issued tax invoices for their contributions to P, who deducted the input VAT appearing on them.

The Polish tax authority did not object to the contribution being charged to VAT. A dispute arose over the taxable amount of the transaction. The tax authority believed the taxable amount was the nominal value of 50 zloty per share and not the issue price of 35,287.19 zloty per share. As the dispute escalated, the Polish Administrative Court agreed that the consideration, which was due to the company making a contribution in kind to the other company in a way that did not qualify as a transfer of business, corresponded to the nominal value of shares P gave the investors to compensate for their investment. As the litigation went on, the dispute landed in the Polish Supreme Administrative Court, which asked the CJEU a preliminary question. As regards the monetary valuation of shares, the Supreme Administrative Court said that under Polish law the nominal value of a company's shares is the per-share value of financial and non-financial assets defined in its articles of association and contributed by its founders. This is the value of each share fixed by the shareholders incorporating the company and determined according to their contributions to the company on that date. The issue value of a share corresponds to its value at the time of issue. So the value of a share at incorporation equals its nominal value. However, the company's value may increase or decrease during its existence such that the value of each share may become greater or smaller than its nominal value. If a company whose share value has increased during its existence issues new shares, their issue price is typically higher than the nominal value of existing shares.

The preliminary question was meant to help the Supreme Administrative Court establish whether the taxable amount of the real estate contribution to the company's share capital in exchange for its shares should be measured at the nominal value of shares if the recipient company and the investor companies have agreed that the consideration for this contribution to share capital will be the issue value of shares.

In hearing this case, the CJEU said the taxable amount is everything that goes into the consideration the supplier has received or will receive for a supply of goods or services. And there is no requirement for the consideration to be in cash. Barter agreements with a consideration in kind by definition, and transactions where the consideration is paid in cash, are economically and commercially two identical situations under the VAT directive. Accordingly, the consideration for a supply of goods or services may also be a supply of goods or services.

Next, in order to establish whether there was a supply of goods or services for a consideration (only a supply for a consideration is a taxable transaction), the CJEU needed to find out whether there is a direct link between the goods or services being exchanged and whether their value can be expressed in monetary terms. Such a direct link is found if there is a legal relationship between the supplier and the customer involving reciprocal performance and if the fee the supplier received is the actual consideration for services supplied to the customer.

The CJEU said P had increased its share capital by obtaining ownership of the real estate previously owned by W and B. The consideration they received for their contributions to P's share capital corresponds to a certain number of shares P issued for this purpose. This shows a direct link between the transfer of real estate by W and B and the transfer of shares in P to the two companies. And the value of shares transferred can be expressed in monetary terms.

It follows from the above that a contribution in kind in exchange for shares, made in any form other than a transfer of business, is recognised by the CJEU as a transaction for VAT purposes.

As regards the taxable amount, the CJEU said this is the consideration the taxable person has in fact received. This is not a value measured according to some objective criteria but rather a subjective value – the one that has been received. Since the parties have not agreed on a sum of cash to ensure the amount is subjective, it must be measured at the value being assigned to the transaction and must correspond to the amount they are willing to pay. In this case the subjective value of the consideration for the real estate contributions corresponds to the cash value W and B assigned to the shares in P by agreeing to accept them in exchange for their contributions to P's share capital. The CJEU finds it possible that the consideration for bringing the real estate previously owned by W and B into P's share capital corresponds to the allocation of a number of shares whose value is based on their issue price. This implies that the subjective value of each share corresponds to its issue price, not the nominal value. The CJEU also said this method of determining the taxable amount does not prevent the national court from verifying that the value agreed between the parties actually reflects the economic and commercial reality and is not the result of misconduct.

It's important to note that there is an earlier CJEU ruling (C-98/21 W GmbH dated 8 September 2022) on a dispute over the right to deduct input VAT. Deduction rights were claimed by an investor whose contribution to a subsidiary was a supply of certain services. Under the German VAT Act, a business is not considered to be carried on independently if:

1. Individuals alone or together are integrated in the company such that they have to follow its instructions.
2. The general structure of the actual relationships suggests that in financial, economic and organisational terms the legal entity is part of the main company (a financial unit). The financial unit applies only to internal services between the company's branches in the country. These branches must be treated as a single entity. [..]"

Based on these rules, where W had a 94% stake in X, and Z had a 6% stake in X, and the two shareholders agreed to make contributions – Z in cash and W in services, neither the German tax authority nor the CJEU raised concerns about W's contribution being a taxable transaction (a supply of services for a consideration). W treated this contribution in kind – the obligation to supply services – as an out-of-scope transaction and did not charge VAT on it. The CJEU did not question the VAT treatment of the transactions and only said W had no right to deduct the input VAT on goods and services acquired to make the contribution in the form of services in exchange for a share of the company's profits.

As mentioned above, section 7 of the Latvian VAT Act states that a transfer of business to another entity for a consideration or free of charge, or as a contribution to the company's share capital, does not qualify as a supply for a consideration. Yet the VAT Act is silent about any contribution that is not a transfer of business.

The idea that any contribution in kind is an out-of-scope supply arises from the rules of section 103 dealing with input VAT adjustments on a contribution to a company's share capital. The basic rule of this section states that input VAT must be adjusted for contributions in kind (including fixed assets and real estate) to a company's share capital in exchange for securities and share certificates. No adjustment is required if the recipient is a registered company that plans to use the contribution for making taxable transactions, or a newly formed company that is registered for Latvian VAT within 30 days after being entered on the commercial register. An adjustment would only be required if the contribution were treated as an out-of-scope supply or an exempt supply.

Since the Latvian VAT treatment of business contributions is not uniform, in the case of a contribution in kind we recommend seeking approval from the State Revenue Service for every aspect of VAT treatment and input VAT deduction to avoid tax risks.