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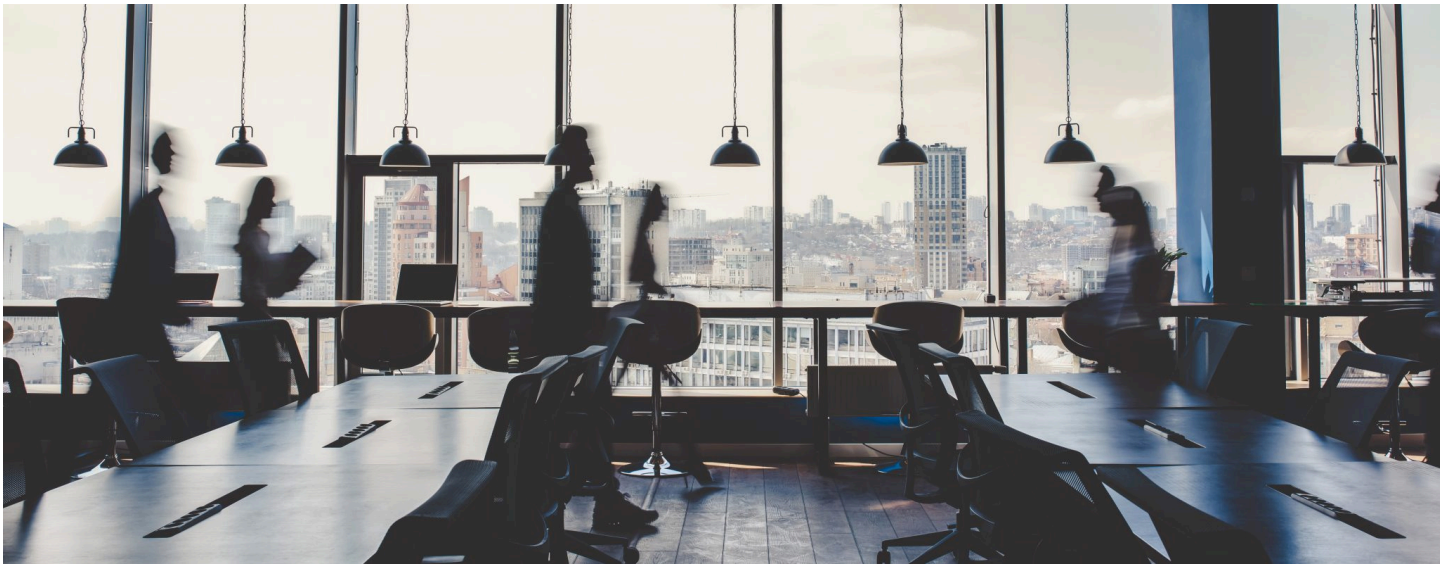

VAT and Holding Companies: Review of the *Covidien* Case

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Introduction

The judgment in the case of *The Revenue Commissioners v Covidien Limited* [2024] IEHC 192 was delivered on 11 April 2024 and upholds the earlier determination of the Tax Appeals Commission (TAC), 81TACD2022, in favour of the taxpayer. There is a large body of case law from the Court of Justice of the European Union (CJEU) endorsing the broad scope of the VAT recovery entitlement for “active” holding companies, but this case is important owing to its particular facts and given the focus on VAT deductibility in respect of the costs associated with corporate transactions. The High Court’s decision will be welcomed by taxpayers and practitioners seeking to determine whether a holding company is entitled to VAT recovery in certain circumstances but also serves as a useful reminder of the importance of ensuring appropriately documented intra-group arrangements to support a claim for VAT recovery for relevant holding companies. The taxpayer’s ability to adduce clear oral and documentary evidence in support of its claim at TAC level was essential to its appeal.

Recap on VAT Recovery for Holding Companies

Before delving into the details of the *Covidien* case, it is helpful to summarise the established rules in respect of VAT recovery for holding companies.

The question of whether a holding company can deduct the VAT incurred on its costs has been the subject of much litigation at CJEU level over the last 30 years or so. The overarching principle that emerges from such case law is that a holding company can reclaim the VAT that it incurs on relevant costs, provided it is engaged in the supply of services to its subsidiaries for consideration and the costs incurred have a direct link to this activity, or to the business of the company as a whole.

Holding companies broadly fall within one of three categories for VAT recovery purposes:

- **Active holding companies** – Holding companies that are engaged in the supply of services to subsidiaries for consideration, and are therefore entitled to VAT recovery, are typically referred to as “active holding companies”, and the services supplied are normally given the umbrella term “management services”.

- **Passive holding companies** – By contrast, those companies that simply hold shares in subsidiaries in a passive manner, without supplying any services for consideration, are referred to as "passive holding companies" and are generally not entitled to recover the VAT incurred on their costs. Note that the receipt of dividends does not constitute consideration for these purposes. The holding of shares in a passive manner is considered a "non-economic activity" for VAT purposes.
- **Mixed holding companies** – The final category of holding company is one that is engaged in the supply of services to some subsidiaries for consideration but holds other subsidiaries in a passive manner. These holding companies are referred to as "mixed holding companies" and are required to apportion their VAT recovery entitlement to ensure that deduction is made only for the portion of VAT incurred that is attributable to their taxable economic activity. Any VAT incurred on costs directly attributable to the non-economic, passive holding of subsidiaries is irrecoverable.

These categories of holding companies are also identified in Revenue's guidance in its Tax and Duty Manual "VAT Deductibility for Holding Companies". Although the law in this area is now relatively settled in many respects, some ambiguity remains when determining whether to restrict the deductibility of VAT for holding companies in certain circumstances – for example, in determining precisely when costs should be attributed to a non-economic activity for mixed holding companies. The deductibility of costs associated with corporate mergers and acquisitions involving the holding company can also be contentious. Tax authorities may take the view that the costs of certain transactions are not directly attributable to the taxable activity of the holding company (even an active holding company) but to the ultimate shareholders' investment in the corporate group, such that VAT recovery should be restricted. This is among the arguments that Revenue sought to advance in the *Covidien* case, albeit unsuccessfully. A summary of the background to this case is set out below.

Background

The taxpayer, Covidien Limited, is an Irish-incorporated and Irish-tax-resident entity that acted as the ultimate holding company for the Covidien Group during the relevant period of 1 July 2011–31 December 2014 ("the Appeal Period"). The Covidien Group is a multinational healthcare business that focused on three particular market segments during the period: medical devices, medical supplies and pharmaceuticals.

During the Appeal Period, the taxpayer held four subsidiaries directly and approximately 300 subsidiaries indirectly, 84 of which were described as "active" subsidiaries.

Covidien Limited entered into two agreements relevant to the supply of management services to subsidiaries:

- The first service agreement was entered into on 26 June 2009 with a group company, Tyco Healthcare Group LP ("Tyco"), for the purchase of services required to provide management services to subsidiaries. The agreement provided that these services consisted of corporate executive, business development,

human resources, internal audit, finance, tax, legal, treasury and risk, management and operations services.

- The second service agreement was for the supply of management services by the taxpayer and was entered into on 26 September 2009 with four of the company's indirect subsidiaries, being Nellcor Puritan Bennett Ireland, Mallinckrodt Medical Imaging Ireland, Mallinckrodt Medical BV and Covidien AG (referred to as "the Service Recipients" throughout the case).

For the purposes of the appeal, the costs incurred by the taxpayer that related to the ongoing holding and management of subsidiaries were referred to as the "ongoing costs" and, we understand, essentially related to the VAT recovery in respect of the ongoing fees charged by Tyco.

Separately, the Covidien Group went through a restructuring process during the Appeal Period, which involved the spin-off of its nuclear medicine and pharmaceutical business into a newly formed company, Mallinckrodt Plc, as part of a project known as "Project Jameson". The VAT incurred on costs associated with Project Jameson was the second category of costs that were the subject of the appeal.

The final category of costs in this case arose from the well-publicised "inversion transaction" involving the acquisition of the Covidien Group by Medtronic ("the Medtronic Transaction"). The acquisition was effected by way of a cancellation scheme of arrangement approved by the High Court and resulted in the cancellation of existing shares in the taxpayer and the issuance of fully paid new shares in the taxpayer to two Medtronic companies.

The taxpayer had claimed full VAT recovery for the period in respect of all "ongoing costs" that it determined to be related to its management activity and in respect of all costs related to Project Jameson and the Medtronic Transaction. After an audit, Revenue concluded that only partial VAT recovery would be permitted in respect of the ongoing costs and that no VAT recovery entitlement arose for the taxpayer in respect of the costs associated with Project Jameson or the Medtronic Transaction.

Accordingly, Revenue raised a number of assessments for VAT for the Appeal Period, which together totalled €45,936,882.

TAC Determination

The TAC proceedings lasted for nine days and involved multiple days of oral testimony and the submission of a large quantity of documentary evidence. This is reflected in a 172-page TAC determination, which examines the evidence provided, together with both parties' legal submissions, in detail. The Appeal Commissioner made a series of material findings of fact on foot of the evidence provided, most of which were highly supportive of the taxpayer's case. These findings of fact are summarised below:

- The taxpayer's board made decisions related to all aspects of the Covidien Group's business, which were then actioned by executive officers and appropriate personnel in relevant subsidiaries.

- There was detailed ongoing involvement by the taxpayer's board in the management of the Covidien Group as a whole and in relation to specific group projects and initiatives.
- Through the first service agreement and the second service agreement, the taxpayer was providing management services not only to the four Service Recipients but also to the 84 subsidiaries connected to them.
- The evidence provided did not support a finding that the taxpayer was engaged in a non-economic activity. The taxpayer was not a passive holding company but at all material times was actively engaged and directly and indirectly involved in the management of its subsidiaries and sub-subsidiaries. Such involvement was "for the purposes of the exploitation of its holdings in those companies for the purposes of obtaining income therefrom on a continuing basis".
- The taxpayer received a single composite supply of services from Tyco. Furthermore, there was a direct and immediate link between (a) the input costs, being on the single supply received from Tyco, and (b) the supply of management services by Covidien to the four Service Recipients and their 84 subsidiaries. The services purchased from Tyco were used in their entirety for the purposes of the supply of services to subsidiaries.
- The decision to undertake the Project Jameson spin-off of Covidien's pharmaceutical business, structured as a "three-cornered demerger", and the subsequent implementation of such decision were an integral part of the active management by the taxpayer's board of the group's business as a whole. The structure of the group among global business units meant that the transaction affected not only the Service Recipients but also their respective subsidiaries throughout the group. Consequently, the services supplied to the taxpayer as part of Project Jameson had a direct and immediate link to the taxpayer's taxable output supplies to both its direct and its indirect subsidiaries.
- The role of the taxpayer's board in the initiation, oversight and execution of the Medtronic Transaction was an integral part of the active management by the taxpayer of the Covidien Group business as a whole.

Points of Law Referred to the High Court

After the taxpayer's successful appeal at TAC level, Revenue appealed the determination by way of case stated to the High Court, and the main points of law referred for determination were whether the Appeal Commissioner was correct in law in:

- his approach to issues of fact, on the one hand, and issues of law, on the other, and in particular, the identification of material findings of fact in his determination;
- concluding that the taxpayer was at all material times wholly engaged in an economic activity for VAT purposes;
- considering that the receipt of a single composite service from Tyco and the supply of a single composite service by the taxpayer were relevant for the purposes of ascertaining the level of input VAT deductible by the taxpayer;

- concluding that there was a direct and immediate link between the entirety of input costs suffered by the taxpayer on the supply of services that it received from Tyco under the first service agreement and the supply of taxable management services by the taxpayer under the second service agreement to the Service Recipients and, through them, to the other 84 legal entities connected to the Service Recipients;
- concluding that the taxpayer was entitled to deduct the VAT inputs that it incurred in respect of services that it received in relation to Project Jameson; and
- concluding that the taxpayer was entitled to deduct the VAT inputs that it incurred in respect of services that it received in relation to the Medtronic Transaction.

Ultimately, Nolan J found in favour of the taxpayer in respect of all questions raised for determination.

High Court Decision

Legal framework

The judge began by examining the legal framework in respect of the entitlement to deduct VAT and noted that the key legislative provisions were Articles 9 and 168 of Council Directive 2006/112/EEC ("the VAT Directive"). Article 9 deals with "economic activity" and provides that "the exploitation of tangible or intangible property for the purposes of obtaining income therefrom on a continuing basis shall in particular be regarded as an economic activity". Article 168 provides that VAT is deductible on the purchase of goods and services "insofar as the goods and services are used for the purposes of the taxed transactions of a taxable person". This is referred to in the judgment as the "used for" test.

The judge also cited with approval a passage from the UK Supreme Court case of *Revenue and Customs Commissioners v Frank A Smart & Son* [2018] STC 806, which helpfully summarises the principles from relevant CJEU case law in respect of the "used for" test and the entitlement to deduct VAT.

Service agreements and the "economic reality" principle

The disregarding of the written agreements in favour of the "economic reality" was fundamental to the taxpayer's success in this case. The second service agreement provided for the supply of services by the taxpayer to the four Service Recipients only. However, there is a principle in VAT law that requires the terms of written agreements to be disregarded where they do not conform to the legal and economic reality.

In this regard, it was determined at TAC level that, in reality, the taxpayer provided services to 84 active subsidiaries, although the consideration for all of these supplies was provided by the four Service Recipients. The TAC found that the operating structure and inter-company transfer pricing policy meant that there was a logic and a benefit to the four Service Recipients' paying for the management services received by their 84 subsidiaries. On the basis of this finding, the TAC determined that the taxpayer was not a "mixed holding company" and was not engaged in a "non-economic activity". This was essential to the taxpayer's case, as

the corollary must be that the taxpayer was engaged only in economic activity, such that any VAT incurred in the course of its activities would be deductible.

Although there was no appeal on the finding of fact, Revenue argued in the High Court that the TAC made a mistake in law in concluding that the written agreements should disregarded in this manner and contended that the taxpayer was bound by its own agreements. Nolan J noted that it seemed that the manner in which the service agreements were actually carried out varied from the precise wording of the agreements, and he upheld the principle that consideration of economic realities is a fundamental criterion for the application of VAT, citing two recent Irish cases in which the principle was applied (*Vieira Limited v Dermot O'Donagain (Inspector of Taxes)* [2021] IECA 334 and *Revenue Commissioners v Novartis* [2022] IEHC 642). The judge held that the Appeal Commissioner was entitled to come to his view that the taxpayer was engaged in a supply to all 84 subsidiaries for consideration based on the evidence that he heard.

Revenue also argued that, under the contract, the services were to be charged to the Service Recipients at cost plus 10% but in practice were charged at 40% of the cost of purchasing the services from Tyco. Revenue argued that this demonstrated that not all of the costs were consumed in the context of the management services supply and that a portion of the costs must have been attributable to a separate, non-economic activity and therefore should be irrecoverable. However, the taxpayer argued that it did not have to make a profit on the transaction in order to claim VAT recovery and that the TAC had found as a fact that the services acquired were used in their entirety for the supply of management services to subsidiaries. Nolan J noted that the disparity in price was due to transfer pricing reasons and agreed with the taxpayer's submission that there was no requirement to make a profit for VAT deductibility purposes. Accordingly, it was determined that the Appeal Commissioner could not be criticised in his approach to this issue. Although one can appreciate the logic of Revenue's argument, the CJEU has in the past rejected any attempts to confine VAT deductibility by reference to a strict equation of costs versus revenues.

It is interesting that the taxpayer was deemed not to be a "mixed holding company" in circumstances where it was found to be engaged in a supply of management services to 84 indirect subsidiaries, out of a total of approximately 300 subsidiaries in the wider group. The fact that only 84 of these companies were "active" was likely determinative, as it was perhaps possible to conclude that none of the activities of the taxpayer (or the costs incurred) related to the inactive subsidiaries. However, this was not addressed in the judgment. Questions, arguably, remain regarding when a holding company should be classified as a "mixed holding company" engaged in partial non-economic activity in the context of larger, multi-layered corporate groups where services are supplied to some but not other subsidiaries.

Single composite supply

The TAC determined that the supply of services from Tyco was a single composite supply, which could not be broken down into its constituent parts. Revenue argued that the TAC had erred in law in this finding. The taxpayer argued that Tyco's service covered a full range of management and professional services in the form of a single supply, a concept well known in VAT law, and that the TAC was correct in coming to its

conclusion. Nolan J sided with the taxpayer, noting that the service must be viewed from the perspective of the consumer, and he agreed with the TAC's approach to the issue in considering the UK case of *HMRC v the Honourable Society of Middle Temple* [2013] UKUT 250.

It seems that the finding that there was a single composite supply greatly simplified the case for the taxpayer because, instead of the court's having to examine separately the merits of each element of the service supplied by Tyco, it was possible to focus on a single input for deductibility purposes.

Approach to issues of fact and law

Nolan J determined that the TAC was correct in its approach to issues of law, on one hand, and issues of fact, on the other. The judge cited the case of *Glynn v Revenue Commissioners* [2021] IEHC 780, in which Stack J noted that alleged errors of law by an Appeal Commissioner should be pleaded with particularity. Nolan J noted that this did not happen in this case, likely because it was hard to be particular. He also held that the Commissioner did not ignore the evidence or the submissions of either party, as these were laid out in detail in his determination. This is a case in which issues of law and fact were particularly intertwined.

Deductibility of VAT on "ongoing costs"

In addition to the arguments set out above, Revenue contended that the TAC had failed to address the issue of the deductibility of ongoing costs through the prism of EU law and had failed to engage with and correctly apply the "used for" test. However, the taxpayer argued that the TAC knew and applied the law correctly and had found that the taxpayer was not engaged in a non-economic activity but used the single composite supply of services received from Tyco wholly for the benefit of the 84 active subsidiaries. Ultimately, Nolan J determined that the TAC was correct in law in determining that the VAT on the ongoing services received from Tyco was deductible. The judge noted that the TAC had not failed to apply the "used for" test and had correctly considered EU law (Article 9 of the VAT Directive) when determining that the taxpayer was exploiting its property (namely, its shareholdings in its subsidiaries) for the purposes of obtaining income therefrom on a continuing basis.

The leading case of *Cibo Participations SA v Directeur régional des impôts du Nord-Pas-de-Calais* C-16/00 was cited, in which it was determined that "direct or indirect involvement in the management of subsidiaries must be regarded as an economic activity where it entails the carrying out of transactions which are subject to VAT". In agreeing with the finding of the TAC, Nolan J held that the services provided by Tyco were utilised in their entirety for Covidien's economic activity, which was based on credible evidence. It was therefore unnecessary to consider whether the costs formed part of the general costs linked to the taxpayer's activities as a whole.

Project Jameson costs

In respect of Project Jameson, Revenue argued that the TAC had erred in its characterisation of the planning and execution of the transaction as constituting an economic activity. Revenue submitted that the TAC

should have considered whether the costs were used for the "taxed transactions" of the taxpayer and asserted that they clearly were not used for the provision of management services, nor did the taxpayer receive any consideration for its activities in this regard. Revenue also argued that the transaction involved a "share-for-share" exchange at the shareholder level, the implication being that the transaction was undertaken by the company's shareholders and not the company itself, such that the costs should not be deductible.

By contrast, the taxpayer argued that the decision to enter into the Project Jameson transaction was an integral part of the active management of the Covidien Group's business as a whole and so the costs had a direct and immediate link to taxable output supplies.

Nolan J upheld the TAC's determination on this point and ruled that the VAT incurred on the Project Jameson costs was deductible in full. With regard to the argument that there was a transaction at the shareholder level only, Nolan J pointed out that the transaction was, in fact, a three-cornered demerger that involved the spin-off of the business by way of a distribution of a dividend *in specie* by the taxpayer.

The judge noted that the TAC's determination on the point was concise but determined that the TAC had correctly applied EU law and considered the range of evidence provided in respect of Project Jameson. He noted that the oral evidence and board packs provided demonstrated the role of the taxpayer's board in the group as a whole, particularly with respect to specific projects and initiatives within the group. The judge held that the taxpayer was at all material times wholly engaged in economic activity, including in the context of Project Jameson. He noted that it would be illogical to be wholly engaged in economic activities at all material times yet not be wholly engaged in economic activities during a crucial reconstruction of the business of the taxpayer, i.e. Project Jameson.

The judge further held that the Project Jameson costs were comparable to those analysed in the CJEU decision in the joined cases of *Larentia + Minerva v Finanzamt Nordenham* C-108/14 and *Finanzamt Hamburg-Mitte v Marenave Schiffahrts AG* C-109/14. In this respect the judge referred to the principle that a taxable person has the right to deduct VAT in respect of costs even where there is no direct and immediate link between the particular costs incurred and the output transactions of the business, provided those costs are part of the general costs of the business and are, as such, components of the price of the goods or services that the business supplies. The judge held that:

> "[s]uch costs do have a direct and immediate link with a taxable person's economic activity as a whole. Restructuring of the company had as its goal the benefit to the group as a whole and thus to the price of the goods and services which the taxpayer supplied."

Medtronic Transaction costs

Finally, with respect to the Medtronic Transaction, Revenue argued that the TAC had erred in law in equating the transaction to the share issuance activity analysed in the *Kretztechnik AG v Finanzamt Linz* C-465/03 decision, as there was no capital-raising purpose in effecting the transaction. Revenue also argued that it

was a mistake in law to hold that the board's initiation, oversight and execution of the transaction was an integral part of the active management by the board of the taxpayer as a whole. There was also no finding that the transaction affected group companies, which Revenue argued was fatal.

The taxpayer's arguments for deductibility were essentially in line with its arguments in respect of Project Jameson, i.e. that the costs formed part of its general costs and the VAT thereon was therefore deductible, as it was not engaged in an exempt or non-economic activity.

In his deliberations Nolan J noted that the TAC's finding that the board's involvement in the transaction was an integral part of the active management of the Covidien Group's business as a whole was logical and consistent on the basis that it found that Covidien had been wholly engaged in an economic activity. In response to Revenue's argument that there was no finding that the transaction affected group companies, he stated:

> "The Medtronic transaction was clearly a transaction for the benefit of the group as a whole which in my view clearly arises from [the Commissioner's] finding that the taxpayer was wholly engaged in economic activity. Therefore, it seems to me that this is a finding that I cannot set aside since I do not believe that no reasonable commissioner would have come to the same conclusion."

Accordingly, the judge ruled that the TAC was correct in law in concluding that Covidien was entitled to an input VAT deduction in respect of costs related to the Medtronic Transaction.

Considerations for Practitioners

This case provides another helpful precedent in support of the entitlement of active holding companies to reclaim VAT on costs – in particular, in respect of the costs of corporate transactions. Given the helpful findings of fact at TAC level, it is perhaps not surprising that the taxpayer was determined to be entitled to full VAT deducibility. The earlier case of *Ryanair v The Revenue Commissioners* C-249/17 had, arguably, already given full expression to the principle that active holding companies are entitled to reclaim the VAT incurred on transaction costs in both the Irish and EU courts (at least in the context of acquiring companies to which management services are intended to be supplied). However, Revenue may have considered that it had a stronger case in this context, given the particular nature of Project Jameson and the Medtronic Transaction and in light of the fact that the taxpayer had entered into agreements with only four indirect subsidiaries. Our understanding is that the case has not been appealed.

In the context of corporate transactions, Revenue's "VAT Deductibility for Holding Companies" currently notes that some costs will not be deductible even if incurred by active holding companies. The guidance specifically cites as an example the "costs of restructurings that seek to create shareholder value but do not relate to the taxable economic activity of the holding company". The *Covidien* case demonstrates that a strict differentiation of costs in this manner may be misguided and that costs that create shareholder value are

capable of deduction provided they form part of the general costs of a company that is engaged in fully taxable activities.

Finally, a key takeaway for practitioners is to ensure that there is appropriate documentation of intra-group arrangements where the intention is to have an active holding company. The fact that the taxpayer had put in place management services agreements with subsidiaries was, arguably, essential to its appeal. Although the written agreement unhelpfully provided for a supply of services to just four subsidiaries, the taxpayer's ability to provide strong witness testimony and documentary evidence, such as board packs, to show that, in reality, the company was engaged in a supply of services to a larger number of subsidiaries was very important. Where applicable, holding companies should ensure that they take steps to document clearly the active management role played in the business of its subsidiaries in order to support their VAT deductibility position in the event of a Revenue challenge.