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# BREAKING WITH TRANSITION

## THE EU VAT SYSTEM AND THE INTERNAL MARKET

PhD in Law

2006

Rita Aguiar de Sousa e Melo de la Feria

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## ABBREVIATIONS

BTR – British Tax Review

B2B – Business to Business

B2C – Business to Consumers

CMLRev. – Common Market Law Review

EC – European Community

ECR – European Court Reports

ECTR – EC Tax Review

EEC – European Economic Community

ELRev. – European Law Review

EMU – Economic and Monetary Union

IGC – Inter-Governmental Conference

JCMS – Journal of Common Market Studies

MLR – Modern Law Review

OJ – Official Journal

QMV – Qualified Majority Voting

SEA – Single European Act

TCE – Treaty establishing a Constitution for Europe

TEU – Treaty of the European Union

VAT – Value Added Tax

# INTRODUCTION

This thesis focuses on VAT in the context of the EU internal market. Its central objective is to prove that the current EU VAT system is incompatible with the concept of internal market, as set out in the EC Treaty and interpreted by the Court of Justice. In recent times, largely by virtue of the Court's activities, the impact of the concept of internal market over Member States' direct tax systems has been the target of growing academic interest.[1] However, during the same period comparatively modest academic attention has been paid to the area of VAT, which is in fact more fundamental to the proper functioning of the internal market. It has been left to the European institutions, particularly the Commission, to take the lead in fostering debate on these matters, with limited academic exception. Through providing in-depth legal analysis of these issues, this thesis aspires to contribute towards a reversal of this trend in scholarly focus, stimulating increased academic awareness of the centrality of VAT to the internal market, as well as providing a theoretical framework for future studies of this increasingly important area of EU law.

The internal market was officially established on 1 January 1993. The project initiated in 1985 by the White Paper on the completion of the Internal Market[2] was held out as an overwhelming success, one to which the Commission was keen to draw attention:

> "The legislative programme established in 1985 has now been more than 95% completed [...]. It is now possible for goods, services and capital to move freely across the entire community."[3]

However, such bold statements appear somewhat premature. To paraphrase Mark Twain, reports of the existence of an internal market have been greatly exaggerated, at least insofar as VAT is concerned. In fact, the figures for approved legislation mask a much more complex reality: in order to get Council approval for some of these proposals, the Commission actually had to make substantial concessions, sometimes to the extent that the very essence of their initial proposal had to be radically changed. This has particularly been the case regarding VAT.

One of the main arguments presented as evidence of the establishment of the internal market was the abolition of border controls, which included fiscal controls. A fundamental aspect of the abolition of these controls was the substitution of the VAT arrangements previously applicable to intra-Community transactions. The system initially envisaged by the Commission as a substitute for border VAT controls was fundamentally described as a system whereby tax would be charged in the Member State of origin, with consequent abolition of remittance of tax on inter-Member State

---

[1] See for example papers presented at the European Tax Law Professors Annual Conference on *Fundamental Freedoms and National Tax Sovereignty in EU*, Paris, June 2004.

[2] *Completing the Internal Market – White Paper from the Commission to the European Council*, COM(85) 310, 14 June 1985, hereafter "White Paper".

[3] *Reinforcing the effectiveness of the Internal Market*, Working document of the Commission on a Strategic Programme on the Internal Market, Communication to the Council and the European Parliament, COM(93) 256, 2 June 1993, p. 1.

supplies. However, this system, which became known as the VAT definitive system, was regarded by Member States as too ambitious. An alternative system was agreed upon whereby the functions previously performed by border controls were done *a posteriori*, within the Member State where the taxable person was established. This system, which became known as the VAT transitional system, was only supposed to be in place for a short period of four years. Nevertheless, further attempts by the Commission to introduce a definitive VAT system, namely through its 1996 programme,[4] proved unsuccessful. By the late nineties the Commission had decided to abandon, at least temporarily, the aim of introducing a definitive VAT system, and opted for a new strategy, which principally consisted in the improvement of the VAT transitional arrangements.

Thirteen years since the entry into force of the transitional system there are no expectations for the approval of a VAT definitive system. Meantime, the Community has been faced with new challenges, such as the EMU, enlargement, and, particularly, the Lisbon Strategy, which all test the effectiveness of the VAT system on several fronts. In this context, it would appear timely to assess whether the current EU VAT legal system fulfils, or has the potential to fulfil through jurisprudential developments, the conditions of an internal market. This thesis argues that it does not meet such conditions on the basis of historical, practical and jurisprudential analysis. Historical analysis will demonstrate that the current EU VAT system has failed to reach the minimum level of harmonisation traditionally regarded as a pre-requisite for the establishment of the internal market. From a practical perspective, this thesis highlights that the current system gives rise to serious difficulties, which qualify as obstacles not merely to the functioning of the internal market, but to its very establishment. Finally, through analysis of existing EU VAT jurisprudence, it is argued that these obstacles cannot be overcome through incremental developments emerging from the Court of Justice but can only be resolved through fundamental and substantive legislative amendment.

The structure of this thesis essentially reflects this tripartite division of legal argument. However, the presentation of these arguments will be preceded by analysis of the concept of internal market, the main objective of which is to establish the basic legal framework for this thesis. This will be undertaken in Chapter 1, which highlights the bipartisan definition of internal market in the EC Treaty: an area without internal frontiers; where the free movement of factors of production is ensured. The chapter also examines the inextricable linkage of this definition to the White Paper programme. It will be demonstrated that the EC Treaty creates a temporally unlimited obligation for the Community to approve legislation with the aim of establishing and improving the functioning of the internal market. Moreover, this obligation also includes both the elimination of obstacles to free movement and existing distortions of competition. The Court of Justice jurisprudence will be examined in order to

[4] *A common system of VAT – A programme for the Single Market*, COM(96) 328 final, 22 July 1996.

demonstrate that Article 14 EC Treaty does not give rise to legal effects, in particular direct effect. Finally, it will be shown that the exercise of the Community's internal market competence is subject to the principle of subsidiarity, and therefore the level of Community intervention required will depend on the relevant subject matter. As regards VAT, however, a high level of intervention is required, which can be characterised as following a mitigated centralised model of economic constitution.

Chapter 2 deals with the historical argument, highlighting how VAT has played a fundamental role in the European integration process from the outset, initially as an integral part of the common market policy, and later as an essential element of the internal market policy. Furthermore, ensuring fiscal neutrality, eliminating distortions to competition and abolishing the imposition of tax on importation and the remission of tax on exportation in intra-Community trade, have all been principal aims of the common system of VAT, since its introduction by the First VAT Directive in 1967. A detailed analysis of the VAT legislative proposals presented by the Commission in 1987 as part of the internal market project, as well as of the negotiations which ultimately led to the approval of the VAT transitional system, will also be undertaken. Finally, a review of the Commission's failed attempts to introduce a definitive VAT system and its ultimate decision to adopt a new strategy will be performed.

Chapter 3 will focus on the practical difficulties arising from the current EU VAT system. A brief overview of the current legal system will be carried out, highlighting its vastness, complexity, and consequent inefficiency. Moreover, in order to better illustrate the difficulties raised by this system, four problematic areas are chosen for more focused analysis: inter-jurisdictional issues; convergence of VAT rates; non-deductible input VAT; and VAT treatment of public sector bodies. These correspond to specific areas of the system, which constitute obstacles, either to the establishment, or to the efficient functioning of the internal market. Although legal analysis has been limited to these four fields, the comparative length of this chapter to those which precede it reflects not only the multitude of difficulties that the EU VAT system currently stimulates, but also the importance of highlighting these difficulties in order to emphasize the incompatibility of the current system with the internal market. Additionally, by reason of the nature of the difficulties which the VAT system creates for traders and tax administrations alike, this Chapter will rely to some extent on data from economic analysis as well as micro-economy concepts, such as efficiency.[5]

Finally, Chapter 4 concentrates on the jurisprudential argument, demonstrating that the difficulties caused by the current EU VAT system have given rise to an extensive body of case-law emerging from the Court of Justice. Maintaining the same four areas of the system analysed in Chapter 3 as a starting point, this chapter shows how despite extensive case-law, the Court has been unable to resolve the intrinsic problems of the VAT legal system. The effectiveness of the interpretative methods

[5] Defined as "the science of rational choice in a world", see R.A. Posner, *Economic Analysis of Law*, 4th Edition, Little, Brown & Co., p. 3.

used by the Court of Justice in VAT cases, in particular teleological interpretation and recourse to principle-based decisions, will be assessed. This will lead to the eventual conclusion that these methods are demonstrative of both the difficulties faced by the Court and the limits of jurisprudential solutions. Reflecting the extensive body of case-law emerging from the Court of Justice, this chapter, like its predecessor, is comparatively longer than the first two chapters.

The outcome of the legal analysis undertaken in the four above-described chapters is summarised in the Conclusion.

One final point regarding the legislative and jurisprudential information considered in this thesis must also be emphasised. The area of EU VAT is in constant mutation, with developments, either legislative or, more frequently, jurisprudential, occurring on a weekly basis. In this context it became unavoidable to establish a point from which new developments could no longer be included within this thesis. Therefore, the information included is current up to 1st December 2005.

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# CHAPTER 1

# THE INTERNAL MARKET CONCEPT

## 1) ARTICLE 14 EC TREATY

The central provision, in terms of the internal market policy, is currently Article 14 EC Treaty,[6] which reads:

> "1. The Community shall adopt measures with the aim of progressively establishing the internal market over a period expiring on 31 December 1992, in accordance with the provisions of this Article and of Articles 15, 26, 47(2), 49, 80, 93 and 95 and without prejudice to the other provisions of this Treaty.
>
> 2. The internal market shall comprise an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of the Treaty.
>
> 3. The Council, acting by qualified majority on a proposal from the Commission, shall determine the guidelines and conditions necessary to ensure balanced progress in all the sectors concerned."

This provision contains three basic rules, as follows:

— definitional rule: paragraph two sets out the legal definition of internal market;

— competence rule: paragraph one establishes that the Community has the competence to adopt measures in order to establish the internal market, *i.e.*, the Community's legislative competence in this area; and

— procedural rule: paragraph three establishes the Council's obligation to determine the guidelines and conditions to ensure a balanced progress in establishing an internal market.[7]

Although the third rule – the procedural rule – is of less importance,[8] the two others are fundamental to comprehension of the internal market policy.

## 2) LEGAL DEFINITION

---

[6] The numbering of these has been altered on two occasions: prior to the entry into force of the TEU (OJ C 191, 29/07/1992), it was Article 8a EEC Treaty, as amended by the SEA; post TEU it was Article 7a(2) EC Treaty, until the passage of the Treaty of Amsterdam, which altered the provision's numbering to the current Article 14(2) EC Treaty, OJ C 340, 10/11/1997.

[7] As discussed below, Article III-130 of the new European Constitution includes similar rules, albeit some important differences, in particular as regards the reference to a time limit.

[8] In fact, it emerged during negotiations for the new European Constitution, that this rule had never been used. It was therefore suggested by the working party of experts nominated with a view to making technical adjustments to the EC Treaty, that the paragraph should be deleted, see European Convention, *Part Two of the Constitution – Report by the working party of experts nominated by the Legal Services of the European Parliament, the Council and the Commission*, CONV 618/03, 17 March 2003, p. 15. The recommendation was not, however, taken up and the paragraph was kept in the TCE.

Internal Market is defined in paragraph two of Article 14 EC Treaty as "an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of this Treaty". This definition has remained unchanged since its introduction in the EEC Treaty by the SEA, and this will continue to be the case under the new Constitution.[9] Yet, despite this definitional coherence, and as the Commission has implicitly acknowledged, its interpretation is far from clear.[10]

The definition has dual components, as follows:

— an area without internal frontiers;

— in which the free movement of goods, persons, services and capital is ensured.[11]

### a) AN AREA WITHOUT INTERNAL FRONTIERS

The expression "an area without internal frontiers" has been the subject of intense controversy: severely criticised by some,[12] and regarded as the "key part of the definition" by others.[13] Its origins seem to be rooted in the Commission's White Paper Programme, which revolved around the idea of "abolition of frontiers", divided into physical, technical or fiscal frontiers. The IGC discussions confirm this assumption to the extent that the expression was included in the SEA on the basis of Commission's proposals.[14] It has been suggested that the expression was put forward by the Commission in order to include within the scope of the internal market other aspects, which might not be covered by the Treaty provisions relating to free movement, in

---

[9] Several amendments were suggested during the discussions held by the European Convention, most of which maintained the essence of the definition but added other elements to it, such as reference to approximation of laws and free competition – see for example, the suggestions put forward by an independent group of lawyers at Cambridge University, so-called "Cambridge Text", released as European Convention, *Contribution by Mr. P. Hain, member of the Convention – Constitutional Treaty of the European union*, CONV 345/1/02, 16 October 2002; the suggestions of a Franco-German research working group, known as "Freiburg Draft", released as European Convention, *Contribution submitted by Mr. Erwin Teufel, member of the Convention: "Freiburg Draft of a European Constitutional Treaty"*, CONV 495/03, 20 January 2003; and the contribution of Mr. Elmar Brok, member of the European Convention, released as European Convention, *Contribution by Mr. Elmar Brok, member of the Convention: "The Constitution of the European Union"*, CONV 325/2/02, 7 March 2003. Ultimately, however, Article III-130(2) TCE only includes a minor change to the current text: the substitution of expression "this Treaty" by "the Constitution".

[10] See A.A.M. Schrauwen, *Marche Interieur – Recherches sur une notion*, Doctorate Thesis, University of Amsterdam, 1997, p. 138. Equally, G. de Burca comments that "internal market" is one example of "terms which are highly significant within the EU legal and political context, but which remain nonetheless or even deliberately uncertain in scope and meaning", in *Reappraising Subsidiarity's Significance After Amsterdam*, Harvard Jean Monnet Working Paper 7/99, p. 9.

[11] Some add a third part to this formulation: "in accordance with the provisions of the Treaty", see A.A.M. Schrauwen, *op. cit.*, pp. 144-145. However, even if regarded as a separate part of the definition, this sentence is of considerably less importance, as accepted by Schrauwen herself.

[12] See P. Pescatore, who comments "what does Article 8A mean when it speaks of 'an area without internal frontiers'? What are frontiers in this context?", in "Some critical remarks on the 'Single European Act", (1987) *CMLRev.* 24, p. 16.

[13] See C.D. Ehlermann, "The Internal Market following the Single European Act", (1987) *CMLRev.* 24, p. 364.

[14] However, the formula suggested by the Commission was slightly different: it referred to "an area without internal frontiers ... under conditions identical to those obtaining within a Member State", see C.D. Ehlermann, *ibid*, Annex III, p. 408. The final sentence was ultimately omitted and substituted by "in accordance with the provisions of this Treaty".

particular as regards free movement of persons.[15] This would seem to indicate that the scope of "an area without internal frontiers" is broader than that of free movement. If this was in fact the Commission's intention, the tactic might have worked slightly too well: the expression is potentially so broad that some commentators, and the Court alike, have tended to concentrate on the other aspect of the definition of internal market: the so-called four freedoms.[16] This approach, however, is not universally accepted amongst commentators, with some arguing to the contrary: that free movement is a broader concept than "an area without internal frontiers" and that even where internal borders have been abolished free movement might still not have been attained.[17] For these authors the attainment of an area without internal frontiers can be judged by whether any border controls still exist on the free movement.

Regardless of the controversy, and even if one accepts the narrower approach to the interpretation of the expression "an area without internal frontiers", *i.e.*, that it entails only the abolition of border controls, it seems clear than in some areas, such as VAT, this aim has not (yet) been attained. In fact, as will be demonstrated in Chapter 3, insofar as VAT is concerned there are still border controls, albeit taking a different format from those applicable before 1993.

### b) FREE MOVEMENT OF GOODS, PERSONS, SERVICES AND CAPITAL

The separate reference to the four freedoms in Article 14 has also been the target of criticisms.[18] Once again, as with the expression "an area without internal frontiers", the main difficulty seems to be the lack of precision, *i.e.*, when can it be said that goods, persons, services and capital move freely within the Community? There are two possible answers to this question, which reflect two different criteria, as follows:

— narrower (and perhaps easier) criterion, according to which free movement will be attained once the White Paper programme has been accomplished; and,

— wider criterion, according to which in order for free movement to be attained several other measures have to be put in place in addition to those contained in the White Paper.[19]

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[15] See C.D. Ehlermann, *ibid*, p. 366.

[16] See A.A.M. Schrauwen, who comments "les horizons de l'espace sans frontiers etant larges, ses limites devront venir des autres carateristiques essentielles", *op. cit.*, p. 142.

[17] See P. Craig and G. de Burca, *EU Law – Text, Cases and Materials*, Oxford University Press, Third Edition, 2003, p. 1180.

[18] P. VerLoren van Themaat, former Advocate-General at the Court of Justice, comments that the separate reference to the free movement, without mention of fair competition and unity of market, constitutes an "artificial separation", which cannot but create "practical, political and legal problems", in "The Contributions to the Establishment of the Internal Market by the Case-Law of the Court of Justice of the European Communities", in R. Bieber et al (eds.), *1992: One European Market? A Critical Analysis of the Commission's Internal Market Strategy*, Nomos Verlagsgesellshaft, Baden-Baden, 1988, p. 115. Also P. Pescatore points out that in his opinion the reference to free movement is merely informative and does not merit the qualification as legal definition, see A.A.M. Schrauwen, *op. cit.*, pp. 142-143.

[19] There is of course a third possible answer, which reflects an even narrower criterion, that is that free movement can be achieved without the implementation of the measures set out in the White Paper. This, however, does not seem to be a credible criterion in light of the history of SEA, the IGC negotiations and the link between the SEA and the White Paper.

There is an undeniable link between the White Paper programme and achieving free movement. In fact, it has been said that "the 1992 programme and the SEA are inseparable from one another".[20] Moreover, this connection is confirmed by Declaration 3 annexed to the SEA, entitled "Declaration on Article 8a EEC Treaty", which states:

> "The conference wishes by means of the provisions in Article 8a to express its firm political will to take before 1 January 1993 the decisions necessary to complete the internal market in those provisions, and more particularly the decisions necessary to implement the Commission's programme described in the White Paper on the Internal Market".[21]

Relying on this connection some authors have defended that "if the White Paper's strategies are applied correctly and with dexterity, there is a real chance of achieving the free movement of goods, persons, services and capital".[22] Others however have argued that the White Paper programme is "the tip of an iceberg" and several others measures would need to be taken before free movement was achieved.[23]

The continued reference to the "internal market policy" post-1992 in Community official documentation seems to confirm this wider approach. However – and in parallel with what has been said as regards "an area without internal frontiers" – even if the narrower approach was to be adopted, *i.e.*, that free movement would be attained once the White Paper programme was fully implemented, then the conclusion would have to be, that insofar as VAT is concerned, free movement has not been attained. In fact, as will be demonstrated in Chapter 2, the measures set out in the White Paper in respect of VAT have yet to be implemented. Moreover, if the wider, more dynamic - and most probably correct - approach to the meaning of free movement is adopted, it is clear that the current VAT system does not fulfil the criterion, as will be demonstrated in Chapter 3 through the analysis of the practical problems caused by this system.

## 3) COMMUNITY INTERNAL MARKET COMPETENCE

The Community's competence as regards the Internal Market can be immediately inferred from Article 3(1)(c) EC Treaty, which reads:

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[20] See D. Allen, "European union, the Single European Act and the 1992 programme", in D. Swann (ed.), *The single European market and beyond – A study of the wider implications of the Single European Act*, Routledge, London, 1992, p. 50.
[21] OJ L 169, 26/06/1987, p. 24.
[22] See S.H. von Sydow, "The Basic Strategies of the Commission's White Paper", in R. Bieber *et al* (eds.), *1992: One European Market? A Critical Analysis of the Commission's Internal Market Strategy*, Nomos Verlagsgesellshaft, Baden-Baden, 1988, p. 106.
[23] See P. Craig, "The Evolution of the Single Market", in C. Barnard and J. Scott (eds.), *The Law of the Single European Market – Unpacking the Premises*, Hart Publishing, Oxford and Portland, Oregon, 2002, p. 15.

"1. For the purposes set out in Article 2, the activities of the Community shall include, as provided in this Treaty and in accordance with the timetable set out therein:

(...)

(c) an internal market characterised by the abolition, as between Member States, of obstacles to the free movement of goods, persons, services and capital;"[24]

However, the details and scope of this competence are only set out in Article 14(1) EC Treaty.

### a) SCOPE OF INTERNAL MARKET COMPETENCE

Article 14(1) has a dual formulation: on one hand it sets out what can be called the substantive scope of the Community's internal market competence, *i.e.*, the competence to adopt measures in matters falling under the internal market banner; on the other, it seems to establish a temporal scope, a time period during which the Community will hold that competence. It is not clear from the wording of the provision what should be the consequences of the expiration of that time limit, both in terms of the Community's competence, and as regards the legal effect of the provision. This matter will be discussed *infra*. However, a prior analysis of the substantive scope of the Community's competence should be undertaken.

#### i) SUBSTANTIVE SCOPE

Article 14(1) states that the Community has competence "to adopt measures with the aim of progressively establishing the Internal Market". This competence should be exercised "in accordance with the provisions of this Article and of Articles 15, 26, 47(2), 49, 80, 93 and 95". However, the exact nature of the connection between "the provisions of this Article" and the other listed Articles is not clear from the wording of the provision.[25] One possible interpretation is that the Community has a specific competence within the fields covered by those individual provisions, which should be exercised in accordance with the legislative procedure set out therein; and a residual competence included in Article 14, which covers other measures necessary for the establishment or functioning of the Internal Market, but that are not covered

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[24] The expression "an internal market characterised by", and the reference to "goods" were only included in this provision by the TEU. Prior to that Treaty, Article 3(1)(c) EEC Treaty only made reference to "the abolition, as between Member States, of obstacles to freedom of movement for persons, services and capital".

[25] Article 26 sets out the legislative procedure in relation to the Common Customs Tariff; Article 47(2) relates to the freedom of establishment and exercise of activities as self-employed persons; Article 49 establishes the legislative procedure as regards the freedom to provide services; Article 80 sets out the procedure as regards measures relating to transport; Article 93 establishes the legislative procedure as regards the harmonisation of indirect taxation; and Article 95 (former Article 100a) sets out the general legislative procedure for measures which have as their object the establishment and functioning of the internal market. As opposed to these provisions, Article 15 (former Article 8c) does not set out the legislative procedure applicable to a specific field, rather it establishes a general recommendation for the Commission to "take into account the extent of the effort that certain economies showing differences in development will have to sustain during the period of establishment of the internal market".

specifically by any of the individually referred Articles. Another possible explanation, however, is that the wording of Article 14(1) only emphasises the inter-connection between Article 14 itself and those individual provisions: these provisions would be a mere reflection of the general competence established in Article 14(1), and therefore should be interpreted in light not only of that general competence principle, but also of the legal definition of internal market set out in paragraph 2 of that Article.

Three factors militate in favour of this last approach. Firstly, Article 14 does not itself establish any legislative procedure, therefore posing the question: can legislative measures be based exclusively on Article 14, *i.e.*, if this Article could constitute the sole legal basis for a legislative measure, which legislative procedure should be applied? Secondly, with the exception of the issues highlighted in Article 95(2), all other issues relating to the establishment and functioning of the internal market are potentially covered by Article 95(1) EC Treaty. For those areas covered by Article 95(2), Article 94 can clearly be used as the legal basis (or any other more specific provision in the Treaty, should one exist). In practice, therefore, Articles 94 and 95, are themselves residual provisions, establishing fall-back legislative procedures for internal market related measures, and, consequently there is no need to regard Article 14 as constituting a residual competence rule. Thirdly, and perhaps most importantly, the Court of Justice has itself emphasised the role of Articles 14 and 3(1)(c) as ancillary to the interpretation of the individual Treaty provisions, in particular Article 95. In fact, in the famous *Tobacco Advertising* case, the Court stated:

> "Under Article 3(1)(c) of the EC Treaty, the internal market is characterised by the abolition, as between Member States, of all obstacles to the free movement of goods, persons, services and capital. Article 14 of the EC Treaty, which provides for the measures to be taken with a view to establishing the internal market, states in paragraph 2 that that market is to comprise an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of the Treaty.
>
> Those provisions, read together, make it clear that the measures referred to in Article 100a(1) of the Treaty are intended to improve the conditions of the establishment and functioning of the internal market."[26]

The inter-connection between these provisions as set out by the Court in *Tobacco Advertising* also highlights the limits to the exercise of the Community's competence as regards the internal market.

### (1) LIMITS TO COMMUNITY'S INTERNAL MARKET COMPETENCE

#### (a) PRINCIPLE OF CONFERRAL OF POWERS

In the main, the Community's competence is limited by the principle of conferral of powers, according to which Community institutions can only act within the powers

[26] Case C-376/98, *Germany v Parliament and Council*, [2000] ECR I-8419, paragraphs 82 and 83.

conferred to them by the Treaty.[27] The principle, set out in the first paragraph of Article 5 EC Treaty, applies to all areas of Community action, but has assumed particular relevance as regards the Community's internal market competence. This stems from the fact that several provisions of the Treaty, such as Articles 93 and 95(1), only confer legislative competence upon the Community, insofar as the measures to be adopted are necessary to ensure "the establishment and the functioning of the internal market". The Community's legislative competence is therefore, to a great extent, dependent and limited by the concept of internal market.[28]

This issue assumed particular relevance after the Court's judgment in *Titanium Dioxide*.[29] The case concerned the adoption in June 1989 of Council Directive 89/428/EEC on the harmonisation of programmes for the reduction and elimination of pollution caused by waste from the titanium dioxide industry.[30] The Commission, taking the view that the measure was necessary for the establishment and functioning of the internal market, had presented the proposal for a Directive on the basis of Article 95. However, despite the objections of the European Parliament, which considered the legal basis proposed by the Commission to be appropriate, the Council believed that the measure concerned the Community's environment policy, and therefore adopted the directive on the basis of Article 175 (formerly Article 130s). In this context, the Commission decided to bring an action before the Court for the annulment of Council Directive 89/428/EEC on the grounds that it lacked a valid legal basis. The Commission's main argument was that the directive, although contributing to environmental protection, had as its "main purposes" or "centre of gravity" the improvement of conditions of competition in the titanium dioxide industry, and was therefore a measure concerning the establishment and functioning of the internal market, within the meaning of Article 95(1). The Council however argued that the "centre of gravity" of the measure was the elimination of pollution caused by waste from the titanium dioxide.

The case raised two main questions for the Court to decide, as follows:

— Is the pursuit of improvement of conditions of competition part of the main aim of ensuring the establishment and proper functioning of the internal market?

— If the answer to the first question is affirmative, then what were the "main purposes" or "centre of gravity" of the directive?[31]

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[27] This principle, also known as the "principal of no inherent powers", or the "principle of limited powers", is clearly set out in Article I-11(1) and (2) TCE.

[28] In *Tobacco Advertising* and *Imperial Tobacco* (case C-74/99, [2001] ECR I-8599), Advocate-General Fennelly defended that "the scope of Community competence is defined by reference to a criterion of a *functional* nature, extending laterally to all measures designed to ensure the attainment of the single market", see Opinion of the Advocate-General, paragraph 62. The Advocate-General was referring to Article 95, but the same rationale should apply as regards other provisions, such as Article 93.

[29] Case C-300/89, *Commission v Council*, [1991] ECR I-2867.

[30] OJ L 201, 14/07/1989, p. 56.

[31] The so-called "centre of gravity" doctrine seems to be the standing method used by the Council for choice of legal basis, see R. Barents, "The Internal Market Unlimited: Some

As regards the first question the Court stated that "in order to give effect to the fundamental freedoms in Article 8a [Article 14], harmonising measures are necessary to deal with disparities between the laws of the Member States in areas where such disparities are liable to create or maintain distorted conditions of competition".[32] Having replied affirmatively to the first question, the Court went on to analyse the second aspect, concluding that "the directive at issue displays the features both of action relating to the environment, with which Article 130s [Article 175] of the Treaty is concerned, and of a harmonising measure which has as its object the establishment and functioning of the internal market, within the meaning of Article 100a [Article 95] of the Treaty".[33] The difficulty however lay in the fact that Articles 95 and 175 set out different legislative procedures, and therefore a choice had to be made between one of the two provisions. Ultimately, the Court concluded in favour of Article 95, invoking three inter-connected arguments as the basis for its choice:

— Firstly, the reference in Article 174(2) [former Article 130r(2)] to the fact that "environmental protection requirements shall be a component of other Community policies", indicates that a Community measure cannot be covered by Article 175 merely because it also pursues objectives of environmental protection.

— Secondly, this interpretation is confirmed by Article 95(3), which requires the Commission in its proposals to take into consideration the impact of the proposal in terms of environmental protection; therefore, this provision implicitly accepts that the objectives of environmental protection referred to in Article 174 may be pursued by means of harmonising measures adopted on the basis of Article 95.

— Thirdly, and consequently, environmental measures which are aimed at eliminating distortions of competitions fall within the scope of Article 95.

The Court's ruling in *Titanium Dioxide*, and in particular the adoption of such a wide interpretation of the concept of internal market, gave rise to intense controversy. It was said at the time that it endangered the rule of law[34] and that it constituted a clear sign of the decline of the principal of conferral[35]. The Court's ruling in *Waste Directive* appears to narrow down the scope of the internal market competence;[36] however, it

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Observations on the Legal Basis of Community Legislation", (1993) *CMLRev.* 30, pp. 100-101. The doctrine results largely from the Court's established jurisprudence that "the choice of legal basis for a measure may not depend simply on an institution's conviction as to the objective pursued but must be based on objective factors which are amenable to judicial review", see case 45/86, *Tariff Preferences*, [1987] ECR 1493, paragraph 11. In *Titanium Dioxide*, and subsequently in other cases, such as *Waste Directive*, the Court has stated that "these factors include in particular the aim and content of the measure", see *Titanium Dioxide*, paragraph 10, and case C-155/91, *Waste Directive*, [1993] ECR I-2869, paragraph 7.

[32] Paragraph 15 of judgment.

[33] Paragraph 16 of judgment.

[34] See S. Crosby, "The Single Market and the Rule of Law", (1991) *ELRev.* 16, pp. 451-465.

[35] See R. Barents, *op. cit.* Although the author's comments seem to come as praise, rather than criticisms, for the Court's ruling.

[36] The Court ruled in this case that "the mere fact that the establishment or functioning of the internal market is affected is not sufficient for Article 100a of the Treaty to apply. It appears from the Court's case-law that recourse to Article 100a is not justified where the measure to be adopted has only the incidental effect of harmonising market conditions within the Community", see paragraph 19 of the judgment.

was not until a few years later, in *Tobacco Advertising*, that the Court seem to put these fears definitively to rest by firmly establishing the boundaries of the internal market concept.

The case concerned Directive 98/43/EC, which essentially banned the sponsorship and advertising of tobacco products within the Community.[37] The Directive had been adopted on the basis of Articles 47, 55 and 95 EC Treaty[38], as according to the European Parliament and the Council, it constituted an internal market measure; however, Germany, which had voted against the Directive, disagreed, and decided to bring an action before the Court for its annulment on the grounds of lack of Community competence.[39] It argued that the Directive did not contribute to the improvement of the internal market, and that instead its main focus was on protecting public health. Central to the case, therefore, was the Community's internal market competence.

The Court, following the Opinion of Advocate-General Fennelly, ruled that measures referred to in Article 95 must be intended to improve the conditions for the establishment and functioning of the internal market and that the Article did not vest in the Community the general power to regulate the internal market.[40] Implicit in the judgment therefore is the distinction between:

— Measures intended to improve conditions for the establishment and functioning of the internal market; and,

— Measures intended to regulate the internal market.

The Community's competence under Article 95 is limited to the first aspect.[41] Moreover, according to the Court "the mere finding of disparities between national rules and of abstract risk of obstacles to the exercise of fundamental freedoms or of distortion of competition" was not sufficient to justify the choice of Article 95 as a legal basis.[42] On the specific aspect of distortion of competition, the Court limited the interpretation adopted in *Titanium Dioxide* by ruling that only where the distortion is "appreciable" can a measure be adopted on the basis of Article 95 as "in the absence of such a requirement, the powers of the Community legislature would be practically unlimited".[43]

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[37] Directive 98/43/EC of the European Parliament and of the Council of 6 July 1998, OJ L 213, 30/07/1998, p. 9.

[38] Former Articles 57, regarding freedom of establishment, 66, on the free movement of services, and 100a, respectively.

[39] Although Germany had put forward several arguments defending the invalidity of the Directive, including the violation of the principle of subsidiarity, undoubtedly the most important issue in the proceedings was the choice of legal basis.

[40] Paragraphs 83 of the judgment and the Advocate-General's Opinion.

[41] The same rationale applies *mutatis mutandis* to Article 93, and equally to all other Treaty provisions, which refers to adoption of measures with a view to "the establishment and functioning of the internal market".

[42] Paragraph 84 of the judgment.

[43] Paragraphs 106 and 107 of the judgment. See also paragraphs 89 and 90 of the Advocate-General's Opinion.

Advocate-General Fennelly suggests in his Opinion that in order to determine whether a Community measure pursues internal market objectives, the following two-part test has to be fulfilled:

— First, it must be ascertained whether the "preconditions for harmonisation exist", *i.e.*, disparate national rules which either constitute barriers to the exercise of the four freedoms or distort conditions of competition in an economic sector;

— Second, the action taken by the Community must either intend to eliminate those barriers or intend to eliminate the distortions of competition.[44]

Although not explicitly referring to it the Court essentially follows this test, with some important qualifications, namely to the first requirement: the existing obstacles to the four freedoms must be *concrete* and existing distortions of competition must be both concrete and *appreciable*.

Ultimately, and in light of the above, the Court annulled the Directive on the grounds of lack of competence.[45] The ruling has been hailed as one of the most important ever delivered by the Court on Community legislative competence, and one which "reverses a long trend towards the expansive interpretation of the legislative competence of the Community".[46]

### (b) PRINCIPLE OF SUBSIDIARITY

The question of whether the Community's internal market competence is limited by the principle of subsidiarity has been the subject of intense controversy in recent times. The principle is established in Article 5 EC Treaty, paragraph two,[47] which reads:

> "In areas which do not fall within its exclusive competence, the Community shall take action, in accordance with the principle of subsidiarity, only if and insofar as the objectives of the proposed action cannot be sufficiently achieved by the Member States and can therefore by reason of the scale or effects of the proposed action, be better achieved by the Community."[48]

It is clear from the wording of the provision that the principle only applies to areas which do not fall within the exclusive competence of the Community.[49] What is more difficulty, however, is to determine which areas fall within this category.[50] The Commission has taken a broad view of "exclusive competence", arguing that an area

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[44] Advocate-General's Opinion, paragraph 93.

[45] As S. Douglas-Scott comments, the first case in which the Court did so, "thus presenting itself as the first full application of the principle of limited powers by the Court", in *Constitutional Law of the European Union*, Longman, First Edition, 2002, p. 168.

[46] In G. Tridimas and T. Tridimas, "The European Court of Justice and the Annulment of the Tobacco Advertising Directive: Friend of National Sovereignty or Foe of Public Health?", in (2002) *European Journal of Law and Economics*, Vol. 14, No. 2, p. 179. See also P. Craig, *op. cit.*, pp. 32-33.

[47] Further guidelines can be found on the *Protocol on the application of the principles of subsidiarity and proportionality* attached to the Treaties.

[48] The TCE includes a similar provision, Article I-11(3).

[49] This has been criticised by G. de Burca, see *op. cit.*, p. 23.

[50] See comments of A. G. Toth in "A Legal Analysis of Subsidiarity", in D. O'Keeffe and P. Twomey (eds.), *Legal Issues of the Maastricht Treaty*, London, Chancery Law Publishing, 1994, Chapter 3, p. 39.

falls within the exclusive competence of the Community if the Treaties impose an obligation to act on the Community, as in these cases it is regarded as having sole responsibility for the performance of that particular task.[51] Equally, the Court seems to have implicitly adopted a wide approach to the concept of Community's exclusive competence in some of its early judgments (prior to the introduction of the subsidiarity provision in the EC Treaty).[52] Some authors, however, have suggested a much more strict approach, indicating that the number of areas falling within the realm of Community's exclusive competence is limited.[53]

Specifically as regards the internal market, there seems to be no conclusive argument as to whether it should be regarded as an exclusive, or a shared competence. The Commission has included the removal of barriers to the free movement of goods, services, capital and persons in the list of areas, which according to it should be regarded as exclusive competence of the Community.[54] In practice, this would mean that the internal market competence would be to a great extent regarded as exclusive Community competence. This position has gathered some support amongst the Court's Advocates-General: in *Deposit Guarantees* Advocate-General Leger considered that the Community's competence under Article 47, as regards freedom of establishment, as an exclusive competence;[55] and in *Tobacco Advertising* and *Imperial Tobacco*, Advocate-General Fennelly expressly rejected the application of the principle of subsidiarity as regards the Community's internal market competence.[56] The Court refrained from taking a definitive position in both cases, but more recently in *Tobacco Labelling* seems to have taken the opposite view. The Court noted in this case that,

> "The principle of subsidiarity applies where the Community legislature makes use of Article 95, inasmuch as that provision does not give it exclusive competence to regulate economic activity on the internal market, but only a certain competence for the purpose of improving the conditions for its establishment and functioning,

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[51] *The Principle of Subsidiarity*, SEC(92) 1990, 27 October 1992.

[52] In *ERTA* for example, the Court stated that the existence of Community powers "excludes the possibility of concurrent powers on the part of the Member States", see case 22/70, [1971] ECR 263, paragraph 31. A strict application of this approach to the interpretation of paragraph two of Article 5 has as a result, as A.G. Toth comments, that the principle of subsidiarity as defined in Article 5 "could not apply to any matter covered by the original EEC Treaty", *op. cit.*, p. 40.

[53] J. Steiner concludes that "the only areas in which the Community has exclusive competence for the purposes of Article 3b [current Article 5] are those in which *it has already legislated*", in "Subsidiarity under the Maastricht Treaty", in D. O'Keeffe and P. Twomey (eds.), *Legal Issues of the Maastricht Treaty*, London, Chancery Law Publishing, 1994, Chapter 4, p. 58. See also F. de Quadros, *O Principio da Subsidiariedade no Direito Comunitario apos o Tratado da Uniao Europeia*, Lisboa, Almedina, 1998, p. 38.

[54] Although this position has been criticised by G. de Burca, see *op. cit.*, p. 22, it has gathered the support of N. Emiliou and N. Reich, see "Subsidiarity: Panacea or Fig Leaf?", in D. O'Keeffe and P. Twomey (eds.), *Legal Issues of the Maastricht Treaty*, London, Chancery Law Publishing, 1994, Chapter 5, p. 75; and "Competition between Legal Orders: A New Paradigm of EC Law?", (1992) *CMLRev.* 29, p. 895, respectively.

[55] Case C-233/94, *Germany v European Parliament and Council*, [1997] ECR I-2405, paragraphs 82 to 86.

[56] The Advocate-General concluded in these cases that "the exercise of Community competence under Articles 57(2) and 100A of the Treaty is exclusive in character and that the principle of subsidiarity is not applicable", paragraph 142 of the Opinion.

by eliminating barriers to the free movement of goods and the freedom to provide services or by removing distortions of competition."[57]

Recent events seem to confirm the view that the Community's internal market competence is a shared competence, and therefore subject to the principle of subsidiarity. First, the new TCE expressly lists internal market as one of the areas of shared competence between the Union and the Member States.[58] Secondly, and specifically as regards VAT measures, the Commission's most recent proposals make express reference to respect for the principle of subsidiarity.[59] Moreover, some of the most recent VAT directives also make reference to subsidiarity in the preamble.[60] There is therefore an implicit admission that VAT is a shared competence, and consequently subject to the principle of subsidiarity.[61]

### ii) TEMPORAL SCOPE

Article 14(1) EC Treaty states that the Community has competence to adopt measures with the aim of progressively establishing the internal market "over a period expiring on 31 December 1992". The reference, not only in Article 14, but also in several other Treaty provisions such as Article 93, to the date 31 December 1992 in connection with the Internal Market policy, has given rise to considerable controversy. Particularly keenly debated is whether the expiration of that deadline will give rise to legal effects; less debated, however, is the distinct issue of whether that date represents a temporal limit to the Community's internal market competence, *i.e.*, whether the Community still has competence to legislate as regards the internal market *post* 31 December 1992.

Although not totally clear, the wording of Article 14(1) seems to indicate that the Community's competence as regards the *establishment* of the internal market is

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[57] Case C-491/01, [2002] ECR I-11453, paragraph 179. Not entirely clear from the Court's ruling, however, is whether as regards measures aimed at "improving the conditions for the establishment and functioning of the internal market" the Community has exclusive competence.

[58] See Article I-14. It is interesting to note that initial drafts paradoxically included the "free movement of persons, goods, services and capital" and "establishment of competition rules within the internal market" as exclusive Community's competences; whilst the internal market was listed as a shared competence, see the following European Convention documents: *Reactions to draft Articles 1 to 16 of the Constitutional Treaty – Analysis*, CONV 574/1/03, REV 1, 26 February 2003, pp. 86 *et seq.*; and *Draft Constitution, Volume I – Revised text of Part One*, CONV 724/03, 26 May 2003, pp. 69 *et seq.* Amid harsh criticisms the references to free movement and competition as exclusive competences were deleted from the final draft, see M. Dougan, "The Competences and Constraints in the Draft Constitutional Treaty", Paper presented at conference on *The Making of a Constitution for Europe*, Irish Centre for European Law Fourth Annual Conference, 24 May 2003, Dublin; *Report of the Selected Committee on the European Union of the House of Lords presented by Lord Tomlinson and Lord Maclennan "Contribution to the work of the Convention"*, CONTRIB 267, CONV 598/03, 6 March 2003, p. 18; and comments included in the above cited European Convention documents.

[59] See for example *Proposal for a Council Directive amending Directive 77/388/EEC with a view to simplifying value added tax obligations*, COM(2004) 728 final, 29 October 2004.

[60] See for example Council Directive 2004/7/EC of 20 January 2004, OJ L 27, 30/01/2004, p. 44.

[61] The fact that VAT measures were subject to the principle of subsidiarity had already been suggested by S. Smith in "'Subsidiarity' and the Co-ordination of Indirect Taxes in the European Community", (1993) *Oxford Review of Economic Policy*, Vol. 9, No. 1, p. 68.

indeed temporally limited to 31 December 1992.[62] Moreover, although no reference to the *functioning* of the internal market is made in that provision, Article 93 appears to indicate that, at least insofar as VAT is concerned, this temporal limitation to Community's competence extends to measures adopted with a view to improve the functioning of the internal market. Practice, however, has cast significant doubts on this reading: in fact, countless legislative measures have been adopted by the Community since 1 January 1993, which fall under the internal market policy,[63] with no questions ever being raised over the validity of these measures on grounds of lack of Community competence.[64] The unavoidable conclusion, therefore, is that the date 31 December 1992 does not constitute a limit to the Community's internal market competence, and that this competence is perceived as temporally unlimited.

This conclusion seems to be confirmed by the fact that the reference to 31 December 1992 in Article 14 was maintained by subsequent Treaties,[65] until the recent TCE.[66] In fact, had there been any questions over the competence of the Community as regards the internal market policy *post* 31 December 1992, Member States would probably have deleted the reference to that date in Article 14 at the first possible occasion:[67] the only reasonable explanation for the fact that they did not seems to be that the change was not perceived as necessary to ensure the Community's competence in the area.

### 4) LEGAL EFFECT

Connected with the reference to a time limit in Article 14 EC Treaty, but distinct from discussion on the temporal scope of the Community's internal market competence, is the issue of the provision's legal effect. The question here is whether, more than

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[62] This seems also to be the view implicitly adopted by H.G. Schermers, who, writing in 1991, considered only two alternative options as regards Community measures falling within the internal market policy post 31 December 1992: if only minor barriers to the internal market remained, the Council could adopt measures to remove those barriers; if impossible to establish the internal market prior to that date, then attempts to postpone the deadline would take place – see "The effect of the date 31 December 1992", (1991) *CMLRev.* 28, pp. 286-288. H.G. Schermers failed to envisage a third alternative, which time proved to be the correct one: where significant barriers to the internal market would still remain, but no attempt to alter the deadline was made.

[63] In the VAT area alone, over twenty-five legislative measures have been adopted, where the legal basis was (partially or totally) Article 93 EC Treaty.

[64] At least not in light of the expiration of the time period set out in Article 14 EC Treaty; as discussed above the validity of legislative measures, which fall under the internal market policy, was indeed questioned but on substantive grounds. This is true even as regards the Tobacco Advertising directive, which was approved in 1998: the validity of this directive was never questioned by the parties in *Tobacco Advertising* on the basis of expiration of Article 14's time limit.

[65] Treaty of Amsterdam, OJ C 340, 10/11/1997, and Treaty of Nice, OJ C 80, 10/03/2001.

[66] The only substantial difference between the wording of current Article 14 EC Treaty and the wording of the new Article III-130 TCE is the elimination of the reference, in this last provision, to a time limit. The elimination of the time limit was suggested by a working party of experts, nominated by the EU institutions with a view to making technical adjustments to the draft Constitution, see *op. cit.*, CONV 618/03, 17 March 2003, p. 14.

[67] The possibility of alteration of time limits included in the Treaty *via* secondary legislation had been rejected by the Court in *Defrenne*, case 43/75, [1976] ECR 455, where it stated that "the Treaty can only be modified by means of the amendment procedure carried out in accordance with Article 236". The case concerned specifically the reference in Article 119 EEC Treaty to the implementation of the principle of equality between men and women "during the first stage", *i.e.*, until 1 January 1961; however, the same reasoning could be applied as regards Article 14 EC Treaty.

conferring competence to the Community as regards the Internal Market, Article 14 imposes an obligation on the Community. If so, then what is the legal effect of such an obligation, *i.e.*, what should be the legal consequences where the internal market has failed to be established during the period set out in that provision?

During the negotiations, which presented the approval of the SEA, the Commission proposed that failure to respect this time limit would have significant legal consequences, *i.e.* Member States would be obliged to "recognise the equivalence of the rules of the other Member States concerning persons, goods, services and capital".[68] The measure was regarded as "radically progressive" and the Commission was forced to abandon its original ideas. In the final text recognition of equivalence as an automatic effect was replaced by a more moderate provision.[69] Moreover, a declaration on Article 8A was added, stating that setting the date of 31 December 1992 does not create an automatic legal effect.

The subject has been the target of intense controversy since then. There is a dual dimension to the source of this controversy: on one hand the wording of Article 14(1), namely the use of the word "shall", suggests the provision has a mandatory nature, *i.e.* that it creates an obligation upon the Commission to act; on the other hand, Declaration 3 annexed to the SEA provides that "setting the date of 31 December 1992 does not create an automatic legal effect". The discussion over the legal effect of Article 14 has largely concentrated on the interaction between these two elements.

At this point it is necessary to distinguish between two types of legal effect, which Article 14 might give rise to:

— legal effect for the Community itself;

— legal effect for Member States.

The first is connected specifically with whether Article 14 creates an obligation on the Community to act, and, if so, whether the failure to act might give rise to proceedings under Article 232 EC Treaty. The second relates to the issue of direct effect, *i.e.* whether an individual might bring an action against a Member State for failure to comply with Article 14 *post* 31 December 1992.

### a) LEGAL EFFECT FOR THE COMMUNITY

The compulsory nature of Article 14 has been denied by some commentators. The basic argument is that Article 14(1) sets out a mere political aim, not capable of creating legal effects; therefore, failure to act within the time limit set out in that

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[68] C.D. Ehlermann reproduces the Commission's three most relevant contributions to the negotiations, as follows: the first Commission working paper, dated 16 September 1985; a commentary on this first working paper, dated 23 September 1985; and the amended working paper, dated 5 October 1985 – see "The Internal Market following the Single European Act", (1987) *CMLRev.* 24, Annexes I, II and III.

[69] See below.

provision would not be capable of being challenged under Article 232 EC Treaty.[70] This has also been the view adopted by several Member States in the famous *Wijsenbeek* case.[71] Both commentators and Member States alike, draw support from the wording of Declaration 3 annexed to the SEA.

Notwithstanding the above, most authors have defended that Article 14 does indeed impose an obligation of the Community to act, denying the binding nature of Declaration 3.[72] This interpretation has been confirmed by Advocate-General Cosmas in *Wijsenbeek*.[73] More controversial, however, is whether this obligatory nature signifies that failure to act can be challenged before the Court under Article 232: some commentators have pointed out that the possibility of using Article 232 in the event of Community institutions' inaction would depend on whether the criteria for such proceedings were met,[74] and this might prove a difficult task;[75] others have contended that failure to establish an internal market by 31 December 1992 could indeed give rise to the application of Article 232's procedure.[76] Unfortunately, the Court has not as yet been called to decide on this issue. In this context, however, VAT could be regarded as the perfect field in which to test the applicability of the procedure. In fact, as will be discussed *infra*,[77] the VAT system envisaged by the White Paper as necessary for the establishment of an internal market has never been approved, despite several Commission proposals to that effect; therefore, the question which naturally emerges is whether the Council's failure to adopt the Commission's proposals in this area should be regarded as a "failure to act" within the meaning of Article 232.[78]

### b) LEGAL EFFECT FOR MEMBER STATES

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[70] See C. Gulmann, "The Single European Act – Some Remarks from a Danish Perspective", (1987) *CMLRev.* 24, p. 36.

[71] Case C-378/97, [1999] ECR I-6207. The Governments of Spain, Netherlands, Ireland and United Kingdom all defended the political nature of Article 14, see Opinion of Advocate-general Cosmas, paragraph 37.

[72] See H.G. Schermers, *op. cit.*, p. 278; P. Craig, *op. cit.*, p. 16; and F. Schockweiler, "Les consequences de l'expiration du delai imparti pour l'etablissement du marche interieur", (1991) *Revue du Marche Commun et de l'Union Europeenne*, No. 353, pp. 884-885. For a detailed analysis of the nature of the Declarations annexed to the SEA, see A.G. Toth, who concludes, "whatever the meaning of this statement [Declaration 3], it is submitted that it itself can have no legal effect", in "The Legal Status of the Declarations Annexed to the Single European Act", (1986) *CMLRev.* 23, p. 812.

[73] According to the Advocate-General "the Article in question [Article 14] has a compulsory content. It created an obligation on the Community to progressively establish an internal market, with a view to creating a 'space without internal frontiers'" (author's translation from the Spanish version of the Advocate-General's Opinion). Moreover, for the Advocate-General, the declarations annexed to the Treaty, and in particular Declaration 3, can only be regarded as a secondary aid to the interpretation of Article 14, see paragraphs 38 and 56.

[74] P. Craig and G. de Burca point out that the existence of wide discretionary powers on the part of the Commission, normally precludes the Court from finding that there was indeed a failure to act, see *op. cit.*, p. 521.

[75] See P. Craig, *op. cit.*, p. 16.

[76] See H.G. Schermers, *op. cit.*, p. 280. A. Arnull *et al* point out that whether Article 232 applied would depend on the fulfilment of the test formulated by the Court in *Transport* (case 13/83, [1985] ECR 1513), see *Wyatt and Dashwood's European Union Law*, Fourth Edition, Sweet & Maxwell, London, 2000, pp. 504-505.

[77] See Chapter 2.

[78] Although, as P. Craig and G. de Burca note: "Article 232 has been held to refer to a failure to act in the sense of a failure to take a decision or to define a position. It does not refer to the adoption of a measure different from that desired by the applicant", *op. cit.*, p. 521.

The debate over the potential direct effect of Article 14 derives primarily from the fact that the expiration of the time limits set out in some Treaty provisions, had in the past, been interpreted by the Court of Justice as signalling the beginning of the direct effect of those provisions.[79] Based on this jurisprudence, some commentators seemed to defend the direct effect of Article 14.[80] The difficulty with this position is that Article 14 must fulfil the general conditions for direct effect, including that the provision does not require any further action. It is manifest that Article 14 does indeed require further positive action.

The first inkling that the Court of Justice would reject the direct effect of Article 14 came in 1993 with *Baglieri*,[81] however, a clear statement did not surface until years later in *Wijsenbeek*. The case concerned Mr. Wijsenbeek's refusal to present his passport at the Rotterdam airport, upon arrival from Strasbourg. Mr. Wijsenbeek argued that the border controls were contrary to Article 14 and that, since the expiry of the deadline on 31 December 1992, this provision had direct effect. The Court, following the opinion of the Advocate-General, rejected this interpretation of Article 14 on the basis that the provision required further action:

> "That Article cannot be interpreted as meaning that, in the absence of measures adopted by the Council before 31 December 1992 requiring the Member States to abolish controls of persons at the internal frontiers of the Community that obligation automatically arises from expiry of that period. [...] such an obligation presupposes harmonisation of the laws of the Member States governing the crossing of the external borders of the Community, immigration, the grant of visas, asylum and the exchange of information on those questions."[82]

The Court's ruling in *Wijsenbeek* seems to have put the matter definitively to rest: [83] Article 14 EC Treaty does not have direct effect.[84] It remains to be seen whether this would also be the case under the new TCE provisions.[85]

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[79] See comments of A.G. Toth, *op. cit.*, p. 812 and A. A. M. Schrauwen, *op. cit.*, p. 156. In fact, the Court of Justice's jurisprudence most probably weighed heavily on Member States' decision to include Declaration 3 in the SEA.

[80] See H.G. Schermers, *op. cit.*, p. 288, although his position on this matter is not totally clear, see p. 278. For the opposite view see C. Gulmann, *op. cit.*, p. 37.

[81] Case C-297/92, [1993] ECR I-5211. The Court held in that case that Article 14 "cannot be interpreted as meaning that, in the absence of measures adopted by the Council by 31 December 1992 requiring the Member States to admit person who have been subject to compulsory insurance in another Member State to voluntary affiliation to their social security schemes, an obligation to that effect arises automatically by reason of the expiry of that deadline", paragraph 16.

[82] Paragraph 40 of the judgment.

[83] The ruling seems to have been implicitly reiterated by the Court in *Echirolles Distribution*, case C-9/99, [2000] ECR I-8207.

[84] This is not to say that the concept of internal market contained in that provision, and in particular the fundamental freedoms, have not had a significant impact on the development of the Court of Justice's jurisprudence, and arguably on the European integration process. In fact, on several occasions the Court has ruled that national provisions should be struck down on the basis that they are contrary to the fundamental freedoms. A good example of an area where this line of argument has been used consistently by the Court is the area of direct taxation, leading I. Roxan to observe in 2000 that the Court's application of the fundamental freedoms in direct taxation cases mirrored direct effect, see "Assuring Real Freedom of Movement in EU Direct Taxation", [2000] *MLR* 63, p. 831.

## 5) EXERCISE OF COMMUNITY INTERNAL MARKET COMPETENCE

Intrinsically connected to discussion on the scope of the Community's internal market competence is the debate on how that competence should be exercised.[86] This debate, which is centred on matters of flexibility, has been implicitly present in all internal market policy initiatives since the publication of the White Paper. The basic question is one of scale: it is clear that a certain level of harmonisation is required in order to establish the internal market;[87] what is less clear, however, is what that level is, *i.e.*, what is the minimum level of harmonisation necessary and what level of flexibility or differentiation should be allowed to Member States.[88]

### a) EUROPEAN ECONOMIC CONSTITUTION MODELS

It has been defended that the institutional choices regarding the allocation of regulatory powers within the Community may be represented in three ideal constitutional models of the European Economic Constitution, as follows:

— centralised constitutional model;

— competitive constitutional model; and

— decentralised constitutional model.

The centralised model favours a process of market regulation by the replacement of national laws with Community legislation. The basic principle behind this model is that Member States' domestic legislation is incompatible with the aim of an integrated market and should therefore be replaced by harmonised Community legislation. The competitive model promotes competition between legal orders, namely through the principle of mutual recognition. The basic idea here is that market forces will work to create an integrated and more efficient market. In the decentralised model, Member States will retain regulatory powers, but are prevented from developing protectionist policies.[89]

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[85] The TCE includes a provision, separate from those dedicated to the internal market policy, regarding fundamental freedoms, Article I-4. The first paragraph of the Article reads: "the free movement of person, services, goods and capital, and freedom of establishment shall be guaranteed within and by the Union, in accordance with the Constitution". It is interesting to note that in an earlier draft of the TCE the provision referred to "directly applicable guarantees", rather than solely "guarantees" – the question which therefore arises is whether something should be read into this alteration, namely whether Member States feared that a reference to "directly applicable guarantees" would be interpreted by the Court as "directly effective", and consequently that the Article I-4 would be regarded as having direct effect.

[86] See in particular the discussion on the limitations imposed by the subsidiarity principle and the shared vs. exclusive competence controversy.

[87] The distinction between harmonisation and other terms such as approximation and co-ordination is unclear, see comments of D. Vignes in "The Harmonisation of National Legislation and the EEC", (1990) *ELRev.* 15, pp. 360-361. Within this research the term harmonisation will be used, as it is the one chosen by the legislator in relation to turnover taxes in Article 93 EC Treaty.

[88] The establishment of the internal market does not necessarily require uniformisation of laws. As P.J. Slot points out, "the objective is the achievement of a common market rather than a single legal system", in "Harmonisation", (1996) *ELRev.* 21, p. 379.

[89] See M. Poiares Maduro, *We, the Court – The European Court of Justice & the European Economic Constitution*, Hart Publishing, Oxford, 1998, pp. 108-149. Although the author is referring primarily to market regulation under Article 30 EC Treaty, the distinction between these

In practice, however, these constitutional models are not applied separately within the Community. Instead there is an interaction between the three in different Community policy areas: within the internal market policy it is clear that, although the presence of the decentralised model is less evident,[90] there is a continuous interplay between the centralised and the competitive models. This interplay is evident in the White Paper and the SEA: on one hand it endorses a new approach to integration based on the principle of mutual recognition; on the other hand a new harmonisation instrument is made available, which would (and has) considerably simplified the harmonisation process, Article 95 EC Treaty.[91] Different commentators reflect this duality, with some emphasising this new approach as a reflection of the Community's move towards the competitive model;[92] whilst others consider that the introduction of a new provision, which will facilitate the harmonisation process, constitutes an implicit endorsement of harmonisation as the prime method of pursuing the internal market policy.[93]

It is equally important to note that the interplay between these two constitutional models is not restricted to mutual recognition vs. harmonisation dichotomy. Flexibility and competition between legal orders can also be reflected in different levels of harmonisation, which will in turn allow for distinct degrees of differentiation.

### b) FLEXIBILITY AND DIFFERENTIATION: DIFFERENT LEVELS OF HARMONISATION

Flexibility and differentiation understood within the legislative context can be observed at two different levels: macro level and micro level.[94] Macro-flexibility can be witnessed in legislation, which either leaves a high degree of discretion to Member States as regards their implementation, as in the case of directives, or establishes general derogations or exceptions.[95] Micro-flexibility takes place where the legislation in question does not provide for general derogations or exceptions, but a specific derogation is allowed to a Member State, or States, from a fairly concrete obligation provided for in the legislation.

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alternative models is useful for other areas of what he refers to as the "European Economic Constitution".

[90] This is mainly because under the decentralised model Member States retain their regulatory powers, whilst it is clear that as regards the internal market policy the Community has competence.

[91] See above.

[92] N. Reich comments that "[the White Paper] implicitly recognises competition between legal orders as a substitute for harmonisation", in *op. cit.*, p. 861. See also J. Pelkmans who lists the drawbacks of the so-called "traditional approach" and the "essence of the new approach", in "The New Approach to Technical Harmonisation and Standardization", (1987) *JCMS*, Vol. XXV, No. 3, pp. 249-269.

[93] See D. Vignes, *op. cit.*.

[94] See G. de Burca, "Differentiation within the Core: The Case of the Common Market", in G. de Burca and J. Scott (eds.), *Constitutional Change in the EU – From Uniformity to Flexibility?*, Hart Publishing, Oxford 2000, Chapter 7, pp. 138-139.

[95] Put in these terms, flexibility has also to be seen in light of the principle of proportionality, enshrined in Article 5 EC Treaty, and according to which a specific measure has to fulfil the following requirements: first, it was suitable to achieve the desired end; second, it was necessary to achieve the desired end; and third, it did not impose a burden on the individual that was excessive in relation to the objective sought to be achieved, see P. Craig and G. de Burca, *op. cit.*, p. 372.

It has been said that there is "an apparent shift in the paradigm of European governance from one of uniformity and harmonisation to one of flexibility and differentiation". Moreover, that while it is not possible to identify a specific point in time at which this metamorphosis occurred, it can broadly be said to have taken place since the beginning of the nineties with the negotiations that led to the Treaty of Amsterdam.[96] Nevertheless, although the discussion surrounding the theme seems to have indeed intensified since then,[97] the practice of allowing for flexibility and differentiation within Community policies, at both macro and micro levels, appears to have been present long before that, in particular insofar as the internal market policy is concerned.[98]

This macro and micro flexibility is in turn reflected in different levels, or methods, of harmonisation, which have been adopted in diverse areas of the internal market policy. In fact, harmonisation can span from "total harmonisation", under which no derogation is allowed, to "minimum harmonisation", according to which only a minimum set of rules is provided at Community level, the rest being left to Member States' discretion.[99] Traditionally these different levels of harmonisation are discussed in the context of, what has been designated here as, macro-flexibility; however, this approach does not reflect the true picture: in reality the impact of micro-flexibility can be so significant that it will indirectly impact on the level of harmonisation. As discussed below this is the case within the area of VAT. In this context, it can be said that macro-flexibility can be reflected in formal levels of harmonisation, whilst micro-flexibility will reveal informal levels of harmonisation.

In light of what has been said it would seem that ultimately any conclusion on whether, as regards the internal market policy, institutional choices favour a competitive or a centralised approach allowing for more, or less, differentiation will have to be reached on a case-by-case basis: *i.e.* the degree of harmonisation which will be required, and the extent to which Member States will be allowed to differentiate, will depend on the area of the internal market policy in question.[100] A discussion on the position as regards the area of VAT will be undertaken *infra*.

## 6) VAT POLICY AS PART OF THE INTERNAL MARKET POLICY

The harmonisation of indirect taxes, and in particular the harmonisation of turnover taxes, has been present within the European integration project from the outset.

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[96] See G. de Burca and J. Scott, "Introduction", in G. de Burca and J. Scott (eds.), *Constitutional Change in the EU – From Uniformity to Flexibility?*, Hart Publishing, Oxford 2000, Chapter 1, pp. 1-2.

[97] See the comments by M. Dougan, "Minimum Harmonisation and the Internal Market", (2000) *CMLRev.* 37, pp. 853-885.

[98] See G. de Burca, "Differentiation within the Core: The Case of the Common Market", *op. cit.*, in particular Tables 1 and 2.

[99] For a comprehensive list of the different methods of harmonisation, see P.J. Slot, *op. cit.*, pp. 382 *et seq.*

[100] As M. Poiares Maduro points out a balance has to be struck: "there must be a decision on when it is possible to choose among different efficient regulatory frameworks enacted by States (optimal diversity) and when uniformity should be preferred (securing free trade)", in *op. cit.*, pp. 147-148.

Although it was initially perceived as an integral part of the aim of achieving a common market, it seemed to gain new impetus with the introduction of the internal market policy. In fact, within the framework of this policy, harmonisation of VAT laws was granted primordial position: on one hand it was made clear by the White Paper that if the internal market was to be established a certain level of harmonisation of VAT laws would have to be achieved; on the other, Article 14 EC Treaty clearly confirms VAT policy as part of the internal market policy by making express reference to it in Article 93 EC Treaty.[101]

Article 93 EC Treaty, which regulates the harmonisation of turnover taxes, states in its current version:

> "The Council shall, acting unanimously on a proposal from the Commission and after consulting the European Parliament and the Economic and Social Committee, adopt provisions for the harmonisation of legislation concerning turnover taxes, excise duties and other forms of indirect taxation to the extent that such harmonisation is necessary to ensure the establishment and the functioning of the internal market within the time limit laid down in Article 14."

Although this provision has been renumbered and subject to some amendments, in particular those introduced by the SEA, its basic principles remain untouched since its introduction in 1957.[102] Firstly, it confers powers on the Community to harmonise turnover taxes to the extent that is necessary for the internal market (or common market); and secondly, it establishes that this harmonisation is subject to the Council's unanimous vote.

### a) SCOPE OF COMMUNITY VAT COMPETENCE

Although the Community's competence as regards VAT could probably be inferred from Article 14 EC Treaty, it is expressly set out in Article 93 EC Treaty. Similarly to Article 14, Article 93 has a dual formulation: on one hand it establishes the substantive scope of the Community's VAT competence; on the other hand, it appears to set out a temporal scope for this competence.

Substantive scope

In terms of substantive scope Article 93 establishes that the Community has competence to "adopt provisions for the harmonisation of legislation concerning turnover taxes [...] to the extent that such harmonisation is necessary to ensure the establishment and the functioning of the internal market". It is clear from the wording that the provision only confers competence on the Community within the VAT area

[101] This position is also reinforced by the TCE: in fact, in the new Treaty the provision regarding harmonisation of turnover taxes appears under the heading Title III, Chapter 1, which is dedicated to the "Internal Market".

[102] This will still be the case under the new TCE. Article III-171 TCE reads: "A European law or framework law of the Council shall establish measures for the harmonisation of legislation concerning turnover taxes, excise duties and other forms of indirect taxation provided that such harmonisation is necessary to ensure the establishment and the functioning of the internal market and to avoid distortions of competition. The Council shall act unanimously after consulting the European Parliament and the Economic and Social Committee."

insofar as it is necessary for the "establishment and the functioning of the internal market".[103] Substantially, therefore, the scope of the Community's VAT competence is limited in two respects: firstly by the concept of internal market itself; secondly by the meaning of the expression "establishment and functioning". Although extensive consideration has already been given above to the concept of internal market, it is worth adding some thoughts on the meaning of the expression "establishment and functioning".

Although the Court has never been called to interpret this expression in the context of Article 93 EC Treaty, it has done so in the context of Article 95 EC Treaty. As discussed *supra*, in *Tobacco Advertising* the Court implicitly drew a distinction between: measures intended to improve the conditions for the establishment and functioning of the internal market, and measures intended to regulate the internal market. Of these, only the first type was included in the scope of Article 95.[104] Considering the similarity of the wording in Articles 95 and 93, it seems legitimate to assume that the Court's interpretation of Article 95 should apply *mutatis mutandis* to Article 93, *i.e.*, VAT harmonising measures intended to merely regulate the internal market are not included within the scope of that provision.

Moreover, and for the reasons set out above, the Community's VAT competence is equally limited by the general principle of subsidiarity, as *per* Article 5 EC Treaty.

Temporal scope

The reference in Article 93 to the time limit set out in Article 14 seems to indicate that the Community's VAT competence is temporally limited to the date set therein, *i.e.*, 31 December 1992. Nevertheless, the comments made in respect of Article 14's temporal scope should also apply here: for the reasons highlighted then, it seems reasonable to conclude that the reference to the time limit in Article 93 should *not* be interpreted as a limitation to the temporal scope of the Community's VAT competence.[105]

### b) DECISION-MAKING PROCEDURE FOR VAT LEGISLATION

The decision-making procedure set out in Article 93 is a rarity within the EC Treaty, a leftover from the original Treaty of Rome. According to this provision approval of legislation has to follow the so-called consultation procedure, under which after the presentation of the legislative proposal by the Commission, the European Parliament

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[103] It is interesting to note that the wording in Article III-171 TCE is slightly different: under this provision the Community has competence insofar as "harmonisation is necessary to ensure the establishment and the functioning of the internal market and to avoid distortions of competition". The sentence "to avoid distortions of competition" has been therefore added. Should anything be read into this amendment? The elimination of distortions to competition has already been recognised by the Court has part of the concept of internal market – see *Titanium Dioxide*, case C-300/89, [1991] ECR I-2867. Therefore, arguably, measures to avoid distortions to competition were already included within the scope of Article 93 EC Treaty. It is submitted, therefore, that the new wording should be regarded as mere clarification and reflection of the Court of Justice's jurisprudence and does not constitute any substantive amendment.

[104] Case C-79/99, [2001] ECR I-8599.

[105] Worth noting is the fact that in Article III-171 TCE the reference to the time limit has been eliminated.

and the Economic and Social Committee are consulted.[106] It is then up to the Council to approve (or disapprove) the proposal, for which, under Article 93, a unanimous vote is required.

These two components – consultation procedure and unanimity voting – constituted the most frequent form of approving Community legislation within the original version of the EEC Treaty. Consecutive amendments to the Treaty, however, have almost eradicated this decision-making procedure, substituting the consultation procedure mostly (although not exclusively) by the cooperation procedure and the co-decision procedure, both of which give considerably more power to the European Parliament; and the unanimity voting by QMV. This trend away from intergovernmentalism to a more democratic approach to decision-making procedures, which involved a higher input from the European Parliament, was initiated by the SEA[107] but was largely consolidated in subsequent Treaties. Tax, however, remained one of the few areas which defied this political and legislative trend.

It has been said that during the negotiations, which preceded the approval of the SEA, the Commission fought hard for the switch to QMV in respect of taxation, and in particular as regards indirect taxation.[108] In a last attempt, the Commission attempted to limit the use of QMV to specific areas of indirect taxation by proposing that the following provision be added: "By way of derogation from Article 99, the harmonisation of legislation concerning turnover taxes, excise duties and other forms of indirect taxation shall be decided upon by the Council acting by qualified majority to the extent to which such harmonisation is necessary in order to ensure the establishment and functioning of the internal market".[109] However, the Commission encountered the opposition of the United Kingdom, to which tax issues in general, and indirect taxation issues in particular, were matters of political sensitivity.[110]

The matter was again a bone of contention during the European Convention negotiations which led to the TCE. A majority of the members of the Working Group on Economic Governance, whose competence included the area of taxation, agreed that "amendments should be made to the decision-making procedures in order to facilitate progress in the area of fiscal policy". In this context, it recommended the move from unanimity to QMV for specific type of measures, namely those "linked to the proper functioning of the internal market, areas affecting directly the fundamental freedoms or where such measures might be essential for sustainable development".[111]

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[106] It is important to note that although the results from the consultation are not mandatory, the Court has ruled that consultation itself is still a mandatory requirement, see *Roquette Freres*, case 138/79, [1980] ECR 3333.

[107] For a discussion on the move from unanimity to QMV witnessed in the SEA, see above.

[108] See C.D. Ehlermann, *op. cit.*, p. 380.

[109] Commission's amended working paper, dated 5 October 1985, Article 2(2).

[110] See D. Allen, *op. cit.*, p. 42.

[111] According to the Working Group "the objective should be to provide for sufficient approximation of rates, minimum standards and tax bases in the areas of indirect and company taxation to ensure that the proper functioning of the single market is not affect by harmful tax competition or serious internal trade distortion". Therefore explicit reference would be made to

These recommendations, however, found some opposition amongst Member States[112] and the Treaty's final draft included a much less radical approach:[113] unanimity would continue to apply as regards harmonisation of indirect taxes as a general rule; as an exception, QMV would apply where the measures relate to administrative cooperation or to the combating of fraud. This proposal could potentially give rise to definitional difficulties: in fact, if the term "administrative cooperation" can be regarded as relatively straightforward, the same cannot be said for the expression "combating tax fraud" – potentially all tax measures could be said to aim at "combating tax fraud".[114]

Ultimately however Member States could not agree on these proposals and in the final version of the TCE unanimity was maintained for all tax measures.

One last word as regards the legal instruments adopted for the purposes of VAT harmonisation. Although Article 93 EC Treaty makes no reference to the type of legal instruments which should be used for those purposes, in general, harmonising measures have tended to adopt the form of Directives.[115]

### c) EXERCISE OF COMMUNITY VAT COMPETENCE: MITIGATED CENTRALISED MODEL

As has already been highlighted above, a conclusion, on whether a competitive or centralised model is favoured in relation to the internal market policy, has to be reached on a case-by-case basis, *i.e.*, it will depend on the area of the internal market in question. As regards the VAT policy, the reference in Article 93 to "harmonisation of legislation concerning turnover taxes" clearly indicates that the legislator has favoured a centralised approach. Moreover, the use of the word "shall" in the beginning of the provision indicates that not only is the Treaty conferring competence on the Community to harmonise VAT laws, but that there is an obligation on the European institutions to do so.

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the fact that "measures adopted by QMV cannot directly or indirectly affected the substance of other areas of tax policy, in particular personal and property taxation". It is interesting to note that although this was the view adopted by the majority of the members of the Working Group, reference is made to the fact that some members of the Group wished to see a wider extension of the QMV in the area of taxation; whilst others would prefer to maintain unanimity in all decisions on taxation, see *Final Report of Working Group VI on Economic Governance*, CONV 357/02, 21 October 2002, pp. 6-7.

[112] See the proposals by the CDU and the CSU, *op. cit.*, CONV 616/03, 1 April 2003, for a strong defence of the adoption of the "competition model" as regards the area of taxation.

[113] According to the Presidium "the objective has been to respond to calls from the Working Group for a move to QMV on tax issues, whilst recognising the sensitivity of this issue as expressed by a number of members of the Convention both in the Working Group and the plenary", see *Draft sections of Part Three with comments*, CONV 727/03, 27 May 2003, p. 4.

[114] This problem would only occur as regards indirect taxation, as in relation to direct taxation the new provision established that the Council had to previously agree unanimously that a certain measure related to administrative cooperation or combating tax fraud, before adopting that measure by QMV, *ibid*, pp. 5-6.

[115] Exceptions are the legislation relating to Intrastat and administrative cooperation, see Regulation (EC) No. 638/2004 of the European Parliament and of the Council of 31 March 2004, OJ L 102, 07/04/2004, p. 1; and Council Regulation (EC) No. 1798/2003 of 7 October 2003, OJ L 264, 15/10/2003, p. 1, respectively. The new Article III-171 TCE makes express reference to "European laws" and "European framework laws" as the legal instruments of election for harmonisation of indirect taxes: "European laws" correspond to the former Regulations; whilst "European framework laws" is the new designation for directives, see Article I-33 TCE.

Notwithstanding this, however, the establishment of limits to this harmonising competence in Article 93 – as discussed the Community only has competence to harmonise "to the extent that such harmonisation is necessary to ensure the establishment and the functioning of the internal market" – signals that there is still room for competition between legal orders within the area of VAT. Competition between legal orders will be basically allowed in areas which do not interfere with "the establishment and functioning of the internal market". For this reason it seems that the legislator has adopted within the VAT policy, what is designated here as, a "mitigated centralised model": one that is based on a centralised approach, but under which a limited level of competition between legal orders is not only allowed, but mandatory.

Yet, as will be demonstrated in the following chapters, "a mitigated centralised model" is not in place within the VAT area: there are many aspects of the tax which, as will be set out, constitute serious obstacles to either the establishment or the functioning of the internal market and where, as harmonisation has not taken place, competition between legal orders is still a reality. Moreover, even where harmonisation has taken place, Member States have been allowed a broad scope of flexibility and differentiation at both macro and micro level. In fact, macro-flexibility can be witnessed through the inclusion within the Sixth Directive[116] of general exceptions, options and, in some areas of the system, a high degree of discretion as regards the implementation of provisions; whilst micro-flexibility is evidenced by the numerous authorisations granted to Member States to derogate from the Sixth Directive provisions.[117] As this thesis will demonstrate, the lack of harmonisation of areas which impact on the establishment or functioning of the internal market, together with these different levels of differentiation, have had disastrous consequences for the Community's VAT policy.[118]

[116] Sixth Council Directive 77/388/EEC of 12 May 1977, OJ L 145, 13/06/1977, p. 1. Hereafter "Sixth Directive".
[117] See Chapter 3.
[118] For an analysis of the potential negative effects of micro flexibility and differentiation within the internal market policy in general, see G. de Burca, "Differentiation within the Core: The Case of the Common Market", *op. cit.*, pp. 142 *et seq.*

# CHAPTER 2

# THE ROLE OF VAT IN THE INTERNAL MARKET POLICY – HISTORICAL OVERVIEW

## 1) TURNOVER TAX SYSTEMS IN THE BEGINNING OF THE EUROPEAN INTEGRATION PROCESS

From its very outset, turnover taxes have played a fundamental role in the European integration process.[119] In fact, it soon became clear that harmonisation of these taxes was an integral part of achieving a common market – both in the context of a sector-based common market, as in the case of the European Coal and Steel Community, as well as in the context of a generic common market, as was the case with the European Economic Community.

### a) TURNOVER TAXES AND THE EUROPEAN COAL AND STEEL COMMUNITY – THE TINBERGEN REPORT

The Treaty of Paris establishing the European Coal and Steel Community represented the first significant step towards harmonisation of turnover taxes, providing the institutional framework in which to initiate discussions on the introduction of a common turnover tax system. Although there was no specific reference to turnover taxes in the Treaty as a potential obstacle to the establishment of a coal and steel common market,[120] there was an awareness of the potential negative impact that the application of different turnover taxes across Member States could have. It was this awareness that led the High Authority of the European Coal and Steel Community to set up the Tinbergen Committee, this way initiating the process that would ultimately result in the establishment of the EU VAT system.

In March 1953 the High Authority of the European Coal and Steel Community set up a Committee of Experts entrusted with the investigation of the various turnover tax systems' impact on the common market.[121] The aim was to identify means to facilitate the movement of products within the common market and to avoid double taxation situations. Specifically under discussion was the possibility of adopting a new tax system for the common market, *i.e.*, a tax system only applicable to the coal and steel products different from the tax systems applicable to all other commodities.

In April the same year the Committee presented a report based on the information obtained through hearings and analysis of documents received from professional

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[119] As emphasised by P. Miconi, member of staff at the European Commission, in 1978, at a conference organised by the Portuguese Tax Association, see "Razoes Justificativas da Introducao de um Sistema de Imposto sobre o Valor Acrescentado", *Ciencia e Tecnica Fiscal*, No. 244/246, April/June 1979, p. 407.

[120] Article 4 ECSC Treaty lists several duties, measures and subsidies which would be incompatible with the common market for coal and steel. However, there is no reference to turnover taxes.

[121] Order No. 1-53 of 5 March 1953, Official Gazette of the Community of 7th March 1953.

associations and Member States' delegations. The Report, known as the Tinbergen Report,[122] starts by affirming the basic principle of fiscal neutrality:

> "In order that the aim of the common market should not be frustrated, tax considerations must not intervene to induce the buyer to alter his decisions."[123]

Based on this principle and after analysing the different turnover taxes applied by Member States, the Committee concluded that a new common turnover tax system, applicable to the common market of coal and steel, should be adopted by the Community. This common turnover tax system would be based on the principle of taxation in the country of destination, under which the exemptions or refunds are limited to the amount of the tax on the final transaction.

Although the recommendations of the Committee were never applied within the context of the European Coal and Steel Community, the report constituted a significant historical breakthrough in terms of the harmonisation of turnover taxes. For the first time in the history of European integration the idea that different turnover taxes might constitute an obstacle to the proper functioning of the common market was expressed in an official document. Equally, for the first time the suggestion was put forward that some kind of harmonisation should be pursued in the area of turnover taxes in order to make the common market function effectively. Although the word "harmonisation" was never used by the Committee, its recommendation points clearly in that direction.

### b) TURNOVER TAXES IN THE EUROPEAN ECONOMIC COMMUNITY

Soon after the publication of the Tinbergen Report, the Spaak Report, calling for the creation of a general common market, was released. The Report contained a chapter devoted to the problems of "Distortion and Harmonization of Legislation", raising the issue of potential distortions to the common market which could result from different legislation and the need, in some cases, to harmonise the Member State legislations. This chapter seems to have been a direct result of the position adopted by France during the intergovernmental negotiations, which consistently pointed out that if it was to join the common market some kind of variation of "harmonization of fiscal and social charges"[124] had to be inserted.

The considerations set out in the aforementioned chapter, together with the stated aim of achieving a free movement of commodities, are fundamental to the comprehension of what would become the Treaty of Rome's turnover tax provisions.

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[122] After the Committee's chairman, J. Tinbergen from the "Nederlandse Economische Hogeschool", Rotterdam – Order No. 2-53 of 5th March 1953, Official Gazette of the Community of 7th March 1953. Order No. 3-53 of 12th March 1953, Official Gazette of the Community of 15th March 1953, appointed the remaining members and the experts assisting the Committee.

[123] *Report on the problems raised by the different turnover tax systems applied within the Common Market*, Report prepared by the Committee of Experts set up under Order No. 1-53 of the High Authority, dated March 5, 1953, Luxembourg, 8 April 1953, p. 15.

[124] For an analysis of the reasons behind the French position see Raymond Bertrand, *op. cit.*, pp. 564-66.

Under the heading "Fiscal Provisions" the EEC Treaty included several tax provisions, namely Articles 95 to 99.[125] It has been said that "the chapter on Fiscal Provisions is formulated in the most limiting kind of language" and that "as regards taxation policy, the Treaty contains only the most timid of starting-points".[126] However, it should be said that, in terms of turnover taxes, if Article 99 represented only a starting point, it was undoubtedly an important one.[127] In fact, it is clear from the wording of this provision that, following the Tinbergen report, the authors of the EEC Treaty considered that the existence of different turnover tax systems would be incompatible with the objectives of the newly established Community.[128] Article 99's function therefore consisted of the initiation of the process of harmonisation of turnover taxes.

## 2) INTRODUCTION OF A VALUE ADDED TAX SYSTEM

### a) WORKING GROUP No. I, SUBGROUPS A, B AND C AND FISCAL AND FINANCIAL COMMITTEE

Acting on the mandate provided by Article 99 EEC Treaty, the Commission set up several consecutive working groups in order to determine whether harmonisation of turnover taxes was indeed necessary "in the interest of the common market", and, if so, what were the available methods for achieving such harmonisation. The first of these working groups was the so-called "Working Group No. I", which in their report dated late 1959 concluded that "the maintenance of the diversity of tax systems currently applied in the different Member States is prejudicial in character to the good working of the Common Market and it is desirable (...) to go on toward a harmonisation of the differing legislation relating to turnover taxes". Amongst the principal disadvantages resulting from the diversity of turnover tax legislation highlighted by the Working Group No I, were the following:

— the encouragement of vertical concentration (integration) of enterprises inherent in a multistage cumulative ("cascade") system of turnover taxes;

— the barriers to the free circulation of goods caused by the maintenance of tax frontiers; and

— the complications in relation to international trade which stem from the multiplicity of tax systems. [129]

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[125] In their original numbering; these provisions currently correspond to Articles 90 to 93, and are included under the heading "Tax Provisions".

[126] W. Hallstein, former president of the European Commission, in *Europe in the Making*, London, George Allen & Unwin Ltd, 1972, pp. 156-157.

[127] See J. Reugebrink's comments in "The Sixth Directive for the Harmonisation of Value Added Tax", in (1978) *CMLR* 15, p. 309.

[128] The differences between turnover taxes applied by Member States at the time were quite extensive. For a summary of the main differences, see K.V. Antal, "Harmonisation of Turnover Taxes in the Common Market", in (1963) *CMLRev.* 1, pp. 42-50.

[129] *The EEC Reports on Tax Harmonisation – The Report of the Fiscal and Financial Committee and the Report of the Sub-Groups A, B and C*, IBFD Publications, Amsterdam, 1963, p. 13.

In response to this report the Commission decided to set up three further working groups and a committee: the working groups, known as Sub-Groups A, B and C, were established in order to examine different aspects of the problem and various alternative solutions;[130] whilst the Fiscal and Financial Committee, chaired by Professor Fritz Neumark, was in charge of studying the extent to which the disparities of public finance within Member States prejudiced the establishment of a Common Market which "guarantees conditions analogous to those of an internal market".[131] Despite the apparent broadness of the Fiscal and Financial Committee's mandate, the Commission acknowledged from the outset that questions of indirect taxation, and particularly of turnover taxes, would constitute one of the principal problems requiring the Committee's attention.[132]

Both the Sub-Groups and the Fiscal and Financial Committee released their reports in 1962. Of these, the report of the Fiscal and Financial Committee, known as the Neumark Report, would undoubtedly turn out to be the most influential.

As predicted, the Neumark report dealt in great detail with the issue of harmonisation of turnover taxes. The overall conclusion was that those Member States, which levied cumulative turnover taxes should replace them with a general system of value added tax.[133] The report presented several reasons in support of this conclusion, in particular the fact that despite being the simplest type of turnover taxes, the deficiencies of cumulative taxes were well documented, in particular they created the so-called cascading effect, *i.e.*, tax upon tax occurred as a taxed product passed from manufacturer to wholesaler to retailer.[134] Moreover, the fact that taxation of services would be a much easier task under a VAT system was also perceived as a great advantage.[135]

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[130] Sub-Group A was to study the potential removal of physical inspection at frontiers; Sub-Group B was to focus on the potential adoption of a single-phase general tax applied at the stage prior to retail trade, combined eventually with a tax on retailers; and Sub-Group C was to analyse the potential application of a common tax at the production stage, together with an entirely autonomous tax applied at the trading stage, or alternatively a common tax on added value, should occasion arise, combined with a tax levied at the trading stage. The Sub-Groups were to examine the extent to which each of these possibilities would allow the removal of the disadvantages put forward by the Report of the Working Group No. I.

[131] *Mandate entrusted to a scientific committee for the study of fiscal and financial problems in the EEC*, Appendix A of the Report of the Fiscal and Financial Committee.

[132] Interestingly, one of the Commission's recommendations to the Committee was to assume the desirability of reducing tax frontiers to a strict minimum when analysing the questions relating to indirect taxation.

[133] At the time all Member States, with the exception of France, applied cumulative taxes. France was the first country in the world to introduce a value added tax system.

[134] In fact, it was reportedly trying to mitigate the disadvantages of the cascade element that a VAT, in its invoice-credit form, developed initially in France.

[135] The overall comparative advantages of introducing a VAT system has made VAT one of the most popular taxes in the world, see Ebrill, Liam *et al*, *The Modern VAT*, International Monetary Fund, Washington D.C., 2001, pp. 4-13 and M. Keen, "The VAT Experience", Paper presented at *International Tax Dialogue VAT Conference,* Rome, 15-16 March, 2005. This outstanding growth and spread of the tax has led authors to comment that "the nearly universal introduction of VAT should be considered the most important event in the evolution of tax structure in the last half of the 20th century", and that "the rise of VAT is an unparalleled tax phenomenon", see S. Cnossen, *Global trends and issues in value added taxation*, OCfEB Research Memorandum 9802, Erasmus University Rotterdam, The Netherlands, 1998, p. 4; and A.A. Tait, *Value Added*

### b) FIRST AND SECOND DIRECTIVES – THE BIRTH OF THE EU VAT SYSTEM

In light of the recommendations of the Neumark Report, the Commission submitted to the Council in late 1962 a proposal for a Directive which envisaged the adoption by Member States of a common system of VAT.[136] Under this proposal harmonisation would take place in stages which would lead to a common VAT system by the end of 1969.[137] Although the ultimate declared aim was the abolition of "fiscal frontiers" within the Community, no time limit was fixed for this aim to be achieved.

The proposal was referred to the Parliament and to the Economic and Social Committee for consultation. The Economic and Social Committee and in particular the Parliament, although welcoming the intention to adopt a common VAT system, were critical of the proposed method of achieving this objective. In its report the Parliament emphasised the importance of an early removal of fiscal frontiers, and rejected the proposal of a two-stage approach, considering the transitional period as redundant, and recommending the immediate adoption of a value added tax system. [138]

In light of these criticisms, the Commission decided to revise its original draft. Under the revised proposal Member States were to adopt a common VAT system by the end of 1967. However, the adoption of a common VAT system without a transitional period required the details of that system to be established immediately, rather than during the second stage. In this context, the Commission presented a proposal for a Second Directive in April 1965.[139]

On 11 April 1967, the Council adopted, with some modifications, the following:

— First Council Directive 67/227/EEC on the harmonisation of legislation of Member States concerning turnover taxes; and

— Second Council Directive 67/228/EEC on the harmonisation of legislation of Member States concerning turnover taxes – Structure and procedures for application of the common system of value added tax.[140]

#### i) FIRST DIRECTIVE

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*Tax – International Practice and Problems*, International Monetary Fund, Washington D.C., 1988, p. 3, respectively.

[136] Doc. IV/COM(62) 217. The process that ultimately led to the Commission's proposal was far from straightforward. In fact, W. Hallstein, former president of the Commission, has qualified it as a "long and painstaking preparatory work", *op. cit.*, p. 158.

[137] Although the Commission's preference for a stage-based harmonisation plan was known for a while, the details of this plan were only released after the publication of the Neumark Report. For a critical overview of the Commission's stage-based plan, see K.V. Antal, *op. cit.*, pp. 51-57.

[138] Report of the Parliament's Internal Market Committee, known as the Deringer Report, *Deringer Report: Rapport fait au nom de la Commission du Marche Interieur sur la proposition de la Commission de la CEE au Conseil concernant une Directive en matiere d'harmonisation des legislations des Etats Membres relative aux taxes sur le chiffre d'affairs*, European Parliament, Documents de Séance 1963-1964, No.56.

[139] Doc. IV/ COM(65) 144.

[140] OJ 71, 14/04/1967, pp. 1301-1312. Hereafter, referred to as the "First Directive" and the "Second Directive", respectively.

The Preamble of the First Directive sets out in a clear manner, the reasons behind the approval of this Directive and the introduction of a common VAT system:

> "The main objective of the Treaty is to establish, within the framework of an economic union, a common market within which there is healthy competition and whose characteristics are similar to those of a domestic market;
>
> The attainment of this objective presupposes the prior application in Member States of legislation concerning turnover taxes such as will not distort conditions of competition or hinder the free movement of goods and services within the common market;
>
> The legislation at present in force does not meet these requirements;
>
> It is therefore in the interest of the common market to achieve such harmonisation of legislation concerning turnover taxes as will eliminate, as far as possible, factors which may distort conditions of competition, whether at national or Community level, and make it possible subsequently to achieve the aim of abolishing the imposition of tax on importation and the remission of tax on exportation in trade between Member States;"

The VAT introduced by the First Directive is defined as a tax on consumption, which is based on the right to deduct input tax, extends to the retail stage and whose ultimate aim is the abolition of fiscal frontiers, *i.e.*, imposition of tax on importation and the remission of tax on exportation in trade between Member States. This ultimate aim is also reflected in the Preamble:

> "It is not possible to foresee at present how and within what period the harmonisation of turnover taxes can achieve the aim of abolishing the imposition of tax on importation and the remission of tax on exportation in trade between Member States"

Article 4 of the First Directive leaves it to the Commission to submit to the Council before the end of 1968 proposals as to how, and within what period, the harmonisation of turnover taxes can achieve this aim.

Member States were required to implement the First Directive, and adopt a VAT system, not later than 1 January 1970. France already had a VAT system in place (although amendments to the existing system had to be made, if it was to comply with the principles of the new common VAT system); however, the other five countries had to replace their cumulative turnover tax systems. Germany, the Netherlands and Luxembourg did so in a relatively short period; however, difficulties were experienced both in Belgium and Italy and the deadline for implementing the new system had to be postponed.[141]

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[141] See Third Council Directive 69/463/EEC of 9 April 1969, OJ 320, 20/12/1969, p. 34; Fourth Council Directive 71/401/CEE of 20 December 1971, OJ L283, 24/12/1971, p. 41; and Fifth Council Directive 72/250/EEC of 4 July 1972, OJ L162, 18/07/1972, p. 18.

### ii) SECOND DIRECTIVE

The Second Directive set out the details of the new common VAT system. As highlighted in the Preamble, the system put in place under the Second Directive established only a basic framework, leaving a considerable autonomy for Member States insofar as the basis of assessment of the tax and the applicable rates were concerned.

The Directive, consisting of twenty-one Articles and two Annexes, included provisions on taxable transactions,[142] territorial scope of the tax,[143] place of supply,[144] concept of taxable person,[145] taxable amount,[146] tax rates,[147] tax exemptions,[148] right to deduct,[149] and administrative obligations.[150] Overall, the basic rules were similar to the ones currently applicable under the amended version of the Sixth Directive. However, despite the similarity in these basic rules, the level of freedom left to Member States was very high. Member States were free to establish their own rates structure, including number and level of rates;[151] subject to some restrictions, they were permitted to determine exemptions,[152] to adopt special measures to simplify procedures or prevent frauds,[153] to exclude certain expenditure from the right to deduct,[154] and to apply special schemes to small undertakings and to agricultural activities.[155] This high level of freedom and the low level of legislative detail gave rise to a considerable amount of judicial disputes, which following referral from the national courts, allowed the Court of Justice to initiate the process of building case-law within the VAT area.[156] Ultimately, however, it was exactly that level of freedom and lack of

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[142] Articles 2, 5, 6 and 7; Annex A (3) to (11); and Annex B.
[143] Article 3 and Annex A (1).
[144] Articles 5(4), 6(4) and 7(2).
[145] Article 4 and Annex A (2).
[146] Article 8 and Annex A (12) to (14).
[147] Article 9 and Annex A (15).
[148] Article 10 and Annex A (16) to (19).
[149] Article 11 Annex A (20) to (24).
[150] Article 12 and Annex A (25) and (26).
[151] Article 9.
[152] Article 10.
[153] Article 13.
[154] Article 11(3).
[155] Articles 14 and 15. For a more detailed analysis of the main aspects of the common VAT system under the Second Directive, see J.C.L. Huiskamp, "The Harmonisation of Legislation of E.E.C. Member States concerning turnover taxes – A general outline", (1967-1968) *CMLRev.*, pp. 179-191.
[156] The following cases concerned the interpretation of Second Directive provisions: cases 154/80, *Dutch Potato*, [1981] ECR 445 and 294/82, *Senta*, [1984] ECR 721, on taxable transactions and the interpretation of Article 2; joint cases 181/78, *van Paassen* and 229/78, *Denkavit*, [1979] ECR 2063, and case 89/81, *Hong Kong*, [1982] ECR 1277, on the concept of taxable person and the interpretation of Article 4 and Annex A(2); case 139/84, *Van Dijk's,* [1985] ECR 1405, on supplies of goods and the interpretation of Article 5; cases 111/75, *Ferrovia del Renon*, [1976] ECR 657, and 126/78, *Spoorwegen*, [1979] ECR 2041, on supplies of services and the interpretation of Article 6 and Annex B; cases 154/80, *Dutch Potato*, [1981] ECR 445 and 222/81, *BAZ Bausystem*, [1982] ECR 3681, on determination of taxable amount and the interpretation of Article 8; cases 51/76, *VNO*, [1977] ECR 773, 165/86, *Intiem*, [1988] ECR 1471, and C-305/97, *Royscot*, [1999] ECR I-6671 on right to deduct and the interpretation of Article 11; joint cases 181/78, *van Paassen* and 229/78, *Denkavit*, [1979] ECR 2063 on consultations and the interpretation of Article 16; and cases 51/76, *VNO*, [1977] ECR 773, Case 415/85, *Commission v Ireland*, [1988] ECR 3097, and Case 416/85, *Commission v United Kingdom*, [1988] ECR 3127 on the transitional period and the interpretation of Article 17.

detail which determined the revocation of the Second Directive and its substitution with the Sixth Directive.

### c) SIXTH DIRECTIVE – COMMON BASIS OF ASSESSMENT

The deficiencies of the First and Second Directives became apparent soon after their entry into force. In fact, the broad discretion which these Directives left to Member States to establish their own VAT systems, and the low level of legislative detail contained within them, determined that in practice VAT systems introduced by Member States differed substantially.[157] Although some of these disparities had the potential to create significant distortions to Community trade and it was clear that they should be removed "in the interest of the common market", [158] the final push for further harmonisation came from an unsuspected direction.

Approval of the Sixth Directive

In 1970 the Council approved a Decision with a view to replacing the financial contributions from Member States as the main source of Community revenue, with Community's own resources.[159] Amongst the Community's envisaged own resources was a small portion of Member States' VAT revenue.[160] According to the Council Decision's this revenue would be obtained by applying a rate not exceeding 1% to an assessment basis determined in a uniform manner for Member States in accordance with Community rules.[161] However, in order for VAT to provide a suitable source of Community revenue it would be necessary to achieve a uniform basis of assessment or, at least, a greater degree of harmonisation of the tax base, so that the coverage of the tax was reasonably equivalent in each Member State.

The delays in Member States' implementation of the First and Second Directive, and the accession of new Member States, determined that not until mid-1973 was the Commission in a position to submit its proposal for a Sixth Directive to the Council.[162] Furthermore, discussions at the Council proved difficult, therefore delaying the legislative process for an additional four year period.[163] The proposal was finally

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[157] As A.J. Easson comments "in 1973, there really existed nine separate and different systems of VAT, rather than a single Community system", in *Taxation in the European Community*, European Community Law Series, The Athlone Press, London & Atlantic Highlands, NJ, 1993, p. 101.

[158] This was the case, for example, with the disparities regarding the VAT rates structure, the granting of exemptions and the treatment of international supplies of services.

[159] Council Decision 70/243/ECSC, EEC, EURATOM of 21 April 1970, OJ L 94, 28/04/1970, p. 201.

[160] Other resources included customs, duties agricultural levies, and levies upon sugar producers.

[161] A.J. Easson contended that the designation of VAT as a source of Community revenue was "undoubtedly the most interesting development" of Council Decision 70/243, *op. cit.*, pp. 3-4.

[162] *Proposal for a Sixth VAT Directive on the harmonisation of legislation of Member States concerning turnover taxes – Common system of value added tax: uniform basis of assessment*, COM(73) 950, 20 June 1975, Bulletin of the European Economic Communities, 1973, Supplement 11. Council Decision 70/243 had called for the full implementation of the system of own resources as from the commencement of the 1975 financial year; however, it was not until 1980 that the own resources system came into full effect. This was principally due to the delays in the implementation of the Sixth Directive.

[163] Difficulties at the Council discussions led the Commission to put forward an amended proposal for a Sixth Directive, see *Amendments to the proposal for a Sixth Council Directive on*

approved in May 1977 amidst high expectations.[164] Although, Member States were required to adopt the necessary implementing legislation by 1 January 1978, at the latest, it soon became clear that most Member States were experiencing difficulties meeting this deadline. Consequently, the Council approved in June 1978 the Ninth Directive, which authorised Denmark, France, Germany, Ireland, Italy, Luxembourg and the Netherlands to extend the time limit for the introduction of implementing legislation until 1 January 1979.[165] The delays in implementing the Sixth Directive provisions and the six months gap between the expiration of the deadline and the approval of the Ninth Directive, gave rise to an interesting legal problem: could the Directive be relied upon by individuals against Member States which had failed to implement it within the prescribed time-limit? In a series of cases, the Court of Justice answered affirmatively, ruling that in the absence of implementation of the Sixth Directive it was possible for that directive to be relied upon by individuals in relation to transactions carried out, both between 1 January and 20 June 1978, and as from 1 January 1979.[166]

The new common VAT system

As already mentioned, the basic VAT principles and rules applicable under the Sixth Directive did not differ substantively from those applicable under the Second Directive. There were, however, significant distinctions, namely the significant increase on the level of detail contained in the various provisions and the decrease on the level of freedom granted to Member States. Rules regarding areas such as transactions subject to VAT, and the definition of taxable transactions, are considerably similar to those included in the Second Directive; whilst rules governing other areas such as exemptions, were substantively different.[167] Moreover, new provisions were added, most significantly in the area of place of supply of services.[168]

Despite the progress achieved in some areas of the system, as regards other areas, such as the rates' structure, non-deductible expenditure and special schemes

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*the harmonisation of legislation of Member States concerning turnover taxes – Common system of value added tax: uniform basis of assessment*, OJ C 121, 11/10/1974, p. 34. The differences between the ambitious original proposal and the modest final text which ultimately emerged from the Council discussions were significant as acknowledged by the Commission, see *First Report from the Commission to the Council on the application of the common system of value added tax, submitted in accordance with Article 34 of the Sixth Council Directive (77/388/EEC of 17 May 1977)*, COM(83) 426 final, 14 September 1983, p. 5.

[164] Some commentators going as far as to consider the Sixth Directive, as an "European VAT Code", see P. Miconi, *op. cit.*, p. 429, and A. E. Genot, "Fiscal Harmonisation and European Integration: A 1978 Appraisal", (1978) *ELRev.* 3, p. 360.

[165] Ninth Council Directive 78/583/EEC of 26 June 1978, OJ L 194, 19/07/1978, p. 16. It is interesting to note that, some years later, the implementation of Community VAT legislation, and in particular the Sixth Directive, also gave rise to difficulties in Greece, see Fifteenth Council Directive 83/648/EEC of 19 December 1983, OJ L 360, 23/12/1983, p. 49; and Twenty-First Council Directive 86/247/EEC of 16 June 1986, OJ L164, 20/06/1986, p. 27.

[166] Case 207/87, *Weissgerber*, [1988] ECR 4433. See also cases 8/81, *Ursula Becker*, [1982] ECR 53; 255/81, *Grendel*, [1982] ECR 2301; and 70/83, *Kloppenburg*, [1984] ECR 1075.

[167] Under Articles 13, 14, 15 and 16 Sixth Directive, exemptions have now a compulsory nature, and Member States are no longer free to grant exemptions. The stimuli for harmonisation of exemptions is highlighted in the Preamble to the Directive, which states "whereas a common list of exemptions should be drawn up so that the Communities' own resources may be collected in a uniform manner in all the Member States".

[168] Article 9 Sixth Directive.

applicable to small undertakings and agricultural outputs, the Council found it impossible to reach agreement. Consequently, the rules applicable to these areas under the Sixth Directive are similar to the ones previously applicable under the Second Directive, and further harmonisation was postponed to a later date.[169] Unfortunately, despite the Commission's efforts to see legislation approved,[170] progress in achieving further harmonisation remained slow in the years that followed the entry into force of the Sixth Directive.[171] In fact, it was not until the publication of the White Paper and the introduction of the Internal Market policy that real development was attained.

## 3) THE NEW INTERNAL MARKET POLICY AND THE ROLE OF VAT

As demonstrated above, the abolition of fiscal frontiers, and a high level of harmonisation of turnover taxes were perceived from the outset as long term aims for the European integration process, and as fundamental aspects of the establishment of a European Common Market. Notwithstanding this, it was not until the publication of the Commission's White Paper and the approval of the SEA, that the role of these aims in the establishment of the Internal Market became fully clear.

### a) THE WHITE PAPER AND THE REMOVAL OF FISCAL BARRIERS

In June 1985, the Commission presented the White Paper for the completion of the Internal Market. The paper laid down a series of measures with a view to establishing an Internal Market by 1992, divided under the following three headings: the removal of physical barriers; the removal of technical barriers; and the removal of fiscal barriers. These fields of action were reportedly not chosen for their feasibility, but due to their necessity – indispensable measures which would need to be implemented if an Internal Market was to be established by 1992.[172] Under the heading removal of fiscal

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[169] In some cases, the Sixth Directive, in its original version, included mandates to the Commission regarding the presentation of proposals for further harmonisation, e.g. under Article 17(6), the Commission was under an obligation to present a proposal for the harmonisation of non-deductible expenditure, within a four year period since the entry into force of the Directive. For an in-depth analysis of this provision and its consequences, see Chapters 3 and 4.

[170] During this period the Commission put forward several proposals aimed at dealing with some of the issues left unresolved by the Sixth Directive, which were unable to gather unanimous support at the Council – see in particular *Proposal for a Fourteenth Council Directive on the deferred payment of the tax payable on importation by taxable persons*, COM(82) 402 final, 5 July 1982; and *Proposal for a Twelfth Council Directive on expenditure not eligible for deduction of value added tax*, COM(82) 870, 25 January 1983.

[171] Only three of the proposed amendments to the Sixth Directive put forward by the Commission prior to 1985, reached agreement in the Council, as follows: Eleventh Council Directive 80/368/EEC of 26 March 1980, OJ L 90, 03/04/1980, p. 41; Tenth Council Directive 84/386/EEC of 31 July 1984, OJ L 208, 03/08/1984, p. 58; and Eighteenth Council Directive 89/465/EEC of 18 July 1989, OJ L 226, 03/08/1989, p. 21. Of these, however, only the Eighteenth Directive, abolishing derogations provided for in Article 28(3) and Annex E Sixth Directive, had considerable impact in terms of furthering harmonisation. One important development during this period however was the approval of the Directives regarding the refund procedure for taxable persons not established in the territory of the country: Eighth Council Directive 79/1072/EEC of 6 December 1979, OJ L 331, 27/12/1979, p. 11; and Thirteenth Council Directive 86/560/EEC of 17 November 1986, OJ L 326, 21/11/1986, p. 40.

[172] As H.S. von Sydow comments: "the question to be answered was not: 'what can be realistically done by 1992?' but: 'what must be done in order to achieve the internal market and

barriers, the paper contained several measures in the field of VAT. The role of this tax within the overall aim of achieving an Internal Market was clearly acknowledged by the Commission:

> "It is clear [...] that the harmonisation of indirect taxation has always been regarded as an essential and integral part of achieving a true common market. Momentum has been lost in recent years but this was due essentially to the impact of the recession on the economic policies of Member States and preoccupation with other problems. But progress is being resumed and now we must proceed vigorously if we are to achieve the target date of 1992 for the completion of the Internal Market"[173]

The question which then arose was what level of harmonisation of VAT was required in order to establish the Internal Market? And more specifically, what VAT measures needed to be put into place in order to achieve that goal? The White Paper's rather vague answer to the first question was that "complete harmonisation, which has come to imply absolute identity in every respect, is not essential", however, a close level of "approximation" was required; this approximation had to be "sufficiently close that the operation of the common market is not effected through distortions of trade, diversion of trade and effects on competition".[174] In order to attain this level of "approximation", progress had to be achieved in three areas of the system:

— tax base or coverage;

— tax rates; and

— arrangements applicable to cross-border transactions.

As regards the approximation of tax base or coverage, the White Paper highlighted the need for the Council to approve the Commission proposals already on the table, as well as committing the Commission to presenting additional proposals covering other areas of the system. On the issue of rates, the Commission was to present a proposal, which would deal both with the number of rates and level of these rates, in particular that of the standard rate. In the meantime, according to the White Paper "provisions should be adopted which will exclude the proliferation of VAT rates in

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how could one squeeze it into the 1992 timetable", in "The Basic Strategies of the Commission's White Paper", in R. Bieber *et al* (eds.), *1992: One European Market? A Critical Analysis of the Commission's Internal Market Strategy*, Nomos Verlagsgesellshaft, Baden-Baden, 1988, p. 89.

[173] White Paper, p. 42. It is interesting to note that the White Paper is not the first Commission document where the connection between establishing, or completing, the Internal Market and VAT harmonisation was established, albeit being the only one which contained detailed instructions on how to attain this objective. In fact, in the years prior to the release of the White Paper, the Commission issued several documents highlighting the need for further harmonisation of VAT, and particularly the abolition of fiscal frontiers – amongst other measures – in order to establish a genuine Internal Market. See in particular *Strengthening the Internal Market*, Communication from the Commission to the Council, COM(82) 399 final, 24 June 1982, pp. 2-5; and *Consolidating the Internal Market*, Communication from the Commission to the Council, COM(84) 305 final, 13 June 1984, pp. 9-34.

[174] White Paper, p. 46.

Member States, or the widening of the gap between VAT rates, since this would make subsequent adjustment more difficult".[175]

The final element to this package of measures was the new arrangements with a view to treating transactions between Member States in the same way as those within Member States. Under the new arrangements VAT would be charged by the vendor on supplies to purchasers established in other Member States; the purchaser would then be allowed to deduct that input VAT in its own VAT return, irrespective of the Member State where the VAT was charged. According to the White Paper "the only formality which would be required of the taxable purchaser would be to include the deductible VAT in the box in his tax return which corresponds to his supplier's Member State". In order to minimise the impact on Member States' budgets, a Clearing House System would be established so that the VAT collected in the exporting Member State and deducted in the country of import could be credited to the latter.

Based on these basic principles it was then up to the Commission to present adequate legislative proposals.

### b) COMMISSION'S VAT PROGRAMME FOR THE INTERNAL MARKET

In the summer of 1987 following on from the White Paper strategy, the Commission issued a Global Communication outlining its proposals for indirect taxes with a view to the completion of the Internal Market.[176] The proposals (and one working paper) presented during the same period became know as the 1987 proposals[177] and envisaged three major changes[178] to the Community VAT system then in force, as follows: -

— abolition for intra-Community trade of the system of exempting (or zero-rating) of tax exports and imposing tax on imports;

— introduction of a VAT clearing mechanism, to ensure fair allocation of revenues; and,

— approximation of VAT rates.

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[175] White Paper, p. 52.

[176] *Completion of the internal market: approximation of indirect tax structures and harmonisation of indirect tax structure. Global Communication from the Commission*, COM(87) 320 final, 5 August 1987.

[177] Not all of these proposals related to VAT, many focussing on excise duties: see *Proposal for a Council Directive completing the common system of value added tax and amending Directive 77/388/EEC – Approximation of VAT rates*, COM(87) 321 final, 21 August 1987; *Proposal for a Council Directive completing and amending Directive 77/388/EEC – Removal of fiscal frontiers*, COM(87) 322 final, 21 August 1987; *Completing the internal market – the introduction of a VAT clearing mechanism for intra-Community sales*, Working document from the Commission, COM(87) 323, 5 August 1987; *Proposal for a Council directive instituting a process of convergence of rates of value added tax and excise duties*, COM(87) 324 final, 21 August 1987; and four proposals on the approximation of cigarette taxes, of manufactured tobacco other than cigarettes, of excise duties on mineral oils and of excise duties on alcoholic beverages and other products containing alcohol, COM(87) 325 to 328, 21 August 1987.

[178] Terra and Kajus identify four changes, making a distinction between the proposed administrative treatment of intra-Community supplies of goods and the new substantive treatment proposed for intra-Community supplies of services, see *A guide to the Sixth VAT Directive – Commentary to the Value Added Tax of the European Union*, Loose-leaf, IBFD Publications, 1993-2001, pp. 65 onwards.

These three changes are interlinked and are to a certain extent interdependent.

The principal argument advanced by the Commission to support this package of proposals was of an instrumental nature: the Commission argued that the approval of its proposals was fundamental for "completing the internal market",[179] *i.e.*, harmonisation was advocated as an instrument through which a desired objective (the establishment of an Internal Market) would be achieved, rather than as an end in itself.[180] The instrumental nature of these VAT proposals in relation to the establishment of the Internal Market is of crucial importance: if the approval of these proposals was regarded by the Commission as fundamental to the establishment of the internal market, and as these proposals were never approved, there is a significant basis to argue that the internal market, as regards VAT, was never established.

A more in-depth analysis of the changes proposed by the Commission is now undertaken.

### i) ABOLITION OF FISCAL FRONTIERS AND PRINCIPLE OF ORIGIN

The main aspect of the Commission's 1987 VAT proposals package was undoubtedly the abolition of the system of exempting (or rather zero-rating) exports and imposing tax on imports for intra-Community trade, which the Commission referred to as a switch to the principle of taxation in the country of origin.[181] The two other major

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[179] It is also indicative that several of the Commission's 1987 proposals and working documents used this expression in the title.

[180] The instrumental nature of the arguments advanced by the Commission is defended by Lee, Pearson and Smith. However, these authors consider the ultimate objective to be the abolition of fiscal frontier controls, see Lee, Pearson and Smith, *Fiscal Harmonisation: An analysis of the European Commission's proposals*, The Institute for Fiscal Studies, February 1988, p. 10. This assessment is, if not incorrect, at least limited – the abolition of fiscal frontiers was in itself regarded, since it was first proposed in the White Paper, as an instrument to achieve the ultimate objective of establishing the Internal Market.

[181] The terminology used here is that of the Commission. The meaning of "principle of origin", as opposed to the principle of destination, is not clear-cut. Principle of origin is normally taken to mean that the total amount of VAT paid is determined by the rate levied in the jurisdiction of its origin, and the aggregate revenue goes to the country of origin, see L. Ebrill *et al*, *op. cit.*, pp. 176 *et seq*. Appearing to take a similar view, K. Messere points out that three aspects of the tax treatment of international transactions are potentially relevant to determine whether the principle of destination or the principle of origin applies: (a) which country's rate of tax is applied; (b) which country ultimately gets the revenue; and (c) which country collects the tax – see "Consumption Tax Rules", (1994) *Bulletin for International Bureau of Fiscal Documentation*, December 1994, p. 665. However, under the system proposed by the Commission, VAT is collected by the Member State of origin, but the revenue is later channelled to the Member State of destination, under the clearing house mechanism, as set out below. The Commission's proposed system would therefore respect the principle of VAT as tax on consumption, as the revenue accrued would reflect consumption patterns; a switch to what is normally taken as "principle of origin" would not. As B. Lockwood *et al* comment: "as far as traders are concerned, the proposed system is therefore based on origin taxation, but a clearing-house acts to redistribute revenues in such a way that the outcome is equivalent to the old destination principle", in "On the European Union VAT Proposals: The Superiority of Origin over Destination Taxation", (1995) *Fiscal Studies* Vol. 16, No. 1, p. 5. It is important to emphasise that this proposed system would not apply to transactions with non-Member States, in relation to which the destination principle would continue to apply – such duplicity, whereby the origin principle (in its commonly used meaning) applies within the Union, but the destination principle applies to trade with the rest of the world, has been called by Shibata the "restricted origin principle", who defended it as an ideal model for the European Community, almost twenty years before the White Paper. For a detailed economic analysis of the effects of applying the destination principle, origin principle or the restricted origin principle, see E. Berglas, "Harmonisation of

changes proposed – the approximation of VAT rates and, more importantly the introduction of a VAT clearing mechanism – were regarded as corollaries of this switch, necessary measures to ensure its viability. This dependability was more evident in the case of the introduction of the VAT clearing mechanism, which would only be necessary if the abolition of the system of exempting exports and taxing imports within the Community was to go ahead.

The abolition of the system of imposing VAT on imports and exempting of VAT exports for intra-Community trade was regarded as the ultimate aim of the Community VAT system since its inception. As already referred, the relevance of this aim is emphasised through specific reference in the preamble of the First Directive, and is further reiterated in the preamble to the Sixth Directive.[182] In 1987, following the White Paper and twenty years since the approval of the First Directive, the Commission considered that the conditions for this aim to be achieved were finally set and presented a proposal for the "removal of fiscal frontiers".[183] This new proposal was based on a basic principle: elimination of the distinction between supplies within a Member State and intra-Member States' supplies. Underpinned by this principle the Commission proposed the following:

— modification of tax treatment of intra-Community supplies of goods; and,

— modification of tax treatment and, in certain cases, of place of supply of intra-Community supplies of services.

Tax treatment of intra-Community supplies of goods

Under the proposal, the rules governing the place of supply of goods would not be amended. As a general rule, the place of supply of goods would continue to be the place of consumption.[184] Rather the Commission proposed to change the tax treatment of the intra-Community supplies of goods. Instead of exempting (or more precisely, zero-rating) supplies of goods to another Member State, the VAT rate applicable in the Member State of departure would be charged. The acquisition of supplies of goods from another Member State would no longer be a taxable event. The foreign VAT could simply be deducted by the trader in the Member State of destination (provided the goods were used for taxable transactions) in the same way as the national input tax through their VAT return.

Tax treatment and place of supply of intra-Community supplies of services

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Commodity Taxes – Destination, origin and restricted origin principles", (1981) *Journal of Public Economics* 16, pp. 377-387.

[182] "Whereas account should be taken of the objective of abolishing the imposition of tax on importation and the remission of tax on exportation in trade between Member States; whereas it should be ensured that the common system of turnover taxes is non-discriminatory as regards the origin of goods and services, so that a common market permitting fair competition and resembling a real internal market may ultimately be achieved", in Preamble to the Sixth Directive, OJ L145, 13/06/1977, p. 1.

[183] See *op. cit.*, COM(87) 322 final/2, 21 August 1987.

[184] Article 8 Sixth Directive.

In relation to the intra-Community supplies of services, the proposal entails modifications on two levels: on their tax treatment and on certain place of supply rules. The tax treatment of supplies of services would be similar to the one proposed to supplies of goods, *i.e.*, the supply would be subject to VAT in the country of origin, and this foreign VAT would then be deducted in the Member State of destination. However, this had implications for the place of supply of services rules.

Since the creation of the Community VAT system the rules regarding the taxation of supply of services never required border tax adjustments. The basic rule for the place of supply of services was (and still is) that services are deemed to have taken place where the supplier has established his business. However, there were many exceptions to this basic rule, e.g. in relation to services subject to the so-called "reverse-charge mechanism", these were taxed in the country of destination where the customer was a taxable person.[185] The Commission proposed that these exceptions would be largely revoked.[186]

These new proposals regarding intra-Community trade entailed not only substantive alteration of the rules governing supplies of goods and services, but also radical amendments to the rules governing the right to deduct VAT, including the abolition of the Eighth Directive arrangements. Also, on a more symbolic note, the concepts of importation and exportation would no longer be applicable within the Community and would only apply to trade with third countries.

From a practical (and political) point of view, the proposal would also cause significant disturbances in terms of revenue distribution. In fact, the pattern of VAT receipts among Member States would not necessarily correspond to the pattern of consumption. Compared with the existing system, net importers from other Member States would tend to lose revenue, whereas net exporters would gain. Acknowledging the problem and in order to avoid this redistribution of revenue, the Commission proposed the introduction of a VAT clearing mechanism.

### ii) VAT CLEARING-HOUSE SYSTEM

The idea of a VAT clearing mechanism was first introduced by the White Paper. The Commission considered that in view of the new proposed tax arrangements for intra-Community trade:

> "A Clearing House System would have to be set up between the Member States so that the VAT collected in the exporting Member State and deducted in the country of import could be credited to the latter."[187]

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[185] Article 9(2)(e) Sixth Directive.

[186] In the case of services subject to the reverse-charge mechanism, the Commission considered that it should no longer be necessary to link these supplies to the customers' country, since under the proposed clearing system tax charged in the supplier's country would be deductible in the customer's country.

[187] White Paper, p. 52.

The principal concern was of a budgetary nature. The Commission was aware that the redistribution of revenues which the new system could give rise to would create serious budgetary difficulties for some Member States. In practice this would mean that the Council would never reach the required unanimity for the proposal to be approved. However, the problem did also have conceptual considerations, namely under the principle of VAT as a tax on consumption, revenues resulting from VAT charged on goods should accrue to the Member State of final consumption.

The clearing system as proposed in the White Paper was designed to operate on the basis of bilateral flows between Member States. Importers were to submit a breakdown of the value of goods obtained from each Member State and the amount of tax paid thereon. Member States' tax administrations would then aggregate these input figures in respect of each Member State. Once a year a reconciliation of Member States' claims would then be handled centrally under the supervision of the Commission. Following the release of this proposal, it became clear that it had certain drawbacks, most notably the imposition of significant compliance requirements upon traders and a heavy administrative burden on tax authorities. Moreover, there was the likelihood of costly bilateral disputes.[188]

Against this background, the Commission re-examined its proposal and in 1987 presented a revised version.[189] Under this revised proposal the VAT clearing system would simply operate on the basis of money owed to, or from, a central account run by Commission services – the VAT Clearing-House. Net exporting countries would be required to pay into the account and net importing countries would receive payments from the account. Each Member State would establish how much it owed, or was owed, under the clearing mechanism without any regard to what was being claimed by other Member States. Furthermore, traders would not be required to include a breakdown of input or output tax for each individual Member State, but instead would only have to report the export and import VAT on intra-Community trade as a whole. In order to ensure the proper and efficient functioning of this clearing system, the Commission proposed an additional package of control measures.[190]

According to the Commission, the proposed Clearing-House would be expected to show a surplus, approximately equal to the VAT charged on intra-Community sales to VAT exempt services and other entities that are not entitled to deduct input VAT. This surplus would be periodically distributed to Member States.

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[188] The high level *ad hoc* Group set up by the ECOFIN to study the White Paper proposals highlighted a number of serious problems in its 1986 report, specially with regard to the clearing mechanism, see M. Bos and H. Nelson, "Indirect Taxation and the Completion of the Internal Market of the EC", (1988) *JCMS* Vol. XXVII, No. 1, pp. 29-30.

[189] Technically it was not a formal proposal, but a Commission working document, see *op. cit.*, COM(87) 323 final, 5 August 1987. The Commission never presented a formal legislative proposal on the VAT clearing mechanism.

[190] These included the following: checks and controls built into the clearing mechanism; standardised audit trails and information requirements; improved control and cooperation between national administrations; and, central supervision from the Commission in respect of the clearing system and its related control measures.

### iii) APPROXIMATION OF VAT RATES

The Commission's White Paper provided that, if fiscal frontiers were to be abolished and the principle of taxation in the country of origin was to be applied, a significant approximation of VAT rates would have to be accomplished. In 1987 the Commission put forward a proposal for a new VAT rates structure, which would be compatible with these objectives.[191] This new structure was based on three basic principles, as follows: -

— it was a dual rate system;

— goods / services were compulsorily allocated to each rate;

— temporary derogations, allowing Member States to apply reduced rates and zero rates, were repealed.

Dual rate system

Although, acknowledging that a single VAT rate system would be ideal, as the simplest and most efficient structure, the Commission considered that, as all Member States at the time (excluding Denmark and the United Kingdom)[192] applied at least two VAT rates, a multi-rate system would be preferable not to upset the tax structures of the majority of Member States.[193] However, the question of how many VAT rates this multi-rate system should entail was less clear and the real choice for the Commission lay between a two-rate and a three-rate system.

Ultimately, the Commission considered that a three-rate system would create more complications for both taxpayers and national administrations and that it would be simpler and more cost effective to establish a dual rate system.[194] In light of these conclusions, the rate structure proposed by the Commission entailed a standard rate and a reduced rate. However, instead of fixing these rates, the Commission opted for establishing two rate bands, thereby allowing Member States some degree of flexibility in the choice of the actual rates. The standard rate could vary between 14% and 20% and the reduced rate between 4% and 9%.

The choice of bands seemed to have been based more on practical political considerations, than on optimal economic and efficiency calculations. The Commission considered that a 6 point range for the standard rate, and 5 point for the reduced rate, would be sufficient to avoid potential trade distortions, while allowing for a maximum number of Member States to suffer minimum budgetary repercussions.[195]

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[191] See *op. cit.*, COM(87) 321 final/2, 21 August 1987.

[192] However, although theoretically the United Kingdom had a single VAT rate system, in practice it applied zero rating in a large scale.

[193] See *op. cit.*., COM(87) 321 final/2 of 21 August 1987, p. 1.

[194] See *op. cit.*, COM(87) 320 final of 5 August 1987, p. 10. However, it should be noted that, at the time, the three-rate system under consideration by the Commission entailed standard, reduced and increased rates, and not standard and two reduced rates, as currently applies.

[195] See *ibid*, pp. 11-12; and *op. cit.*, COM(87) 321 final/2, 21 August 1987, p. 2.

List of goods / services subject to reduced rate

Under the proposal the reduced rate would *compulsorily* apply to the following goods / services:

— foodstuffs, excluding alcoholic beverages;

— energy products for heating and lighting;

— water supplies;

— pharmaceutical products;

— books, newspapers and periodicals;

— passenger transport.

There are two different aspects to this proposed list: firstly, the choice of goods / services subject to the reduced rate; and secondly, the compulsory nature of the list. Both aspects reflect the Commission's view on the role of reduced rates within the new rates structure.

Under the proposed list the amount of goods and services subject to the reduced rate is limited.[196] The Commission's selection of items was based on the application of reduced rates which Member States already had in place,

> "In most Member States the coverage of the reduced rate or rates is generally restricted to items of basic necessity. (...) The Commission proposes therefore that the following basic goods and services should be taxed at a reduced rate under the harmonised Community VAT structure."[197]

By choosing a limited number of items which were already subject to reduced rates in most Member States, the Commission sought to achieve two interlinked objectives: first to cause minimum budgetary disturbance to a maximum number of Member States, and second to facilitate the acceptance of the compulsory nature of the list.

The Commission considered that the allocation of goods and services to each rate (all goods / services not listed would be subject to the standard rate) was necessary in order to ensure that "the same type of products or service is placed under the same category of rate in the various Member States, thus avoiding systematic deflections of trade".[198] However, the Commission was aware that this compulsory nature of the new rates structure was likely to face objections by Member States, as their freedom to establish their own rate structures was significantly diminished. In this context, the Commission highlighted that if most Member States already applied reduced rates to the listed items, then the compulsory nature of the list would be almost irrelevant, as it

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[196] Mostly if compared with the list which was ultimately approved by Council Directive 92/77/EEC and still currently in force, see Annex H Sixth Directive. However, as the Commission significantly pointed out, these items represented approximately one third of the common Community tax base, see *op. cit.*, COM(87) 320 final, 5 August 1987, p. 11.
[197] *Ibid*, p. 10.
[198] *Ibid*, p. 2.

did not imply any change to either their domestic legislations, or budgetary consequences. In this way the Commission sought to facilitate Council's approval of the proposal.[199]

Temporary derogations

Article 28(2) Sixth Directive allowed Member States to retain the use of reduced rates and zero rates that were in force on 31 December 1975. The measure was temporary, and destined to be repealed once fiscal frontiers were abolished and taxation within the Community was based on the principle of origin. Attempting to fulfil this objective, the Commission's proposal envisaged the revocation of Article 28(2). It considered that the extensive application of reduced rates and particularly zero-rates had the potential to obstruct the Internal Market and distort competition. Thus, the Commission concluded that it "could not recommend that the Community should abandon what has been its considered and settled policy ever since the VAT was first adopted".[200]

However, as the abolition of this measure was likely to raise difficulties to Member States (and thus, hinder the proposal's approval by the Council), the Commission clarified that it would not be opposed to the possibility of derogations being granted to Member States facing particular difficulties through the abolition of this measure. In this context, it committed itself "to take a constructive part in the discussion of any derogations for which Member States in real difficulty might feel the need".[201]

In the interim, until the new VAT rate structure came into force (along with the abolition of fiscal frontiers on 1 January 1993), the Commission considered that it would be beneficial if VAT rates in the different Member States were to be brought to a standstill. To this end it put forward an additional proposal[202] according to which Member States should basically refrain from altering their rate structures, unless such alterations would bring their structures closer to that being proposed by the Commission, e.g. reducing or abolishing their increased tax rates or bringing their standard and reduced rates within the bands proposed.[203]

## 4) APPROVAL OF A VAT "TRANSITIONAL SYSTEM"

The Commission's 1987 proposals were widely regarded as very ambitious in both their aims and their prospected methods for achieving these aims.[204] Progress in

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[199] As discussed *infra*, this tactic proved unsuccessful, as the proposal failed to get Council approval to a great extent due to the compulsory nature of the list.

[200] See *op. cit.*, COM(87) 320 final, 5 August 1987, p. 13. For a more detailed report on the Commission's position regarding zero-rating see pp. 12-14.

[201] *Ibid,* p. 14.

[202] *Op. cit.*, COM(87) 324 final/2, 21 August 1987. In fact, as the name indicates, the proposal did not regard exclusively VAT, but also excise duties.

[203] *Ibid*, Article 1.

[204] A.J. Easson expressed a widely felt scepticism when he commented: "to expect to achieve an alignment of tax rates by 1992, by the end of the century or even by the middle of the next one, is to be completely unrealistic. The approach which has been exposed by the Commission

Council discussions proved slow and, following an initiative of the Council and the Commission, several working parties were set up in order to establish the best strategy for the abolition of fiscal frontiers. In a Communication to the Council and the European Parliament, dated June 1989, the Commission highlighted the work of the Economic Policy Committee and the deliberations of two working parties, both set up in the beginning of 1989, one on the clearing system and the other on the allocation of VAT rates to different product categories.[205] However, major disagreements regarding the method of abolishing fiscal frontiers still existed and by June 1989 the Commission realised that the Council would fail to reach agreement.

In its June 1989 Communication, the Commission accepted that in order to bring about an agreement within the Council, the adoption of a more pragmatic approach would be required.[206] In this context, the Commission suggested the adoption of a twofold strategy, which basically entailed the introduction of a transitional phase for the approximation of indirect taxes that would last until the end of 1992. The underlying rationale, that a transitional phase would facilitate transition to a system of taxation in the country of origin, not only for Member States' governments but also for traders.

However, the Commission's "two-phase" approach was not sufficient and as early as October 1989 the Council decided that there would be not enough time before 1 January 1993 for the necessary conditions for the introduction of a system of taxation in the country of origin to be fulfilled. Thus, it became essential to agree upon a VAT system which continued to be based on the principle of taxation in the country of destination, but which at the same time permitted the abolition of border controls. The idea of a transitional phase, which would last beyond 1 January 1993, started to take shape. From 1989 to 1991 a series of key meetings of the ECOFIN Council of Ministers took place. From these meetings emerged the basic shape of the VAT arrangements to be applied to intra-Community trade after 1993. These arrangements were to become the VAT transitional system.

### a) ABOLITION OF FISCAL FRONTIERS

The main criticisms levelled at the Commission's 1987 proposals did not concern the basic aims of the abolition of fiscal frontiers proposal – namely the abolition of the system of exempting (or rather zero-rating) exports and imposing tax on imports for intra-Community trade – but rather how such a system would be run in practice, most especially in relation to the functions of the VAT Clearing-House. In the White Paper the Commission considered that:

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for the past twenty-five years or so is doomed to fail", in "The Elimination of Fiscal Frontiers", in R. Bieber *et al* (eds.), *1992: One European Market? A Critical Analysis of the Commission's Internal Market Strategy*, Nomos Verlagsgesellshaft, Baden-Baden, 1988, p. 260.

[205] *Completion of the Internal Market and Approximation of Indirect Taxes*, Communication from the Commission to the Council and to the European Parliament, COM(89) 260 final, 14 June 1989, p. 1.

[206] *Ibid*, pp. 2-12.

"With modern information technology such a Clearing House System would not demand heavy resources. But it would require mutual confidence between Member States' VAT collecting authorities."[207]

However, it was in fact the issues of administrative costs and lack of confidence between Member States that constituted the principal obstacles. It was argued that the complicated and centralised nature of the clearing-house mechanism would constitute a potential source of budgetary conflict between Member States. Tax administrations expressed serious reservations in relation to how it would function in practice: on one hand, it did not offer all the necessary guarantees in terms of control; on the other, it would imply an excessively centralised administration.

In view of these criticisms in its June 1989 communication the Commission proposed a new macro-economic approach to the clearing operation, which would present "appreciable operational advantages" and "could also become politically acceptable".[208] Instead of VAT returns, trade statistics would constitute the basis for the clearing operation in order to calculate Member States' debits and credits. This approach would not require a central clearing fund, involving only an accounting exercise. Additionally, it was not expected to yield a net surplus.[209]

However, this new approach proposed by the Commission was still insufficiently convincing. The *ad hoc* Working Party on the Abolition of Fiscal Frontiers concluded that although a taxation system in the country of origin was still desirable, the conditions which it presupposed could not be met before 1 January 1993. The report issued by the *ad hoc* working party suggested that an alternative solution, which would allow for the removal of tax frontiers, should be considered.[210] The report set out three requirements which such an alternative solution should fulfil, as follows: -

— exempt intra-Community trade between taxable persons from customs formalities and reduce administrative burdens on undertakings;

— ensure freedom of movement and purchase for individuals while avoiding excessive risks of distortion of competition; and,

— ensure administrative monitoring and control of operations to secure correct application of taxes.

If these requirements were met, the report continues, the present arrangements whereby tax would be applied in the country of destination to purchases by taxable

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[207] White Paper, p. 52.
[208] See *op. cit.*, COM(89) 260 final, 14 June 1989, pp. 8-9.
[209] However, as A.L. Bovenbergand and J.P. Horne point out, "a major problem with this proposal is that trade statistics are imprecise. Removing the border controls may make these statistics even less reliable. Moreover, countries would face incentives to understate their exports and to overstate their imports", in "Taxes on Commodities – A Survey", in G. Kopits (ed.), *Tax Harmonisation in the European Community – Policy Issues and Analysis*, International Monetary Fund, Occasional Paper 94, Washington DC, July 1992, p. 28, footnote 30.
[210] Conclusions of the Presidency of the *ad hoc* Working Party on the Abolition of Fiscal Frontiers, also known as the "Lemierre Report".

persons could be maintained. These arrangements should also be coupled with approximation of VAT rates and special arrangements for the following:

— purchases of registered vehicles;

— mail-order purchases and "tele-shopping" by private individuals; and,

— purchases by bodies not subject to VAT, or exempt from it.

This alternative solution would, however, only be acceptable as long as it was exclusively regarded as a transitional measure ending at the latest on 1 January 1997.

In October 1989, in view of the *ad hoc* working party report conclusions, the ECOFIN Council considered that,

> "The creation of a system of taxation in the country of origin, as proposed by the Commission, presupposes the fulfilment of conditions that cannot be met before 1 January 1993. Also in order to achieve the effective elimination of borders by this date for companies and individuals, while respecting the economic neutrality of the common system of value added tax, the Council finds it necessary to continue, for a limited period of time, to collect the VAT in the State of consumption."[211]

The basic principles of the tax mechanism to be established by 1 January 1993 were finally agreed upon by the ECOFIN Council meeting of 13 November 1989.

In May 1990, following on from ECOFIN's guidelines, the Commission presented a new proposal for the abolition of fiscal frontiers.[212] Under this new proposal the current destination based VAT system would be maintained for a transitional period of four years following the elimination of fiscal frontiers on 1 January 1993. Adoption of the definitive system based on the origin principle (whether in the form of a Clearing-House system or an alternative approach) would be postponed until 1997. Until then, tax-related border formalities would be eliminated as planned on 1 January 1993, and border tax adjustments would be administered by the national tax administrations through VAT returns without the need for border declarations – the intra-Community purchase of goods becomes the taxable event, rather than the physical importation of goods.[213]

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[211] Conclusions of the ECOFIN Council meeting of 9 October 1989.

[212] *Proposal for an amendment to the proposal for a Council Directive supplementing the common system of value added tax and amending Directive 77/388/EEC*, COM(90) 182 final, 17 May 1990, OJ C176, 17/07/1990, p. 8. This proposal was subsequently amended to incorporate the amendments suggested by the European Parliament, *Amendment to the proposal for a Council Directive supplementing the common system of value added tax (VAT) and amending Directive 77/388/EEC – Abolition of tax frontiers and transitional arrangements for taxation with a view to establishment of the internal market*, COM(91) 157, 2 May 1991.

[213] As referred by A.L. Bovenbergand and J.P. Horne this system is not unlike the PAS system (postpone accounting system; also known as the deferred payment scheme) proposed by the Commission in 1982, which basically defers the collection of import VAT to the first taxable entity in the importing country, *op. cit.*, pp. 25-29. See also *op. cit.*, COM(82) 402 final, 5 July 1982. In the White Paper the Commission suggested that this approach would be introduced, awaiting the introduction of the Clearing-House mechanism. The proposal was withdrawn when the Commission presented its 1987 proposals package (which included the working document on the Clearing-House system). However, in the ECOFIN meeting on 9 October 1989, the Council suggested that this approach could still be adopted as a transitional measure after

On 16 December 1991 the ECOFIN Council finally approved Directive 91/680/EEC on the abolition of fiscal frontiers.[214] This Directive constituted the cornerstone of the new VAT transitional system and dramatically changed the Community VAT system as a whole. The amendments which resulted from the approval of the Abolition of Fiscal Frontiers Directive can be divided into three main types:

— conceptual or language adjustments;

— substantive provisions; and,

— administrative obligations.

Conceptual or language adjustments

The concepts of "exportation and "importation" were abolished in respect of intra-Community trade and new concepts were introduced (with similar results to a great extent): intra-Community supply and intra-Community acquisition. The concepts are closely linked: an exempt (or zero-rated) intra-Community supply results in a taxable intra-Community acquisition of goods, similar to the situation up to then in which an exempt (or zero-rated) export would be followed by a taxable importation. The substitution of concepts appears to be more symbolic than substantive, and thus more of a linguistic change than a conceptual one.

Substantive provisions

For traders the major difference introduced by the Abolition of Fiscal Frontiers Directive was that, as the fiscal controls at internal frontiers were to be abolished from 1 January 1993, the taxable event, *i.e.*, the intra-Community acquisition must be reported on the internal VAT return rather than to customs officials at the borders.

As for purchases by private individuals, under the new regime they would, as a general rule, be taxed exclusively in the country of purchase. However, there were special rules applicable to the purchase of new cars and other means of transports as well as distance sales.

Administrative obligations

The physical control and the control of documents to be presented upon importation were abolished and substituted by a VAT Information Exchange System (the "VIES").[215] In order to be entitled to an exempt intra-Community supply, similar to the previously exempt export, the supplier must obtain the VAT identification number of the buyer. For this purpose all VAT-registered persons were provided with an

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1992. The fact that the Benelux countries had already been applying this mechanism successfully on their bilateral trade since the early seventies acted as an additional incentive.

[214] Council Directive 91/680/EEC of 16 December 1991, OJ L376, 31/12/1991, p. 1. Hereafter referred to as "Abolition of Fiscal Frontiers Directive".

[215] The VIES was not introduced by the Abolition of Fiscal Frontiers Directive, rather by the Administrative Cooperation Regulation – Council Regulation No 92/218/EEC of 27 January 1992, OJ L24, 01/02/1992, p. 1. However, the introduction of the system was a direct consequence of this Directive, as the new system could not have been introduced without the implementation of control measures.

identification number. The suppliers must report the intra-Community supplies of each buyer and his VAT identification number periodically to the national tax administrations. In the same way, the buyer has to report its intra-Community acquisitions. The exchange of information between Member States guarantees that the intra-Community acquisitions match the intra-Community supplies as listed in the various Member States.[216]

### b) APPROXIMATION OF VAT RATES

The decision to introduce a VAT transitional system had serious implications for the discussions on the harmonisation of VAT rates. Rates approximation was still seen as an absolute necessity if abolition of travellers' allowances and border controls was to take place, however, a close approximation, such as the one put forward by the Commission in its 1987 proposal, was no longer required. The rates approximation as *per* the Commission's 1987 proposal had given rise to controversy from the outset[217] and the decision to introduce a transitional system provided the perfect pretext to bring into force a less extreme approximation.

In its June 1989 Communication[218], the Commission recognised from previous Council and Parliament discussions that certain aspects of the 1987 VAT rates proposal were curtailing the possibility of reaching agreement. These aspects were, as follows: -

— the width of the bands, namely in the case of the standard rate, which was often regarded as excessive and likely to give rise to distortions of competition;

— the range of products to be subject to reduced rate; and

— the problem of zero-rated products.

In fact, as reported by the European Parliament's Committee on Economic and Monetary Affairs and Industrial Policy,[219] as soon as the debate on the Commission's proposal was initiated in the European Parliament, it became clear that a great number of national and special interests were anxious to have the list of items, which could be subject to the reduced rate enlarged. According to the same report, some fifty amendments to the first version of the European Parliament's opinion on the proposal were tabled in the Committee. In light of this, and with a view to facilitate

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[216] As stated by B. Terra and J. Kajus, the new system "requires persons liable to pay VAT to comply with new extensive obligations", in *A guide to the Sixth VAT Directive, op. cit.*, p. 73.

[217] The Economic and Social Committee, for instance, recognised that the Commission's proposal was pragmatic and represented an intermediate position, however, it considered that it could still create severe problems for some Member States, and thus, urged the Commission to examine alternatives to its present proposals, in *Opinion on the completion of the internal market: Approximation of indirect tax rates and harmonisation of indirect tax structure (Global communication from the Commission)*, 88/C237/05, OJ C237, 12/09/1988, p. 14. It was also suggested at the time that the proposal would weigh more heavily on some Member States than others, namely on Denmark, United Kingdom, Ireland and Luxembourg, see M. Bos and H. Nelson, *op. cit.*, pp. 38-39.

[218] See *op. cit.*, COM(89) 260 final, 14 June 1989.

[219] *Resolution on completion of the Internal Market: Approximation of indirect taxation in the Community up to 1993 and thereafter – Report of the Committee on Economic and Monetary Affairs and Industrial Policy on the approximation of VAT rates*, Rapporteur: Alan Metten, A3 427/92, OJ C183, 15/07/1991, p. 293.

agreement within the Council, the Commission suggested in its Communication an alternative rates structure, as follows: -

— minimum standard rate, without any upper limit being set (instead of the proposed standard rate band);

— one reduced rate between 4% and 9% (retention of the band proposed in 1987); and

— maintenance of zero-rating for a limited number of products (instead of the proposed abolition of zero-rates).

This alternative rate structure was significantly more moderate and less ambitious than the structure originally proposed by the Commission. However, it was still over-ambitious for the Member States, namely in relation to the reduced rates regime – number of reduced rates allowed (only one), percentage band allowed (4% to 9%), list of items to which they would be applicable (six items), and finally the compulsory nature of this list.

In an attempt to facilitate agreement regarding the reduced rates regime, the European Parliament suggested that two lists of goods and services would be set up[220], as follows: -

— a first list, covering six items, for which a reduced rate would be mandatory; and,

— a second list, covering twenty-four items, for which a reduced rate would be optional.

The first list contained most of the goods and services listed in the Commission's initial proposal, some of which could be traded across frontiers. The second list broadly covered transactions where differences in VAT rates could not distort competition because the products in question were not generally traded between Member States.

Finally, in March and June 1991, the Council reached agreement on the essential characteristics of the VAT rate structure, which was to apply within the context of the new transitional system. This agreement, which eventually led to the approval of the Council Directive 92/77/EEC of 19 October 1992, known as the Approximation of VAT Rates Directive,[221] not only differed significantly from the Commission's original 1987 proposal, but also differed from the alternative rates structure proposed by the Commission in its 1989 Communication. The European Parliament's two-lists' suggestion was not followed either.

The new VAT rate structure, which would apply from 31 December 1992 onwards, was largely a product of political compromises and an example of the victory of politics over economical efficiency. The price for reaching agreement was an extremely

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[220] *Legislative Resolution embodying the opinion of the European Parliament on the Commission proposal for a Council Directive supplementing the common system of value added tax and amending Directive 77/388/EEC – Approximation of VAT rates*, 12 June 1991, OJ C183, 15/07/1991, p. 122.

[221] Council Directive 92/77/EEC of 19 October 1992, OJ L 316, 31/10/1992, p. 1.

complex system (mostly if compared with the simplicity of the structure initially proposed by the Commission), filled with exceptions and derogations. Overall, the new rate structure comprised two types of rules:

— general rules; and

— temporary measures, which would apply only during the transitional system.[222]

General rules

Member States should apply a standard rate, which should not be lower than 15%. No maximum limit was established. This rule followed from the Commission's 1989 suggestion for a minimum standard rate, instead of the band initially proposed.

Member States could also apply either one or two reduced rates, which could not be lower than 5%. These rates could be applied to a range of seventeen goods and services listed in Annex H and additionally, under certain conditions, to the supplies of natural gas and electricity.

These reduced rates rules were substantially different from the ones originally proposed by the Commission in 1987.[223] The most important difference (and the one which would eventually cause most problems) was the optional nature of the rates: Member States were no longer obliged to apply a reduced rate to a few items, but were instead not only free to choose whether to apply a reduced rate or not, but also free to choose to which items (from the ones listed) that rate would apply. The other obvious differences were the possibility to apply two reduced rates (instead of one) and the increased list of items which could be subject to reduced rates (eighteen instead of six).

However, and despite these differences, the Council did adopt the Commission's approach in relation to the criteria adopted for the choice of items which could be subject to reduced rates:[224] one list of goods and services which were already taxed by a majority of Member States at reduced rates. This approach was substantially different from the one advocated by the Parliament, whose two-lists' proposal was based on a distortion of competition criteria.

Finally, it should be noted that, under the new Article 12(3) Sixth Directive, certain supplies were not subject to these rates' rules, as follows:

— works of art, antiques and collector's items;

— agricultural outputs; and

— gold.

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[222] The temporary nature of these measures is, however, questionable, in view of the fact that more than ten years after their approval, they remain in force.

[223] As discussed *supra*, regarding reduced rates, the Commission's 1989 alternative rate structure did not differ from its original 1987 proposal.

[224] As reported by the Commission in *Report from the Commission to the Council in accordance with Articles 12(4) and 28(2)(g) of the Sixth Council Directive of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes – Common system of value-added tax: uniform basis of assessment*, COM(94) 584 final, 13 December 1994.

These supplies would be subject to special arrangements and thus, the object of autonomous Directives to be approved on a future date by the Council.[225]

Temporary measures

During the transitional period, and until a definitive VAT system was approved, Member States were allowed to maintain and/or introduce measures which derogated from the general rates' rules described *supra*.

The introduction of these temporary measures had not been envisaged by the Commission's 1987 proposal, nor had it been suggested by the Commission in its 1989 alternative rate structure. It most probably emerged from the Council's discussions as a method of reiterating the Community's commitment to a simpler, more efficient and harmonised rate structure, but postponing politically difficult decisions for Member States such as the abolition of zero-rating.

Under these temporary measures, Member States were allowed, subject to certain conditions, to,

— continue to apply reduced rates lower than the 5% minimum;

— continue to apply zero-rates;

— continue to apply both reduced rates lower than the 5% minimum and zero-rates to items not listed in Annex H;

— continue to apply a reduced rate to restaurant services, children's clothing, children's footwear and housing; and

— introduce, dependent on certain requirements, an extra reduced rate, not lower than 12%.

Additionally, Greece was allowed to apply, within part of its territory, rates which were 30% lower than the ones applied in the rest of the country; and Ireland could apply for authorisation to apply a reduced rate to the supplies of energy products for heating and lighting.

The implications of these temporary measures to the overall rate structure were immense, as Figure 2.1 shows.

[225] A Directive on works of art, antiques and collector's items was approved in 1994, and in 1998 the Council approved the Directive on investment gold. These are Council Directive 94/5/EC of 14 February 1994, OJ L60, 03/03/1994, p. 16; and Council Directive 98/80/EC of 12 October 1998, OJ L281, 17/01/1998, p. 31, respectively. In 1994 the Commission put forward a proposal in respect of agricultural outputs – *Proposal for a Council Directive amending Directive 77/388/EEC on the common system of Value Added Tax (taxation of agricultural outputs)*, COM(94) 584 final, 13 December 1994 – however, the Council was unable to reach an agreement and the Commission had no other option except to withdraw this proposal.

**TABLE 2.1**

**APPROXIMATION OF VAT RATES DIRECTIVE**

| GENERAL RATES RULES (ARTICLE 12) | GENERAL RATES RULES + TEMPORARY MEASURES (ARTICLE 28) |
|---|---|
| ➢ Three rates system (one standard rate, two reduced rates)<br>➢ Reduced rates minimum (5%)<br>➢ Eighteen goods / services which may be subject to reduced rates (Annex H and natural gas and electricity) | ➢ Five rates system (one standard rate, two reduced rates, an extra reduced rate and zero-rate)<br>➢ Reduced rates not subject to minimum<br>➢ Twenty-two goods / services which may be subject to reduced rates (Annex H, natural gas and electricity, restaurant services, children's clothing, children's footwear and housing)<br>➢ All goods / services may be subject to reduced rates lower than 5% and zero-rates |

Figure 2.2 provides a comparative overview of the three VAT rate structures discussed *supra*: the structure proposed by the Commission in 1987, the alternative structure suggested by the Commission in 1989 and, finally, the structure which was ultimately approved by the Approximation of VAT rates Directive.

TABLE 2.2

## VAT RATE STRUCTURES – COMPARATIVE OVERVIEW

| COMMISSION'S 1987 PROPOSAL | COMMISSION'S 1989 ALTERNATIVE STRUCTURE | APPROXIMATION OF VAT RATES DIRECTIVE |
|---|---|---|
| ➢ **Two rates system** (standard rate and reduced rate) | ➢ **Two rates system** (standard rate and reduced rate) | ➢ **Five rates system** (standard rate, three reduced rates and zero-rate) |
| ➢ **Standard rate band** (14% to 20%) | ➢ **Standard rate minimum** | ➢ **Standard rate minimum** (15%) |
| ➢ **Reduced rate band** (4% to 9%) | ➢ **Reduced rate band** (4% to 9%) | ➢ **Reduced rates minimum** (5%) in theory; in practice no minimum applies |
| ➢ **6 items** which may be subject to reduced rate | ➢ **6 items** which may be subject to reduced rate | ➢ **22 items** which may be subject to reduced rates |
| ➢ **Compulsory nature** of list of goods / services subject to reduced rate | ➢ **Compulsory nature** of list of goods / services subject to reduced rate | ➢ **Optional nature** of list of goods / services subject to reduced rate |
| ➢ **Abolition of zero-rating** | ➢ **Maintenance of zero-rating** for a limited range of products | ➢ **Maintenance of zero-rating** |

### c) ANCILLARY SYSTEMS AND SIMPLIFICATION MEASURES

The introduction of a VAT transitional system and the abolition of fiscal frontiers entailed additional modifications to the EU VAT system. In particular there was the need to introduce ancillary systems for statistical and control purposes, such as the Intrastat and the VIES systems; and the simplification measures to deal with some of the practical difficulties caused by the new transitional system.

Ancillary systems: Intrastat and VIES

Prior to their abolition, physical frontiers had been both a source of statistical data, and a method of controlling intra-Community trade. Following the decision to introduce a transitional system it was clear that ancillary systems would have to be set up in order to compensate for the lack of physical frontiers.

The system of collecting statistics on the trading of goods between Member States of the European Union, known as the Intrastat system, was introduced by Council Regulation (EEC) No 3330/91 of 7 November 1991[226] and it resulted from the need to create a system which provided a satisfactory level of information on the trading of goods between Member States without involving checks at internal frontiers. Under this new Intrastat system traders were required to periodically submit detailed accounts of their intra-Community transactions in goods (this includes both intra-Community supplies and intra-Community acquisitions). It was believed – and broadly confirmed in practice – that the data collected *via* Intrastat would be a suitable substitute for physical frontiers for statistical purposes.[227]

Similarly to the Intrastat, under the VIES arrangements traders are required to submit periodic declarations of their dispatches of goods to VAT registered traders in other Member States; the difference being that traders are only obliged to report intra-Community supplies of goods, but not intra-Community acquisitions of goods.[228] National administrations on the other hand are required to store and process the information collected from its national exporters.

The VIES was introduced by Council Regulation (EEC) No. 218/92 of 27 January 1992[229], like the Intrastat system, in the aftermath of the abolition of fiscal frontiers. The principal aim of this Regulation was to put in place arrangements which sought both to combat and also to act as a deterrent to VAT fraud. VIES was the main feature of these arrangements and was designed to prevent, as well as deter, abuse of the special VAT zero-rating provisions for intra-community trade.[230]

Simplification measures: First *Nettoyage* Directive

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[226] OJ L 316, 16/11/1991, p. 1.

[227] In practice, however, for businesses engaging in intra-Community trade the system is quite complex and burdensome, see Chapter 3.

[228] Both the Intrastat and the VIES arrangements apply only to intra-Community transactions in goods, although the Commission has currently put forward a proposal to extend the VIES system to services, see Chapter 3.

[229] OJ L 24, 01/02/1992, p. 1.

[230] Similarly to the Intrastat system, the VIES system gives rise to significant practical difficulties, see Chapter 3.

In December 1992 the Council approved Council Directive 92/111/EEC, the so-called First *Nettoyage* Directive, in order to facilitate the application of the provisions introduced by the Abolition of Fiscal Frontiers Directive, and to introduce the simplifications needed.[231] Despite introducing amendments to several of the Sixth Directive's provisions,[232] the Directive is mostly known for simplifying the arrangements applicable to the so-called triangular operations.

Triangular operations occur where a trader established in Member State A sells goods to another trader established in Member State B, which in turn sells the goods to yet another trader established in Member State C; however the goods are directly transported from Member State A to Member State C, as shown in Diagram 2.1. Under the system introduced by the Abolition of Fiscal Frontiers Directive the trader established in Member State B would be deemed to have made an intra-Community acquisition in Member State C,[233] and would therefore be obliged to register in that State. In practice, this arrangement could lead to a situation whereby businesses who operate triangular operations in different Member States would have to register for VAT in all Member States' in which they have purchasers, despite having no presence in those States. On the contrary, under the simplified system introduced by the First *Nettoyage* Directive, the trader established in Member State B would not have to register in Member State C, as it would not be deemed to have made an intra-Community acquisition in that State; instead the trader established in Member State C would be deemed to have made that acquisition and as such be liable to pay tax in that State (reverse-charge mechanism).

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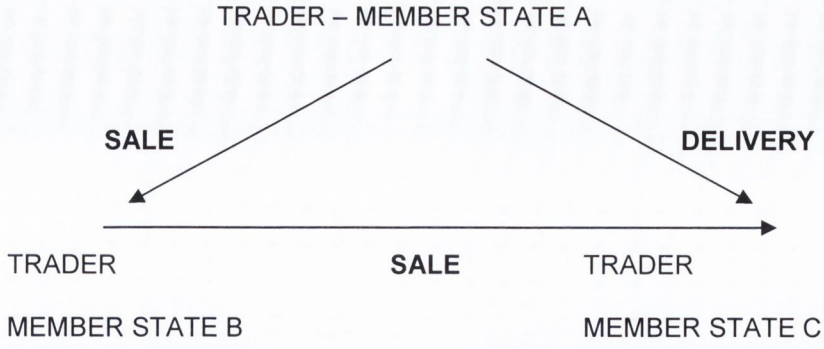
[231] Preamble to Council Directive 92/111/EEC of 14 December 1992, OJ L 384, 30/12/1992, p. 47. Council Directive 95/7/EC, known as the Second *Nettoyage* Directive, was approved to simplify arrangements applicable to chain transactions – Council Directive 95/7/EC of 10 April 1995, OJ L 102, 05/05/1995, p. 18.

[232] The First *Nettoyage* Directive also included provisions regarding special derogations granted to Spain and Italy, the Seventeenth Directive (Seventeenth Council Directive 85/362/EEC of 16 July 1985 on the temporary importation of goods other than means of transport, OJ L 192, 24/07/1985, p. 20) and Council Directive 69/169/EEC of 28 May 1969 on exemption from turnover tax and excise duty on imports in international travel, OJ L133, 04/06/1969, p. 6.

[233] By virtue of joint reading of Article 28a(1)(a) and Article 28b(A)(1) Sixth Directive, whereby an "intra-Community acquisition of goods is deemed to have taken place where the goods are at the time when dispatch or transport to the person acquiring them ends".

**DIAGRAM 2.1 – TRIANGULAR OPERATIONS**




In short, the simplifying measures introduced by the First *Nettoyage* Directive provide that where a taxable person who is not established in the territory of the State, nor is registered for VAT purposes there, makes an intra-Community acquisition of goods in that State and makes a subsequent supply of goods to a taxable person in that State; then, that taxable person to whom the goods are ultimately supplied shall be deemed to have made the supply, and the intra-Community acquisition by the non-established person shall be disregarded.[234]

## 5) TOWARDS A DEFINITIVE VAT SYSTEM – THE DEVELOPMENT OF THE EU VAT SYSTEM AFTER THE OFFICIAL ESTABLISHMENT OF THE INTERNAL MARKET

The VAT transitional system was supposed to be in place for a period of four years following the elimination of fiscal frontiers on 1 January 1993. Member States agreed then on a time plan according to which the Commission would bring proposals forward by the end of 1994, with a view to implementing a definitive VAT system based on the origin principle by 1997. Unfortunately, the Commission was unable to fulfil this time plan and it was not until the summer of 1996 that a work programme was presented for the adoption of the definitive VAT system.[235]

### a) COMMISSION'S 1996 PROGRAMME FOR A DEFINITIVE VAT SYSTEM

Although formal legislative proposals were not presented, the programme contained an outline of the envisaged system, as well as a detailed work plan extending through to mid-1999.[236]

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[234] See Articles 21(1)(c), 28b(A)(2), 28c(E)(3) Sixth Directive. It is worth noting, however, that Member States may derogate from these provisions where the non-established taxable person has a fiscal representative, Article 21(1)(c), last paragraph.

[235] See *op. cit.*, COM(96) 328 final, 22 July 1996. During the period between the adoption of the transitional system and the presentation of the work programme, some legislative progress was achieved. Particularly worthy of notice are the approvals of Council Directive 94/5/EC of 14 February 1994 on special arrangements applicable to second-hand goods, works of art, collectors' items and antiques, OJ L 60, 03/03/1994, p. 16; and Council Directive 95/7/EC of 10 April 1995, OJ L 102, 05/05/1995, p. 18, known as the Second *Nettoyage* Directive.

[236] This means that in practice even if the proposals presented during this period would have been agreed upon by Member States, the definitive VAT system would not be in place until 2001 at the earliest, as the Commission envisaged at least a two year period for

The proposed definitive VAT system

The key features of the definitive VAT system as envisaged by the Commission's 1996 programme were, as follows:

— Abolition of remission/taxation mechanism for intra-Community trade and implementation of principle of taxation of intra-Community transactions at their point of origin;

— Single place of taxation for operators;

— Compensation mechanism, *i.e.*, the allocation of VAT revenues to Member States, would be based on statistics of aggregate consumption;

— Further harmonisation of the main aspects of the VAT system, including rates, extent and conditions of the right to deduct, exemptions, the tax treatment of small firms and other special schemes;

— Uniformity in the application of VAT legislation, which would be ensured by the VAT Committee which would be turned into a regulatory committee;

— Modernisation of the EU VAT system in order to deal with realities of the new world economy, such as telecommunications;

— Cooperation and EU supervision of VAT administration, control and collection in the new system.

Although subject to the same basic aim – the abolition of the remission / taxation mechanism for intra-Community trade – it is immediately apparent that the key features of the proposals contained in the Commission's 1996 programme are substantially different from the 1987 proposals.[237] In fact, although some of the key aspects contained in the 1996 programme were already present in the 1987 proposals – such as the need for a revenue compensation mechanism and further harmonisation of the main aspects of the VAT system – other aspects are rather more innovative. This is the case with the proposal for the transformation of the VAT committee into a regulatory committee; the emphasis placed on the need for modernisation of the EU VAT system, and, in particular, the proposal for a business single place of taxation.[238] Equally innovative was the proposed method of revenue allocation: the Commission proposed that the revenue allocation between Member States should be based on a statistical macroeconomic data regarding levels of consumption, instead of attempting to offset revenue

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implementation of the adopted measures, in order to give businesses and tax administrations time to adapt, see *op. cit.*, p. 34.

[237] See S. Smith, *The Definitive Regime for VAT – An Assessment of the European Commission's Proposals*, The Institute of Fiscal Studies, Commentary 63, London, 1997, p. 2.

[238] For a detailed critical analysis of these proposals see S. Smith, *ibid*, pp. 11-20. The proposal for a single place of taxation can perhaps be regarded as the genesis of the legislative proposal recently presented by the Commission on a VAT one-stop shop, see *op. cit.*, COM(2004) 728 final, 29 October 2004.

redistribution to reflect the pattern of tax payments and input VAT credits on transactions (as under the proposed 1987 Clearing House mechanism).[239]

Work plan and failure to achieve agreement

In order to achieve the proposed definitive VAT system, the 1996 programme set out a provisional timetable, which extended to mid-1999. In this respect the 1996 programme also differs significantly from the 1987 proposals: the 1987 proposals were based on an immediate switchover to the definitive system, what the Commission has referred to as a "big bang" approach; whilst the 1996 programme envisaged a gradual changeover to the definitive system. Unfortunately, as acknowledged by the Commission, this gradual approach proved as difficult to implement as the 1987 "big bang".[240]

The first set back came very soon after the presentation of the 1996 programme, as Member States failed to reach total agreement on the already tabled proposal regarding the establishment of a fixed band for standard rates of VAT. This included a minimum rate of 15% and a maximum rate of 25% and whilst Member States were able to agree on the minimum level, it was impossible to reach unanimity on a maximum level. Ultimately, the proposal was approved but the final text contained no reference to the maximum level of standard rate.[241] The second step as envisaged in the work plan included the change in status of the VAT Committee. In mid-1997 (slightly behind schedule), the Commission presented a proposal to change the legal status of the VAT Committee from an advisory body to a regulatory committee.[242] Discussions, however, proved difficult and after over seven years pending at the Council, the Commission has finally decided to withdraw the proposal. In 1998 (again behind schedule) the Commission made a final attempt by putting forward the envisaged proposal on the harmonisation of the rules governing the right to deduct. Again, discussions at the Council proved difficult, and although the proposal is still formally on the table, it is now accepted that its approval is extremely unlikely. [243]

Ultimately, very little progress was made on the Commission's proposed 1996 programme and it soon became clear that the degree of harmonisation necessary

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[239] The use of macroeconomic data as a method of revenues reallocation had already been suggested by the European Parliament's Directorate General for Research a few months earlier, see *Options for a definitive VAT system*, Working Paper, Economic Affairs Series, E 5, October 1995, En, pp. 65-68.

[240] *A strategy to improve the operation of the VAT system within the context of the Internal Market*, Communication from the Commission to the Council and the European Parliament, COM(2000) 348 final, 7 June 2000, p. 4.

[241] Council Directive 96/95/EC of 20 December 1996, OJ L 338, 28/12/1996, p. 89.

[242] *Proposal for a Council Directive on the Value Added Tax Committee*, COM(97) 325 final, 25 June 1997.

[243] *Proposal for a Directive on the rules governing the right to deduct VAT*, COM(98) 377 final, 17 June 1998.

for the introduction of a definitive VAT system (particularly in terms of VAT rates) would not be achieved.[244]

### b) OTHER PROPOSED OPTIONS FOR A DEFINITIVE VAT SYSTEM

In the last twelve years since the introduction of the VAT transitional system several alternative options, to the ones envisaged by the Commission, for a definitive VAT system have been put forward. Some of these have attracted special attention, as follows:

— Taxation in the country of origin at the rate of the country of destination without clearing, proposed by F. Vanistendael in 1995;[245]

— VIVAT (Viable Integrated VAT), proposed by M. Keen and S. Smith in 1996;[246]

— Dual VATs, proposed by R. M. Bird and P.P. Gendron in 1998;[247] and

— CVAT (Compensating VAT), proposed by C. McLure in 2000.[248]

The starting point for all these proposals are the numerous difficulties and distortions caused by the current transitional system. B. Genser offers an interesting critical analysis of all these proposals in light of what he regards as the key features of a "promising European VAT system", as follows:

— Avoidance of compliance asymmetry;

— Avoidance of zero-rating of intra-Community supplies;

— Adherence to national VAT rate autonomy;

— Incentive compatible VAT administration at the national level.

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[244] This is not to say that there was no progress during the years that followed the presentation of the Commission's programme. In fact, two important Directives were approved during this period, which, although not included in the Commission's programme, broadly fit within its stated key objectives of achieving further harmonisation of rules regarding special schemes and modernisation of the EU VAT system, as follows: Council Directive 98/80/EC of 12 October 1998 on the special scheme for investment gold, OJ L 281, 17/01/1998, p. 31; and Council Directive 1999/59/EC of 17 June 1999 on tax arrangements applicable to telecommunications services, OJ L 162, 26/06/1999, p. 63. Notwithstanding this progress, it is also important to note that during this same period legislation was approved which widens the existing disparities between VAT rates applicable across the EU, namely, Council Directive 1999/85/EC of 22 October 1999 on the possibility of applying on an experiment basis a reduced VAT rate on labour-intensive services, OJ L 277, 28/10/1999, p. 34.

[245] F. Vanistendael, "A Proposal for a Definitive VAT System Taxation in the Country of Origin at the Rate of the Country of Destination, Without Clearing", *ECTR* 1995/1, pp. 45-53.

[246] M. Keen and S. Smith, "VIVAT – The future of value added tax in the European Union", *Economic Policy*, October 1996, pp. 375-419.

[247] R.M. Bird and P.P. Gendron, "Dual VATs and Cross-Border Trade: Two Problems, One Solution?", (1998) *International Tax and Public Finance* 5, pp. 429-442.

[248] C.E. McLure, "Implementing Subnational Value Added Taxes on Internal Trade: The Compensating VAT (CVAT)", (2000) *International Tax and Public Finance* 7, pp. 723-740.

He concludes that (only) VIVAT would fulfil all these criteria.[249] Notwithstanding this, and despite the level of interest they attracted, neither VIVAT nor any of the other proposals for a definitive VAT system, were pursued by the Commission. In fact, by then, and particularly after the failure of the 1996 programme, the Commission had realised that reaching Council's unanimous agreement on a definitive VAT system, whatever its form, would be a virtually impossible task, and had decided to adopt a different approach.

### c) COMMISSION'S 2000 VAT STRATEGY

In 2000 the Commission presented a new VAT strategy. The new strategy was based on a dual premise: on one hand, that the VAT transitional system contained a number of shortcomings which required urgent action; on the other hand, that it was unlikely that progress in establishing a definitive VAT system would be achieved:

> "It should be pointed from the outset that the internal market could and would function better with a VAT system based on taxation in the Member State of origin as this would be easier to administrate (and consequently less costly for business) and less susceptible to fraud (providing a better a guarantee of stable tax revenue). However, it must also be recognised that in the current climate (where the conditions are not propitious for rapid progress towards closer harmonisation of VAT rates and legislation and it would be difficult to introduce a really reliable system of reallocating revenue) it is unlikely that significant progress will be made in the immediate future."[250]

In this context, the introduction of a definitive system was postponed indefinitely as a long term goal. In the short term, the Commission's new "viable strategy" to overcome the shortcomings of the transitional VAT system was based on four main objectives, as follows:

— **Simplification** of current EU VAT rules;

— **Modernisation** of those same rules;

— More **uniform application** of current rules; and

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[249] See B. Genser, *Coordinating VATs Between Member States*, Paper presented at the Conference on Tax Policy in the European Union, Ministry of Finance, The Hague, The Netherlands, 17-19 October 2001, pp. 11 and 20. R.M. Bird and P.P. Gendron, authors of the proposal on Dual VATs, conclude on the other hand that different proposals work better in different contexts: "the dual VAT approach simply explains how an independent sub-national VAT works well in a developed country with a central VAT. The CVAT approach attempts to achieve a similar result for a developing country with weaker tax administration capacity. And the VIVAT approach attempts to deal with the problem of interstate trader when there is no central VAT but a higher degree of agreement among member states", in "CVAT, VIVAT, and Dual VAT: Vertical "Sharing" and Interstate Trade", (2000) *International Tax and Public Finance* 7, p. 759. For a discussion on the advantages and disadvantages of these proposals undertaken by the authors themselves, see also M. Keen, *VIVAT, CVAT and All That: New Forms of Value-Added Tax for Federal Systems*, IMF Working Paper, WP/00/83, April 2000.

[250] *Op. cit.*, COM(2000) 348 final, 7 June 2000, pp. 4-5.

— **Stronger** administrative cooperation.

The Commission's communication set up a detailed action plan:

— As a first point, the Commission urged the Council to approve the several VAT proposals already on the table. These included the following proposal on the changes to the status of the VAT Committee; proposal on the right to deduct and the abolition of the Eighth Directive; and proposal on the person liable for VAT.

— Secondly, it committed itself to present proposals in priority areas within the following year (2001). The Commission identified as priority areas: taxation of postal services; e-commerce; invoicing (including electronic invoice); revision of rules on administrative cooperation and mutual assistance; and minimum standard rate of VAT.

— Finally, it set out a list of future priorities, *i.e.*, areas which the Commission consider warrant a thorough review. These included: treatment of subsidies, public authorities and services in the public interest; treatment of financial and insurance services; Court of Justice judgments; rules on supplies of goods; closer administrative cooperation; review of place of supply of services (Article 9); rationalisation of derogations under Article 27; rationalisation of options, rights and derogations; rationalisation of VAT rates; and scheme applicable to small businesses.

Assessment of the results of the new strategy

The Commission's new VAT strategy has been moderately successful. Although the first point of the action plan – Council approval of proposals already on the table – failed to a large extent,[251] significant progress has been achieved in those areas which the Commission identified as immediate priorities. In fact, despite a slight delay in some cases, the Commission has now presented proposals on all these areas, with a high success rate: only one (taxation of postal services) is still pending at the Council; whilst all others proposals (e-commerce, invoicing, administrative cooperation and mutual assistance, and minimum standard rate of VAT) have been approved.[252] Moreover, in the two years that followed the release of the VAT strategy the Commission put forward additional proposals on other areas of the EU VAT system, some of which had been identified in the VAT strategy as future priorities. Two of these, namely the extension of the Fiscalis

[251] Of those already on the table only the proposal on the person liable for VAT obtained approval at the Council, see Council Directive 2000/65/EC of 17 October 2000, OJ L 269, 21/10/2000, p. 44.

[252] See Council Directive 2001/4/EC of 19 January 2001, OJ L 22, 24/01/2001, p. 17, on the minimum standard rate; Council Directive 2001/115/EC of 20 December 2001, OJ L 15, 17/01/2002, p. 24, on invoicing; Council Directive 2002/38/EC of 7 May 2002, OJ L 128, 15/05/2002, p. 41, on e-commerce; Council Regulation (EC) No. 1798/2003 of 7 October 2003, OJ L 264, 15/10/2003, p. 1, on administrative cooperation; and Council Directive 2003/93/EC of 7 October 2003, OJ L 264, 15/10/2003, p. 23, on mutual assistance.

programme and the introduction of special rules regarding the place of supply of electricity and gas, were also approved soon after their presentation.[253]

In October 2003 the Commission issued a communication reviewing and updating the VAT strategy priorities. On it the Commission highlighted the success of its new approach:

> "Since the new strategy was initiated some three years ago, the Council has adopted nine proposals on VAT. This suggests that the pragmatic approach has succeeded in one very important aim – giving fresh impetus to discussion of VAT within the Council."[254]

Since then the Commission has put forward several other proposals, and three more have been approved, namely on new Intrastat rules, on the conferment of implementing powers and the procedure of adoption derogations and on VAT Committee decisions.[255] Overall, since the introduction of the 2000 VAT strategy the Council has approved over ten significant proposals on VAT and seven more are currently pending, as follows:[256]

— Taxation of postal services;[257]

— Special scheme for travel agents;[258]

— Rationalisation of reduced rates;[259]

— Place of supply of services;[260]

— Recast of the Sixth Directive;[261]

— VAT one-stop shop;[262] and

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[253] See Decision 2235/2002/EC of the European Parliament and of the Council of 3 December 2002, OJ L 341, 17/12/2002, p. 1, on the extension of the Fiscalis programme; and Council Directive 2003/92/EC of 7 October 2003, OJ L 260, 11/10/2003, p. 8 on the place of supply of gas and electricity.

[254] *Review and update of VAT strategy priorities*, Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee, COM(2003) 614 final, 10 October 2003, p. 20.

[255] See Commission Regulation (EC) No. 1982/2004 of 18 November 2004, OJ L 343, 19/11/2004, p. 3 on the new Intrastat rules; Council Directive 2004/7/EC of 20 January 2004, OJ L 27, 30/01/2004, p. 44, on conferment of implementing powers and the procedure of adopting derogations; and Council Regulation (EC) No. 1777/2005 of 17 October 2005, OJ L 288, 29/10/2005, p. 1 on the VAT Committee's decisions.

[256] Some of these proposals will be discussed in more detail in Chapter 3. These figures do not include other minor VAT proposals approved and/or pending, such as the proposals for Council Decisions granting Member States derogations from Sixth Directive provisions.

[257] *Proposal and Amended Proposal for a Council Directive amending Directive 77/388/EEC as regards Value Added Tax on services provided in the postal sector*, COM(2003) 234 final, 5 May 2003 and COM(2004) 468 final, 8 July 2004, respectively.

[258] *Proposal for a Council Directive amending Directive 77/388/EEC as regards the special scheme for travel agents*, COM(2002) 64 final, 8 February 2002.

[259] *Proposal for a Council Directive amending Directive 77/388/EEC as regards reduced rates of value added tax*, COM(2003) 397 final, 23 July 2003.

[260] *Proposal and Amended Proposal on the place of supply of services*, COM(2003) 822 final, 23 December 2003 and COM(2005) 334 final, 20 July 2005, respectively.

[261] *Proposal for a Council Directive on the common system of value added tax (Recast)*, COM(2004) 246 final, 15 April 2004.

[262] *Proposal with a view to simplifying VAT obligations, op. cit.* ; *Proposal for a Council Regulation amending Regulation (EC) No. 1798/2003 as regards the introduction of*

— Rationalisation of existing derogations.[263]

The Commission's efforts to achieve a better and more efficient EU VAT system are undoubtedly praiseworthy. However, notwithstanding the Commission's commitment and the real and significant progress achieved since the introduction of the transitional VAT system, and in particular in the last few years in light of the 2000 VAT strategy, it is clear that the level of VAT harmonisation, which the White Paper regarded as fundamental for the establishment of the Internal Market, has not yet been achieved. As will be discussed in Chapter 3, this has come at a heavy cost.

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*administrative cooperation arrangements in the context of the one-stop scheme and the refund procedure for value added tax*; and *Proposal for a Council Directive laying down detailed rules for the refund of value added tax, provided for in Directive 77/388/EEC, to taxable persons not established in the territory of the country but established in another Member State*, COM(2004) 728 final, 29 October 2004.

[263] *Proposal for a Council Directive amending Directive 77/388/EEC as regards certain measures to simplify the procedure for charging value added tax and to assist in countering tax evasion and avoidance, and repealing certain Decisions granting derogations*, COM(2005) 89 final, 16 March 2005.

# CHAPTER 3

# THE CURRENT EU VAT SYSTEM – PRACTICAL PROBLEMS

## 1) THE CURRENT EU VAT SYSTEM – GENERAL OVERVIEW

Thirty-eight years after the approval of the First Directive and the introduction of a common VAT system, the current EU VAT system can be broadly characterised as vast, complex and extremely detailed.[264] Although the principal legislative instrument since 1977 is undoubtedly the Sixth Directive, which is the source of the majority of EU VAT law's substantive provisions, other VAT related legislation has been approved by Community institutions, either with the objective of regulating specific aspects of the system, or in order to establish procedural law provisions which assist the effective functioning of the system. Overall, the EU VAT system can be divided into five principal areas, as follows: -

— Basis of assessment – which includes the First Directive and the Sixth Directive and all related legislation (amendments, derogations, ancillary legislation);

— Intra-community and international VAT refund system – VAT refund system for taxable persons not established in the territory of the country / Community, which includes the Eighth and the Thirteenth Directives;

— Statistical system – which includes legislation regarding statistics in relation to the trade in goods between Member States, *i.e.*, all Intrastat related legislation;

— Administrative cooperation – including not only the recently approved administrative cooperation Regulation, but also all Fiscalis related legislation;

— Own resources – which includes all legislation in relation to the use of domestically raised VAT as one of the Community's own resources (*i.e.*, for EU budgetary purposes).

### a) BASIS OF ASSESSMENT – FIRST AND SIXTH DIRECTIVES

The most significant and recognized area of the EU VAT system, is the "basis of assessment", which includes the First Directive, and most importantly, the Sixth Directive and all related legislation.[265] It represents the bulk of the EU VAT system and for that reason it is a common misconception to regard the "basis of assessment" as synonymous with the EU VAT system. It is possible to identify three stages in the evolution of the common VAT basis of assessment:

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[264] For a compilation of all EU VAT legislation to date see R. de la Feria, *A Handbook of EU VAT Legislation*, loose-leaf, Kluwer Law International, The Hague / London / New York, 2004 onwards.

[265] The Second Directive would also have been included in this area, before ceasing to be in force.

— Adoption of a common VAT system – First Directive;

— Introduction of a uniform basis of assessment – Sixth Directive;

— Introduction of the transitional VAT system – Directives 91/680/EEC, 92/77/EEC and 92/111/EEC[266].

The First Directive, which is still in force,[267] sets out the basic principles of the common VAT system, and remains an extremely important ancillary instrument to the interpretation of the Sixth Directive rules. However, it is in the Sixth Directive that the substantive legal provisions of the EU VAT system are predominantly situated, forming what is broadly known as the "uniform basis of assessment". Moreover, it is the amendments which have been introduced to the Sixth Directive which have largely determined the evolution of the entire EU VAT system.

An ideal VAT system is a simple VAT system. Unfortunately, several factors have conspired to create an EU VAT basis of assessment under the Sixth Directive which is not only extremely complex, but increasingly so.[268] In fact, if the VAT system under the original version of the Sixth Directive was elaborate, the amendments and derogations which have been subsequently introduced have transformed it into an enigma.[269]

Amendments

The several amendments introduced to the Sixth Directive have basically been designed either to eliminate inconsistencies within the original version of the Directive,[270] or to deal with new emerging situations, such as the development of telecommunications or e-commerce. These amendments have been largely successful in achieving this objective; however, this success came at a cost: the increased complexity of the system. This is a direct result of the legislative procedure applicable to the area of VAT: the unanimity requirement means in practice that in order to arrive to a consensus amongst Member States (which more often than not have diverging interests) exceptions, derogations and options have to be introduced into the text of each amending Directive.

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[266] Council Directive 91/680/EEC of 19 December 1991, OJ L 376, 31/12/1991, p. 1; Council Directive 92/77/EEC of 19 October 1992, OJ L 316, 31/10/1992, p. 1; and Council Directive 92/111/EEC of 14 December 1992, OJ L 384, 30/12/1992, p. 47.

[267] Subject to a few amendments introduced by the Third Council Directive 69/463/EEC of 19 April 1969 (OJ L 320, 20/12/1969, p. 34) and the Sixth Directive.

[268] As J. Swinkels comments "the European VAT system is developing, but in the wrong direction", in "Combating VAT avoidance", *International VAT Monitor*, July/August 2005, p. 246.

[269] Acknowledgement of this fact has prompted the Commission to present a proposal for the recast of the Sixth Directive. This recast would entail the abolition of the Sixth Directive and its substitution by a new Directive, which would incorporate "all the amendments introduced to the Sixth Directive by subsequent acts", include "any relevant provisions currently to be found in separate legal acts", and exclude "provisions which properly belong in other acts", see *op. cit.*, COM(2004) 246 final, 15 April 2004, pp. 3-4.

[270] In many cases these inconsistencies were known at the time of the approval of the Sixth Directive, but political consensus had been impossible to reach and decisions were postponed until after the entry into force of the Directive. In other cases the inconsistencies only emerged once the Directive came into force.

The most paradigmatic example of this is the VAT transitional system. As discussed in Chapter 2 from the Council discussions on the Commission's simple (albeit controversial) proposals, emerged a complex set of rules which gave rise to a system with many types of derogating measures, most of these being "permanently temporary", *i.e.*, theoretically temporary, permanent in practice. As recognised by the European Parliament's Directorate General for Research:

> "One of the most serious defects of the transitional VAT system is its complexity: the scope it allows for varying national interpretations of VAT law. The basic system established under the Sixth Directive is riddled with derogations, exemptions, options and special regimes."[271]

Derogations

The possibility of introducing measures derogating from the Sixth Directive pending Council's authorisation (Article 27 Sixth Directive) has further complicated the functioning of the EU VAT system. Article 27's requirements are extremely broad and in most cases, once the request is made by a Member State to introduce a derogating measure, the Council grants the authorisation without debate. Although these derogations do not affect the common system under the Sixth Directive directly, indirectly the overall functioning of the EU VAT system is affected. In fact, these derogations can potentially distort competition within the Community, increase legal uncertainty and increase compliance costs, making it increasingly difficult for a trader established in a Member State to determine the VAT rules applicable in another Member State.[272]

Moreover, it is not only the complexity of the system that has increased, but also the impact that this complexity has had upon traders. Globalisation and the increased levels of international and intra-community trade amplify the negative consequences of a deficient EU VAT system. As the Commission has acknowledged:

> "By dint of the manner in which the common system was set up (Directives leave the Member States with a lot of powers and options), divergences in its application have existed from the outset. However, the impact of these divergences has been reinforced by the fact that operators are now affected to a greater degree by legislation – and above all the manner in which it is applied – of Member States other than the one in which they are established or pursue their usual activities."[273]

### b) INTRA-COMMUNITY AND INTERNATIONAL VAT REFUND SYSTEM

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[271] In *Tax co-ordination in the European Union*, European Parliament, Directorate-General for Research, ECON 125 EN, 12-2000, p. 29.
[272] As G. De Witt rightly points out "a complicated VAT system is good for lawyers and other advisers, but is bad for business", see "The European VAT Experience", *Tax Notes International*, Vol. 10, No. 1, p. 49.
[273] In *op. cit.*, COM (96) 328 final, 22 July 1996.

The establishment of intra-community and international VAT refund arrangements is a natural corollary of the principle of the right to deduct VAT, as set out in the First and Sixth Directives. These arrangements are basically set out in two legislative instruments:[274]

— the Eighth Directive for taxable persons not established in the territory of the country – for intra-community VAT refunds;[275] and,

— the Thirteenth Directive for taxable persons not established in the territory of the Community – for international VAT refunds.[276]

Although the existence of the Thirteenth Directive procedure is fundamental for the integrity of the right to deduct principle, in practice the procedure has a restricted application and, thus, has not given rise to serious practical problems. However, the same could not be said of the Eighth Directive procedure. As the Commission recognises:

> "In practice, the operation of the Eighth Directive refund procedure poses considerable problems for both traders and the national administrations of the Member States."[277]

From the perspective of business the Eighth Directive procedure constitutes a serious obstacle to intra-community trade.[278] The main complaints relate to the administrative complexity and consequent costs of filling in a refund request, as well as the overall effectiveness of the system. From the perspective of national administrations, the refund procedure has proved more difficult and, thus, more costly to operate than initially expected.

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[274] Although Article 17(4) Sixth Directive sets out a few extra rules regarding namely the concept of taxable person for the purposes of these Directives.

[275] Eighth Council Directive 79/1072/EEC of 6 December 1979, OJ L 331, 27/12/1979, p. 11. Hereafter "Eighth Directive".

[276] Thirteenth Council Directive 86/560/EEC of 17 November 1986, OJ L 326, 21/11/1986, p. 40. Hereafter "Thirteenth Directive".

[277] In *Proposal for a Council Directive amending Directive 77/388/EEC as regards the rules governing the right to deduct Value Added Tax* and *Proposal for a Council Regulation (EC) on verification measures, measures relating to the refund system and administrative cooperation measures necessary for the application of Directive 98/xxx/EC,* COM(98) 377 final of 17 June 1998, p. 3.

[278] In fact, business surveys organised by the European Commission's Internal Market Scoreboard show that the difficulties caused by the VAT system and the VAT procedures (which include the Eighth Directive procedure) have consistently been regarded by traders as one of the main trade barriers to the Internal Market. In November 1997, VAT rules and procedures were the most mentioned obstacle to intra-community trade (*Single Market: business survey reveals cautions optimism*, Internal Market Scoreboard, 19 November 1997,http://europa.eu.int/comm/internal_market/en/update/score/99.htm); in November 1998, the VAT system and procedures was still perceived as a source of concern with 28% of participating businesses considering it a barrier to intra-community trade (*Single Market: business survey reveals positive effects feeding through to companies*, Internal Market Scoreboard, 3 November 1998, http://europa.eu.int/comm/internal_market/en/update/score/busien.htm); similar numbers resulted from the 1999 and 2000 business surveys, with 27% and 26% respectively considering VAT system and procedures as a barrier to intra-community trade (*Internal Market: business satisfaction grows, EU enlargement largely seen as a positive perspective*, Internal Market Scoreboard, 24 November 2000, http://europa.eu.int/comm/internal_market/en/update/score/business.htm).

In this context, the inclusion of recommendations regarding the Eighth Directive procedure within the results of the second phase of the SLIM initiative did not come as a surprise.[279] As the recommendations had the support of both representatives of the national administrations and businesses, the Commission decided to follow-up on them and in 1998 presented two complementary proposals aimed at reforming the rules governing the right to deduct VAT.[280] These proposals, amongst other measures, advocated the abolition of the Eighth Directive procedure and its substitution by a new scheme under which taxable persons established in the Community could deduct the VAT paid in a Member State where they are not established from their periodical VAT returns.

However, the Council was unable to reach an agreement regarding these proposals and seven years later the Eighth Directive procedure is still the applicable method for the deduction of VAT incurred by a taxable person in a Member State other than the one where it is established. In this context, the Commission has recently put forward an alternative proposal with a view to modernising the current refund system laid down in the Eighth Directive without changing its fundamental principles.[281]

### c) THE STATISTICAL SYSTEM, ADMINISTRATIVE COOPERATION AND TRAINING MEASURES – INTRASTAT, VIES AND FISCALIS

The third and fourth areas of the EU VAT system are, respectively, the statistical system, which basically includes all Intrastat related legislation, and the administrative cooperation, which includes not only the administrative cooperation legislation *stricto sensu*, but also the legislation regarding training programmes such as Fiscalis.

Intrastat

As discussed in Chapter 2, the system of collecting statistics on the trading of goods between Member States of the European Union, known as the Intrastat system, was introduced by Council Regulation (EEC) No 3330/91 of 7 November 1991,[282] after the abolition of physical frontiers between Member States.

Although one of the main objectives of the Intrastat system was to ensure exhaustive, reliable and up-to-date statistics, without giving rise to a disproportionate burden for the parties concerned (in particular for small and medium-size businesses), in practice the system raised serious administrative

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[279] The SLIM initiative (Simpler Legislation for the Internal Market) was launched by the Commission in 1996 aimed at identifying ways in which Community and national legislation could be simplified. The second phase of SLIM, concluded at the end of 1997, dealt with EU VAT legislation. The results of this second phase were published in the *Report from the Commission to the Council and the European Parliament on the results of the second phase of SLIM and the follow-up of the implementation of the first phase recommendations*, COM(97) 618, 24 November 1997. For a more detailed analysis of the SLIM initiative, see H. Xanthaki, "The SLIM initiative", *Statute Law Review*, Vol. 22, No. 2, 2001, pp. 108-118.

[280] *Op. cit.*, COM(98) 377 final, 17 June 1998.

[281] *Op. cit.*, COM(2004) 728 final, 19 October 2004.

[282] OJ L 316, 16/11/1991, p. 1.

difficulties for both Member States and businesses. The results of the first phase of the SLIM initiative showed that this was mainly due to the fact that the interests of the data providers (businesses), who generally want formalities to be simplified, are not easily reconciled with those of the data users who generally want detailed information available as quickly as possible.[283] Additionally, since its entry into force in 1993, Council Regulation (EEC) No. 3330/91 had been subsequently implemented, complemented and amended, which gave rise to a complex set of rules, dispersed among several legislative instruments.[284]

In light of the above, in 2003 the Commission decided to put forward a proposal for a new European Parliament and Council Regulation, which aimed to replace the Intrastat legislation in force.[285] This proposal, whose stated objective is to improve and adapt the statistical system in order to take better account of both users' needs and the burden on information providers, has recently been approved by the Council and the new Intrastat legislation has been in application since 1 January 2005.[286]

Administrative Cooperation

Similarly to the Intrastat system, the administrative cooperation system was also born in the aftermath of the introduction of the transitional VAT system, and currently includes two sub-areas:[287]

— administrative cooperation *stricto sensu* – which basically includes the new administrative cooperation Regulation, Council Regulation (EC) No. 1798/2003;[288] and

— training programmes – which include all Fiscalis related legislation.

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[283] Intrastat was chosen in 1996 as a pilot project for the SLIM initiative, see *Report of the Commission of the SLIM Pilot Project – Simpler Legislation for the Internal Market*, COM(96) 559.

[284] Council Regulation (EEC) No. 3330/91 of 7 November 1991 was amended, implemented and complemented by significant amount of legislation. Amendments were introduced by Commission Regulation No 3046/92 of 22 October 1992, OJ L 307, 23/10/1992, p. 27; Regulation of the European Parliament and of the Council (EC) No. 1182/1999 of 10 May 1999, OJ L 144, 09/06/1999, p. 1; and Regulation of the European Parliament and of the Council (EC) No. 1624/2000 of 10 July 2000, OJ L 187, 26/07/2000, p. 1. Commission Regulation (EC) No. 1901/2000 of 7 September 2000, OJ L 228, 08/09/2000, p. 28, implemented the Regulation. Finally, Commission Regulation (EEC) No. 3590/92 of 11 December 1992, OJ L 364, 12/12/1992, p. 32, complemented Regulation (EC) No. 3330/91.

[285] *Proposal for a Regulation of the European Parliament and of the Council on the statistics relating to the trading of goods between Member States*, COM(2003) 364 final, 20 June 2003.

[286] Regulation (EC) No 638/2004 of the European Parliament and of the Council of 31 March 2004, OJ L 102, 07/04/2004, p. 1. This Regulation has already been implemented by Commission Regulation (EC) No. 1982/2004 of 18 November 2004, OJ L 343, 19/11/2004, p. 3.

[287] It previously included a third sub-area regarding mutual assistance, which included Council Directive 77/799/EEC of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct and indirect taxation, OJ L 336, 27/12/1977, p. 15; as amended by Council Directive 92/12/EEC of 25 February 1992, OJ L 76, 23/03/1992, p. 1. However, Council Directive 2003/93/EC of 7 October 2003, OJ L 264, 15/10/2003, p. 23, amended Council Directive 77/799/EEC, removing VAT from the scope of application of this Directive.

[288] Council Regulation (EC) No. 1798/2003 of 7 October 2003, OJ L 264, 15/10/2003, p. 1.

The principal aim of Council Regulation (EC) No. 1798/2003 of 7 October 2003, and before its substitution of Council Regulation (EEC) No. 218/92 of 27 January 1992,[289] is to put in place a system which seeks both to combat and also to act as a deterrent to VAT fraud. The main feature of this system is the arrangement known as the VAT Information Exchange System (or VIES for short) which was designed to prevent, as well as deter, abuse of the special VAT zero-rating provisions for intra-community trade. Under the VIES arrangements, traders are required to submit periodic declarations of their dispatches of goods to VAT registered traders in other Member States; whilst on the other hand national administrations are required to store and process the information collected from its national exporters.

Council Regulation (EEC) No. 218/92 of 27 January 1992 was the subject of severe criticism, most notably in relation to its inadequacy to deal with certain types of fraud and with fraudsters. The Commission has expressed confidence that the Regulation recently approved by the Council will be a major contribution to the resolution of these situations. Only time will tell if the Commission is right or whether VAT fraud will continue to proliferate within the EU.

The training programmes in the field of taxation can also be included in the administrative cooperation area *lato sensu*. These training programmes are directed at the officials of national administrations and their principal aim is to improve the operation of taxation systems in the EU through both the promotion of knowledge of the EU tax system as well as the workings of the other Member States' tax systems. They also seek to engender increased cooperation both amongst Member States' national administrations, and between national administrations and the EU institutions, most especially the Commission.

The first training programme, the Matthaeus programme was only applicable to the field of indirect taxation and was solely directed at indirect taxation officials.[290] Its successor the Fiscalis programme, which ended on 31 December 2002, followed the same path.[291] However, the programme has proved so successful, that the new Fiscalis programme, established for the period of 1 January 2003 to 31 December 2007 has been extended to cover all areas of taxation.[292]

### d) COMMUNITY'S OWN RESOURCES

The fifth and last area of the EU VAT system includes the legislation regarding VAT as part of the Community's own resources. This area of legislation, although less known within the private sector, is extremely important and its development

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[289] Council Regulation (EEC) No. 218/92 of 27 January 1992, OJ L 24, 01/02/1992, p. 1.
[290] Council Decision 93/588/EEC of 29 October 1993, OJ L 280, 13/11/1993, p. 27.
[291] Decision No 888/98/EC of the European Parliament and of the Council of 30 March 1998, OJ L 126, 28/04/1998, p. 1.
[292] Decision 2235/2002/EC of the European Parliament and of the Council of 3 December 2002, OJ L 341, 17/12/2002, p. 1. This success is confirmed by the latest Commission evaluation report on the Fiscalis programme, see *Mid-Term evaluation of the Fiscalis 2007 programme, Commission Staff Working Paper*, SEC(2005) 1045, 29 July 2005, p. 3.

has conditioned the evolution of the EU VAT basis of assessment. In fact, as discussed in Chapter 2, the adoption of VAT as one of the Community's own resources was one of the main causes for the approval of the Sixth Directive.

Currently the main legislative instrument in this area is Council Decision 2000/597/EC, EURATOM.[293] Under this Decision, the maximum rate of VAT resources for 2003 was 0.75% and from 2004 onwards is 0.50%.[294] The VAT base of the Member States is restricted to 50% of their GNP (Gross National Product).[295] However, it is important to note that the system is not as simple as these basic principles may suggest. In fact, the rules regarding Member States' calculation of their VAT own resources base are quite complex. This is mainly due to the complexity of the VAT basis of assessment rules themselves, but also to the options given to Member States in relation to exemptions, such as zero-rating, special schemes, etc. The general rules can be found in Regulation (EEC, EURATOM) No. 1553/89 of 29 May 1989 regarding the definitive uniform arrangements for the collection of own resources accruing from value added tax.[296] However, in order to simplify calculations, several Member States have requested authorisations to derogate from these general rules. These authorisations generally relate to Member States not taking into account certain categories of transactions and using approximate estimates.[297]

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[293] Council Decision 2000/597/EC, EURATOM of 29 September 2000, OJ L 253, 07/10/2000, p. 42.

[294] The maximum rate of the VAT resource was previously 1%, under Council Decision 94/728/EC, EURATOM of 31 October 1994 on the European Communities' own resources, OJ L 293, 12/11/1994, p. 9. However, the European Council meeting in Berlin on 24 and 25 March 1999 concluded that, in order to continue the process of making allowance for each Member States' ability to contribute to the system of own resources and of correcting the regressive aspects of the system then applicable, the maximum rate of the VAT resource should be progressively reduced, see point 9 of Preamble of Council Decision 2000/597/EC, Euratom of 29 September 2000.

[295] The Commission has recently put forward a proposal for a Council Decision, which would substitute and repeal Council Decision 2000/597/EC, however this Decision would continue to apply as regards the calculation and adjustment of revenue accruing from VAT. The only significant amendment proposed within the area of VAT regards the applicable GNP ceiling, which would become limited to 50% to 55% of GNP or GNI for each Member State, depending on the relevant year, and to the correction of budgetary imbalances granted to the United Kingdom for the years 1988 to 2006 – *Proposal for a Council Decision on the system of European Communities' own resources*, COM(2004) 501 final/2, 3 August 2004.

[296] Council Regulation (EEC, EURATOM) No. 1553/89 of 29 May 1989, OJ L 155, 07/06/1989, p. 9.

[297] The following derogations are currently in force. As regards Austria, Commission Decision 96/564/EC, Euratom of 11 September 1996 (OJ L 247, 28/09/1996, p. 39). As regards Belgium, Commission Decision 90/177/Eurotam, EEC of 23 March 1990 (OJ L 99, 19/04/1990, p. 24), as last amended by Commission Decision 94/191/EC, Euratom of 18 March 1994 (OJ L 91, 08/04/1994, p. 35). As regards Denmark, Commission Decision 90/184/Euratom, EEC of 23 March 1990 (OJ L 99, 19/04/1990, p. 37), as last amended by Commission Decision 94/75/EC, Euratom of 1 February 1994 (OJ L 36, 08/02/1994, p. 13). As regards Finland, Commission Decision 96/566/EC, Euratom of 11 September 1996 (OJ L 247, 28/09/1996, p. 43). As regards France, Commission Decision 90/176/Euratom, EEC of 23 March 1990 (OJ L 99, 19/04/1990, p. 22), as last amended by Commission Decision 91/83/EEC, Euratom of 4 February 1991 (OJ L 49, 22/02/1991, p. 25). As regards Germany, Commission Decision 90/179/Euratom, EEC of 23 March 1990 (OJ L 99, 19/04/1990, p. 28), as last amended by Commission Decision 94/72/EC, Euratom of 1 February 1994 (OJ L 36, 08/02/1994, p. 10). As regards Greece, Commission Decision 90/185/Euratom, EEC of 23 March 1990 (OJ L 99, 19/04/1990, p. 39), as last amended by Commission Decision 94/194/EC, Euratom of 18 March 1994 (OJ L 91, 08/04/1994, p. 38).

The interconnection between the rules regarding Member States calculation of the VAT own resources base and the rules on VAT basis of assessment, means that the first will only be as simple as the second allows it to be. The need for having the fairest and least costly system of calculating the VAT own resources base represents an extra motive for the simplification of the Sixth Directive's rules.

## 2) THE DIFFICULTIES CAUSED BY THE CURRENT EU VAT SYSTEM

The brief description of the current EU VAT system undertaken *supra* clearly demonstrates that overall the system is complex, inefficient and susceptible to fraud. Measures have been taken in some areas to ameliorate the functioning of the system (like the new administrative cooperation Regulation) including areas where the competing interests involved are difficult to reconcile (new Intrastat Regulation). However, the bulk of the EU VAT system, namely the Sixth Directive and the Eighth Directive, remains a serious concern. As the Commission has admitted:

> "It is accepted that the current transitional arrangements have a number of shortcomings, because they are complicated, susceptible to fraud (the problem of the so called "carousel fraud" is becoming of increasing concern) and are out of date."[298]

As it currently stands, the system causes difficulties to national administrations and traders alike. It prevents Member States from fulfilling their full revenue potential, and consequently – due to the Community's own resources system – the Community's full revenue potential. It increases administration and compliance costs, against economic efficiency.[299] In some cases it distorts competition within the Community, and represents an obstacle to intra-community trade. Ultimately, it

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As regards Ireland, Commission Decision 84/277/Eurotam, ECSC, EEC of 13 April 1984 (OJ L 135, 22/05/1984, p. 21), as last amended by Commission 88/168/ECSC, EEC, Euratom of 20 January 1988 (OJ L 76, 22/03/1988, p. 23); and Commission Decision 90/183/Euratom, EEC of 23 March 1990 (OJ L 99, 19/04/1990, p. 35), as last amended by Commission Decision 94/193/EC, Euratom of 18 March 1994 (OJ L 91, 08/04/1994, p. 37). As regards Italy, Commission Decision 90/181/Euratom, EEC of 23 March 1990, OJ L099, 19/04/1990, p. 32. As regards Luxembourg, Commission Decision 90/178/Eurotam, EEC of 23 March 1990, (OJ L 99, 19/04/1990, p. 26), as last amended by Commission Decision 96/507/EC, Euratom of 24 July 1996 (OJ L 205, 15/08/1996, p. 47). As regards the Netherlands, Commission Decision 90/180/Euratom, EEC of 23 March 1990 (OJ L 99, 19/04/1990, p. 30), as last amended by Commission Decision 95/78/EC, Euratom of 13 March 1995 (OJ L 65, 23/03/1995, p. 30). As regards Portugal, Commission Decision 92/164/EEC, Euratom of 25 February 1992 (OJ L 73, 19/03/1992, p. 23), as last amended by Commission Decision 96/165/Euratom, EC of 7 February 1996 (OJ L 39 , 17/02/1996, p. 24). As regards Sweden, Commission Decision 96/565/EC, Euratom of 11 September 1996, OJ L 247, 28/09/1996, p. 41. Finally, as regards the United Kingdom, Commission Decision 90/182/Euratom, EEC of 23 March 1990 (OJ L 99, 19/04/1990, p. 33), as last amended by Commission Decision 91/86/EEC, Euratom of 4 February 1991 (OJ L 49, 22/02/1991, p. 28).

[298] In *op. cit.*, COM(2000) 348 final, 7 June 2000, paragraph 10.

[299] Preliminary estimates presented by the Commission in 1996 indicated that, on average, the costs for companies of administering transactions carried out in other Member States is five or six times more than costs would be for similar transactions in their home countries. As the Commission accepted, these costs are likely to constitute an insurmountable barrier to SMEs wanting to penetrate the Internal Market, see *op. cit.*, COM(96) 328 final, 22 July 1996, pp. 3-4.

will be proved that the current system constitutes an obstacle to the establishment, and the functioning of the internal market as defined by the EC Treaty.

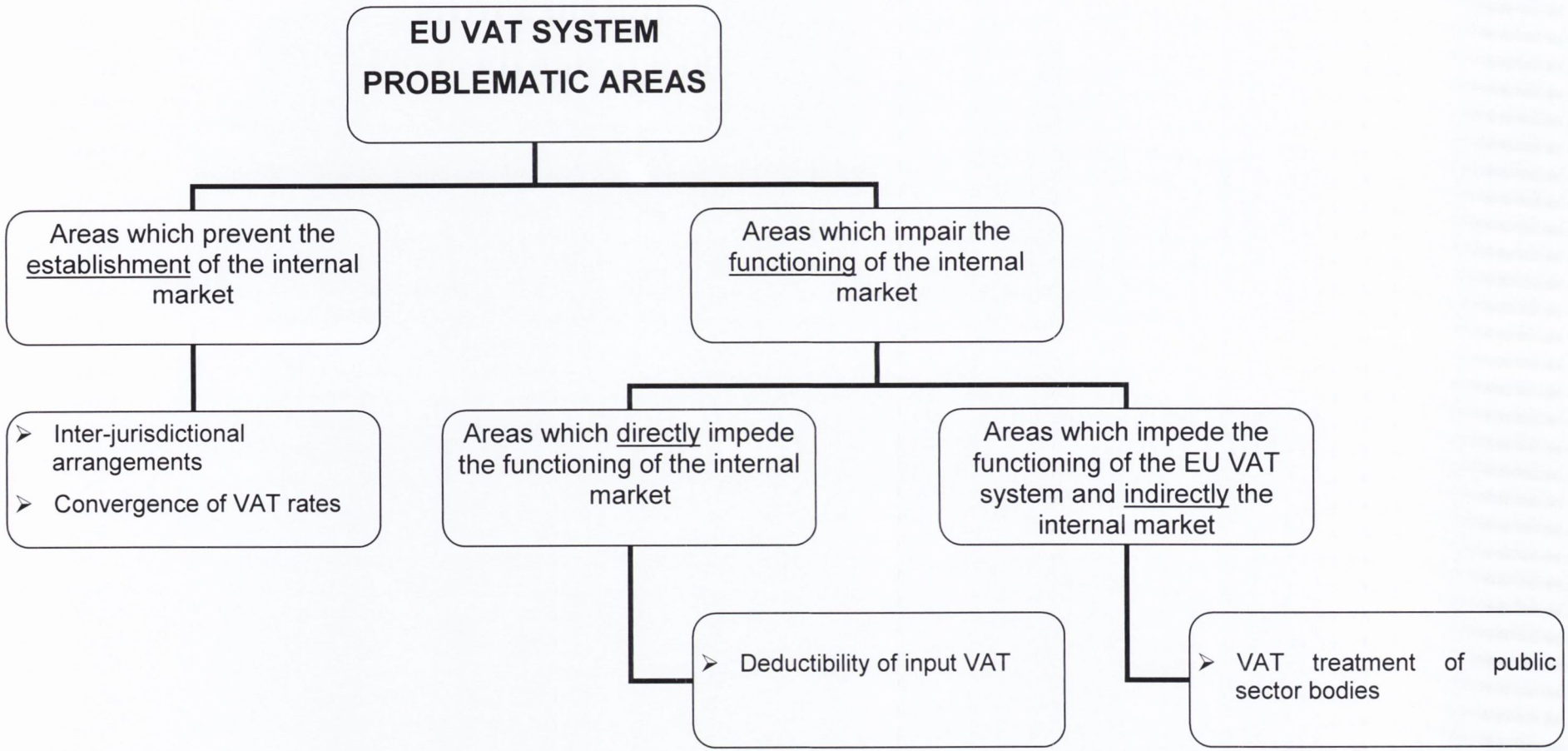
It would be an impossible task to analyse here all the areas (or sub-areas) of the current EU VAT system which give rise to difficulties. Instead, four problematic areas were chosen for analysis as a sample of the overall system: inter-jurisdictional issues, convergence of VAT rates, deductibility of input VAT and VAT treatment of public sector bodies. The criterion used for the selection of these areas was a general assessment (admittedly subjective) of the importance of these areas either as a basis of the whole system or for the functioning of that same system.

The areas selected were then divided between areas which constitute an obstacle to intra-community trade, and free movement of goods and services – inter-jurisdictional arrangements and VAT rates – and areas which constitute an obstacle to achieving the market's full potential, either directly – deductibility of input tax – or indirectly – VAT treatment of public sector bodies. These divisions are highlighted in Diagram 3.1 below.

The division between obstacles to intra-community trade and obstacles to achieving the market's full potential is purely theoretical but fundamental. It is the difference between establishing an internal market as regards VAT, and having an internal market which in terms of VAT has achieved its full potential. The criterion for the distinction is interlinked with the analysis of the concept of Internal Market undertaken in Chapter 1. As regards the distinction between direct and indirect obstacles to achieving the market's full potential, the criterion used has been the way in which these obstacles impact on the Community market – direct obstacles are those areas of VAT which create obstacles to traders engaging, or wishing to engage, in intra-Community trade; indirect obstacles are those areas of the EU VAT system which do not relate directly to intra-Community trade, and are rather seen as internal VAT areas, but which indirectly have a negative impact on the overall efficient functioning of the system.

The analysis of the problematic areas of the current EU VAT system which prevent the establishment of a genuine internal market will be undertaken in the first instance. This will then be followed by the analysis of the areas of the current EU VAT system which prevent the internal market from achieving its full potential, both directly and indirectly.

**DIAGRAM 3.1**


EU VAT SYSTEM
PROBLEMATIC AREAS
Areas which prevent the establishment of the internal market
Areas which impair the functioning of the internal market
Inter-jurisdictional arrangements
Convergence of VAT rates
Areas which directly impede the functioning of the internal market
Areas which impede the functioning of the EU VAT system and indirectly the internal market
Deductibility of input VAT
VAT treatment of public sector bodies

## a) EU VAT SYSTEM AS AN OBSTACLE TO THE ESTABLISHMENT OF THE INTERNAL MARKET – PROBLEMATIC AREAS

### i) INTER-JURISDICTIONAL ISSUES

The principal points of controversy regarding the operation of the VAT transitional system (and of the EU VAT system in general) have been the inter-jurisdictional arrangements, *i.e.*, the rules and procedures applicable to transactions which involve two or more tax jurisdictions. Although these include the arrangements applicable to transactions between Member States and non-Member States, the majority of the problems and consequent criticisms relate to the inter-jurisdictional arrangements applicable between Member States.

These inter-jurisdictional arrangements can be divided into two interconnected and complementary types, as follows:

— place of supply rules; and,

— tax administration arrangements.

The place of supply rules determine in which of the jurisdictions involved, will each specific transaction be taxed. These rules can be found in Articles 8, 9 and 28b Sixth Directive.[300] The tax administration arrangements, which include all administrative rules and procedures applicable to inter-Member States' transactions are to some extent (although not exclusively) dependent upon the place of supply rules. These rules and procedures are spread through several legislative instruments, namely the Sixth Directive, the Eighth Directive, and Intrastat and VIES related legislation.

#### (1) PLACE OF SUPPLY RULES

##### (a) SIXTH DIRECTIVE RULES

Despite their central role within the Sixth Directive system, the place of supply rules remained almost unaltered until the introduction of the transitional system.[301] As described in Chapter 2, the introduction of the transitional system itself entailed some amendments to the existing rules,[302] but the main changes resulted from the need to introduce simplification measures to an otherwise increasingly complex place of supply system.[303]

In the last few years several amendments have been introduced to the place of supply of services' rules – Article 9 Sixth Directive – reflecting the need to adapt VAT rules to the

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[300] The terminology used in the Sixth Directive is "place of taxable transactions" instead of "place of supply". Although the two terms are synonymous the term "place of supply" is the most commonly used.

[301] The exception being the amendments introduced to Article 9 in respect of the hiring out of movable tangible property by the Tenth Council Directive 84/386/EEC of 31 July 1984, OJ L 208, 03/08/1984, p. 58.

[302] Mostly to accommodate the new concepts of intra-Community acquisition and intra-Community supply – Article 28b and minor amendments to Article 8 were introduced by the Abolition of Fiscal Frontiers Directive.

[303] Considerable amendments to Article 8 and 28b were introduced by the First *Nettoyage* Directive and by the Second *Nettoyage* Directive, see Chapter 2.

emergence of new technologies. This was the case with the rules regarding the place of supply of telecommunication services,[304] of radio, television broadcasting services and electronically supplied services[305] and also of electricity and gas.[306] Equally, new rules regarding the place of supply of postal services have been proposed by the Commission,[307] and, perhaps more importantly, the Commission has put forward a proposal, which if approved would entail significant amendments to the current place of supply rules.[308]

However, notwithstanding the above, the basic place of supply rules have not been altered since the entry into force of the Sixth Directive, as follows:

— where the goods are not dispatched or transported, the place of supply of goods is where the goods are when the supply takes place – Article 8(1)(b) Sixth Directive;

— where the goods are dispatched or transported, the place of supply of goods is where the goods are when dispatch or transport begins – Article 8(1)(a) Sixth Directive; and,

— the place of supply of services is the place where the supplier has established his business or has a fixed establishment from which the service is supplied – Article 9(1) Sixth Directive.

What has dramatically changed is the quantity of exceptions to these basic rules. In 1996 the Commission reported the existence within the Sixth Directive of twenty-five different rules for determining the place of supply of goods or services.[309] Since then, the introduction of new rules for telecommunications, radio broadcasting, television broadcasting, electronically supplied services and electricity and gas has probably increased the number of rules to over thirty.[310]

This quantitative increase in the number of rules reflects the reality of an extremely complex place of supply system. In practice, the place of supply, and thus the applicable tax system, may depend on a range of factors, as follows: -

— the place at which the supplier and the person acquiring the goods / services are established;

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[304] Council Directive 1999/59/EC of 17 May 1999, OJ L 162, 26/06/1999, p. 63.
[305] Council Directive 2002/38/EC of 7 May 2002, OJ L 128, 15/05/2002, p. 41.
[306] Council Directive 2003/92/EC of 7 October 2003, OJ L 260, 11/10/2003, p. 8.
[307] *Proposal for a Council Directive amending Directive 77/388/EEC as regards value added tax on services provided in the postal sector*, COM(2003) 234 final of 5 May 2003 and COM(2004) 468 final, 8 July 2004.
[308] See *op. cit.*, COM(2003) 822 final, 23 December 2003 and COM(2005) 334 final, 20 July 2005.
[309] See *op. cit.*, COM(96) 328 final, 22 July 1996, p. 9.
[310] When the new rules regarding radio and television broadcasting and electronically supplied services were approved – Directive 2002/38/EC of 7 May 2002, OJ L 128, 15/05/2002, p. 41, also know as the E-Commerce Directive – it was announced that these amendments would be the last individual amendments to Article 9 Sixth Directive before a more general and thorough review of the rules governing the place of supply of services in totality. However, "increasing liberalization of the gas and electricity distribution sector led to an urgent need for a review of the current VAT rules", and the vow was broken, in *Proposal for a Council Directive Amending Directive 77/388/EEC as regards the rules on the place of supply of electricity and gas*, COM(2002) 688 final, 5 December 2002.

— the tax status of the person acquiring the goods / services, and where it is a taxable person, its respective VAT identification number;

— where it is a supply of services, the nature of the services supplied; and,

— where it is a supply of goods, the location of the goods at the time of supply, and the person who organises transport and the place of departure or arrival.

Annex 1 contains a summary of the place of supply rules currently in force.

**(b) CRITICAL EVALUATION**

The effectiveness of the place of supply rules can be evaluated from two different perspectives:

— as an overall place of supply system; and,

— as individual place of supply rules.

Place of supply system

When considering the place of supply system as a whole the main focus is unavoidably its complexity.[311] In practice, companies engaging in intra-community trade experience serious difficulties in determining whether they are the entity liable to pay tax, and, if so, in which Member State. The problem is grave in the case of supplies of goods, but it is even more severe in the case of supplies of services.[312]

This complexity has more than one negative consequence. The most obvious, and also, most relevant, is the increase in compliance costs. Determining the applicable place of supply rule can be time-consuming, separating between supplies subject to different rules even more so. In many cases the assistance of a professional tax adviser is unavoidable. This monetary burden is undoubtedly an obstacle to intra-Community trade and can potentially act as a deterrent, most notably in the case of SMEs. It also signifies that VAT considerations will impact on traders' decisions, which might have a distortive impact on competition.

The other negative consequence of the system's complexity is the scope it provides for differing interpretations and applications of the rules by tax administrations. The most evident effect of this difference is the possible creation of situations of non-taxation or, more commonly, of double-taxation.[313] These situations should be avoided, at least in relation to the supply of services, through the application of Article 9(3) Sixth Directive, also known as the use and enjoyment clause. However, the practical application of this

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[311] This complexity is well illustrated in Terra's examples, see "VAT in the EEC: The place of supply", (1989) *CMLRev.* 26, p. 464.

[312] In May 2003 it launched a public consultation on place of supply of services in its web-site - *VAT – The Place of Supply of Services*, Consultation Paper, TAXUD/C3/..., May 2003. The conclusions of this consultation – *Summary Report on the outcome of the TAXUD Consultation [May-June 2003]: VAT – The Place of Supply of services*, TAXUD/C3/2357, 12 September 2003 – motivated the Commission to present the already mentioned proposal to amend the place of supply of services rules.

[313] Terra defends that examples of double taxation or non-taxation are abundant, see "VAT in the EEC: The place of supply", *op. cit.*, p. 465.

rule is not without problems. In fact, the results of the Commission's consultation on the place of supply of services showed that the rule is viewed with suspicion and a number of respondents expressed their wish to see the clause reviewed. Firstly, because there is a concern about the frequency of the use of this clause, overriding the general rules; secondly, as the concept of use and enjoyment is not defined, it results in uncertainty and the potential for double taxation. [314]

Additionally, this interpretative subjectivity has also the potential to violate the principle of fiscal neutrality, as defined by the Court of Justice,[315] as well as distorting competition, as some tax administrations may be more flexible and understanding than others giving traders established in those Member States an unfair advantage.

Place of supply rules

When analysing the impact of the individual place of supply rules the focus should not only be on the solutions they provide in terms of substantive law, but equally on what they entail in terms of administrative obligations. In this context, the following main difficulties arise from the place of supply rules:

— conceptual incoherence;

— qualification problems;

— Eighth and Thirteenth Directives' refund claims; and,

— VAT registration in other Member States.

*Conceptual incoherence*. The first difficulty that arises when analysing the place of supply rules is the conceptual incoherence of the basic place of supply of services rule. As discussed *supra*, this rule establishes that the place of supply is deemed to be the place where the supplier has its fixed establishment. The problem is that this rule is in strict contradiction with the principle of VAT as a tax on consumption, which is one of the basic principles of the EU VAT system. As recognised by the Commission:

> "Since work first started in the 1960s on the introduction of a common VAT system in the Community, the view has been that taxation of services should take place in the Member State of consumption. However, during discussions on the Sixth Directive it was recognised that systematically defining the place of consumption as the place of taxation could lead to some serious practical problems. As a result, it was decided that the basic rule for the place of supply of services – and therefore the place of taxation – is where the supplier is located. For any service to be taxed anywhere else it must explicitly be excluded from the basic rule.
>
> At the time, to a very large degree, these rules in fact resulted in the tax accruing to the country of consumption. However, the realities of the Internal Market,

[314] See *Summary Report on the Place of Supply of Services*, *op. cit.*, p. 6.
[315] The Court of Justice has consistently ruled that the fiscal neutrality principle precludes "economic operators carrying on the same activities from being treated differently as far as the levying of VAT is concerned", see Chapter 4.

globalisation, deregulation and technological progression have all combined to create enormous changes in the volume and pattern of trade in services. It is increasingly possible for a number of services to be supplied at a distance."[316]

Although this conceptual breach does not bring any significant practical problem *per se* – at least in relation to traders, the situation is more questionable in relation to the impact it has on Member States' revenues[317] – its legitimacy should nonetheless be questioned on the basis of the violation of a legal principle which underlines the EU VAT system.

*Qualification problems.* The second type of difficulties which arise from the place of supply rules are of a qualification nature. The problem here is not the interpretation of the rules themselves,[318] rather the legal qualification of goods / services within the scope of one of the rules, *i.e.*, determining which rule applies to a specific supply of goods / services. The problem is more dramatic in relation to the supplies of services, as several place of supply of services rules are dependent on the nature of the service, as opposed to the place of supply of goods rules which are more dependent on the location of the goods.

The difficulties determining the nature of the services were highlighted in the results of the Commission's consultation on the place of supply of services. According to the Commission's report a number of respondents complained that for some services, namely composite or bundled services, it was difficult to determine the nature of the service. For other services, notably leasing, advertising, repair of services and forms of transport, it was suggested that a common definition would help clarify the application of a provision.

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[316] In *op. cit.*, COM(2003) 822 final, 23 December 2003, p. 2. Accordingly, one of the main features of this proposal is the amendment of the main place of supply of services rule to "the place where the customer is established", which would "ensure the general principle of taxation at the place of consumption", p. 6. The current conceptual incoherence has also been recently acknowledged, albeit in indirect terms, by Advocate-General Poiares Maduro in *RAL*, who argued for the application of Article 9(2)(c) Sixth Directive, instead of Article 9(1), on the basis of the principle of VAT as a tax on consumption: "I see clear advantages militating in favour of the application of Article 9(2)(c) to the present case. The services described in that article are subject to the connection factor of the place where they are provided, precisely because that place can without difficulty be physically identified and will coincide with the place of consumption. The application of the connecting factor of the place where the activities are carried out is, moreover, far more in conformity with the general principle that VAT should be charged at the place of consumption", case C-452/03, [2005] ECR I-0000, paragraph 30.

[317] The current place of supply of services rules mean that the taxation of services does not follow the pattern of consumption of those same services. Member States which are net importers of services may feel defrauded in terms of revenue, as they are not entitled to tax consumption which takes place within their territory. This problem seems to be behind the current proposal to extend the reverse-charge mechanism to B2C transactions relating to services which can be provided from a distance, see *op. cit.*, COM(2005) 334 final, 20 July 2005. Referring to this proposal current Commissioner for Taxation Laszlo Kovacs, commented "the economic potential of telecom services, broadcasting, and e-services makes it imperative to ensure that the VAT revenues from such services accrue to the Member State where those services are consumed. This proposal is designed to ensure that Member States are better able to collect VAT in services consumed by their residents", see *VAT: Commission proposes changes to taxation rules for services supplied to private consumers*, IP/05/997, 20 July 2005. It is worth noting that the telecommunications and e-commerce business sector has reacted strongly against the proposed amendments, see *VAT – The Place of Supply of Services to Non-Taxable Persons*, Summary Report on the outcome of the public consultation from DG TAXUD, 30 May 2005, pp. 6-7.

[318] This problem was analysed *supra*.

Equally demonstrative of the qualification problems posed by the place of supply of services rules is the number of Court of Justice cases which focus on the qualification of services under Article 9 Sixth Directive,[319] as well as the number of consultations on this matter to the VAT Committee.[320] Surprisingly though, some of the respondents to the Commission's consultation considered the jurisprudence on such matters to be troublesome.

These qualification problems can prove to be extremely expensive. Both from the perspective of businesses and from the perspective of tax administrations, qualification uncertainties give rise to significant extra costs. Something apparently as simple as the definition of advertising services or forms of transport can – and has – given rise to serious and costly disputes. This increase in compliance and administrative costs is not only economically inefficient, but is also a real obstacle to intra-Community trade.

*Eighth and Thirteenth Directives' refund claims.* The refund claim procedures under the Eighth and Thirteenth Directives are another source of difficulties arising from the application of the place of supply rules. The basic problem is that the refund procedure can be complicated and costly. However, from the application of the current place of supply rules (goods and services) it results that often taxable persons (established within or without the Community) incur VAT in a Member State where they are not established, and thus the right to deduct has to be exercised under the Eighth or Thirteenth Directive procedures. The Commission acknowledges the problem:

> "A general problem that arises from Article 9(1) is the obligation for taxable persons who receive a service but not established in the same country as the supplier of the service, to ask for a refund under the Eighth or Thirteenth Directives. The refund procedure can be complicated and time-consuming. In order to avoid this procedure, there is often a tendency to inappropriately use the reverse charge mechanism."[321]

The source of the problem is evidently more to do with the Eighth and Thirteenth Directive procedures themselves, than the place of supply rules. In this context, the specific problems raised by the Eighth Directive procedure will be discussed *infra*. However, it is worthy of notice that traders view the obligation of using those procedures as one of the main problems caused by the place of supply rules.[322]

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[319] See Chapter 4.

[320] Some decisions of the VAT Committee were recently included in a Regulation laying down implementing measures for the Sixth Directive, see Council Regulation (EC) No. 1777/2005 of 17 October 2005, OJ L288, 29/10/2005, p. 1. The Regulation contains several provisions on the qualification of services for the purposes of Article 9, therefore highlighting that this was one of the areas in relation to which the advice of the VAT Committee was most sought.

[321] In *op. cit.*, COM(2003) 822 final, 23 December 2003, p. 6.

[322] See *Summary Report on the place of supply of services*, *op. cit.*, pp. 3-4. Also, symptomatic of this is the fact that in its proposal as regards the place of supply of services, the Commission argues that one of the main advantages of the proposed amendments would be the extension in practice of the use of the reverse-charge mechanism, *i.e.*, the Commission is arguing for the modification of place of supply rules on business to business (B2B) transactions on the basis that they would minimise the use of the Eighth and Thirteenth Directives refund procedures, and thus constitute "major simplifications", see *op. cit.*, COM(2003) 822 final, 23 December 2003, p. 7.

*VAT registration in other Member States.* In some instances the place of supply rules may give rise to the obligation for traders to register for VAT purposes in more than one Member State. The typical case is that of a service provider which supplies entertainment services in a Member State other than where it is established.[323] The place of supply is deemed to be where the services were physically carried out. At present this means that the service provider may be required to register for VAT purposes in that Member State and pay VAT. According to recent estimates from the Commission based on information received from Member States there are currently 250,000 VAT registrations in the European Union which relate to traders established in other Member States.[324] For many businesses this can prove to be administratively onerous, especially where they carry out activities in several Member States.[325] On the other hand, the control of such businesses can also prove burdensome for tax administrations, *i.e.*, again extra compliance and administrative costs.

In sum, it was demonstrated that the current place of supply rules give rise to several difficulties, as follows:

— they are extremely complex;

— they allow for a high degree of subjectivity in their interpretation and application by the tax administrations;

— their application can create situations of non-taxation, and more often, of double taxation;

— they are conceptually incoherent;

— they give rise to legal qualification problems;

— their application often entails the use of the Eighth and Thirteenth Directives' procedures; and, finally,

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[323] The example is valid for any of the services listed in Article 9(2)(c) Sixth Directive – cultural, artistic, sporting, scientific, educational, entertainment or similar activities, valuations and work on movable tangible property.

[324] See *op. cit.*, COM(2004) 728 final, 29 October 2004, p. 4.

[325] These compliance costs are behind the Commission's two most recent proposals on place of supply: the proposal on place of supply of services and the proposal for a one-stop VAT scheme for non-established taxable persons. One of the main advantages of the amendment to the main place of supply of services as regards B2B according to the Commission, would be the minimisation of "instances whereby a supplier would be required to register for VAT purposes when performing services in a Member State other than where he is established", in *op. cit.*, COM(2003) 822 final, 23 December 2003, p. 7. On the other hand, the one-stop shop scheme, which would be limited to B2C supplies, would allow a trader to register only once, in the Member State where he / she is established, and to use a single VAT number for all B2C supplies made within the scope of the scheme. The presentation of this proposal followed a favourable feedback from traders and other interested parties, which emerged from the public consultation undertaken by the Commission – see *VAT: public consultation on One-Stop-Shop project*, Press release IP/04/654, 18 May 2004; and *Consultation Paper: Simplifying VAT obligations – the one-stop system*, TAXUD/590/2004, March 2004. The VAT one-stop scheme was targeted as one of the priorities for the Dutch Presidency during the second half of 2004, unfortunately without effect, see *The Dutch Presidency of the Council of the European Union: Priorities*, p.11, available on: http://www.eu2004.nl/default.asp?CMS_TCP=tcpAsset&id=AB2CCD9E8D1A455FB3970D9512B88791
It is now envisaged that discussions on this proposal will be prolonged within the Council until the Austrian Presidency, in the first half of 2006, see *Results of the 2688th ECOFIN Meeting*, Press Release 13678/05, Brussels, 8 November 2005, p. 21.

— their application sometimes entails registration for VAT purposes in several Member States.

These difficulties have severe negative consequences, as follows:

— increased compliance costs, stopping companies from fulfilling their potential in terms of competitiveness;

— increased administrative costs, stopping governments from achieving VAT's full revenue potential;

— violation of the principle of VAT as a tax on consumption, negating one of the basic principles of the EU VAT system;

— potential distortion of competition within the Community, in contravention of the concept of internal market, as defined by the Court of Justice; and,

— creation of an obstacle to the intra-community trade, constituting an obstacle to the free movement of goods and services.

### (2) TAX ADMINISTRATION ARRANGEMENTS

As described in Chapter 2, the inter-jurisdictional tax administration arrangements, *i.e.*, administrative rules and procedures applicable to intra-Community transactions, changed significantly with the introduction of the transitional VAT system. In fact, the only tax administrative arrangement which was left totally unchanged was the arrangement regarding the right to deduct VAT incurred by a taxable person in a Member State other than the one where he is established – the Eighth Directive procedure.[326] For that reason, and also because the Eighth Directive procedure operates separately from the other tax administrative arrangements, this procedure will receive independent analysis.

Prior to 1992 border controls, within the Community, were the points of imposition of VAT on imports from other Member States and also of collection of statistical information on intra-Community trade. The removal of internal fiscal frontiers entailed the imposition of new tax arrangements. These arrangements constituted the fundamental aspect of the new transitional system. At the time of the approval of the transitional VAT system it was believed that the removal of border controls and the introduction of new tax arrangements would result in significant cuts in business costs of those engaging in intra-Community trade.[327] Although the Commission's surveys show that the assessment of the impact of

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[326] The Commission's 1987 proposals included repeal of the Eighth Directive. VAT incurred in another Member State could be deducted in the same way as VAT incurred in the Member State where the taxable person is established: through periodical VAT returns. However, as described in Chapter 2 these proposals were rejected by the Council and the new transitional VAT system did not include any alteration to the Eighth Directive procedure.

[327] See the Cecchini Report on the economic gains of the establishment of Internal Market, published as P. Cecchini *et al*, *The European Challenge 1992 – The Benefits of a Single Market*, Wildwood House, 1991.

the removal of border controls is broadly positive, the new tax arrangements gave rise to serious (new) difficulties.[328] As recognised by the Commission:

> "This transitional system was a major achievement; it eliminated some 60 million customs clearance documents annually. But it is still burdensome for economic operators and susceptible to fraud."[329]

### (a) SIXTH DIRECTIVE, INTRASTAT AND VIES

The tax administration arrangements applicable under the Sixth Directive, and ancillary legislation, had until recently, remained almost entirely unaltered since the introduction of the transitional VAT system. As a result of the latest legislative approvals as regards the Intrastat system and the administrative cooperation rules, the basic tax arrangements stand as follows:

— Intra-Community supplies are exempt and intra-Community acquisitions are taxable events, which must be reported on the domestic VAT return – legal basis, Sixth Directive;

— Intra-Community acquisitions of goods have to be reported under the Intrastat system for statistical purposes – legal basis, Regulation (EC) No 638/2004 of the European Parliament and of the Council and implementing legislation; [330] and,

— Intra-Community supplies and acquisitions of goods have to be reported under the VIES system for control purposes – legal basis, Council Regulation (EC) No. 1798/2003 and implementing legislation. [331]

The three basic administrative arrangements are interlinked. Together they signify that legal and procedural requirements imposed in respect of intra-Community transactions differ substantially from those imposed on domestic transactions.

Sixth Directive

As described in Chapter 2, the Commission's 1987 proposals envisaged radical alterations to the tax administrative arrangements applicable within the Community. However, the transitional VAT system does not include any of these revolutionary measures and ultimately the changes which it does entail are far from radical. This system's tax administrative arrangements are in fact very similar to the tax administrative arrangements previously applicable: intra-Community exports are still subject to

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[328] The Internal Market Scoreboard business surveys show that the majority of businesses consider that the obstacles to cross-border trade of goods and services within the European Union were "significantly reduced" since 1993, see *Single Market: Business Survey, op. cit.*, 19 November 1997. However, difficulties relating to the VAT system and procedures are consistently referred to as one of the remaining problems, see *ibid*; *Internal Market: business survey*, *op. cit.*, 24 November 2000, *Internal Market business survey estimates potential savings of 50 billion from simpler rules at EU and Member States level*, Internal Market Scoreboard, Business Survey, 19 November 2001.

[329] In *The Internal Market – Ten Years without Frontiers*, 30 January 2003, p. 39.

[330] Regulation (EC) No 638/2004 of the European Parliament and of the Council of 31 March 2004, OJ L 102, 07/04/2004, p. 1; and Commission Regulation (EC) No 1982/2004 of 18 November 2004 implementing Regulation (EC) No 638/2004 of the European Parliament and of the Council, OJ L 343, 19/11/2004, p. 3.

[331] Council Regulation (EC) No. 1798/2003 of 7 October 2003, OJ L 264, 15/10/2003, p. 1; and Commission Regulation (EC) No. 1925/2004 of 29 October 2004, OJ L 33, 05/11/2004, p. 13.

remittance, intra-Community importations are still taxable events. Realistically the only significant alteration, in terms of tax administrative arrangements, was the abolition of border controls and consequently of all the administrative documentation which they entailed. These have been substituted by a system where the functions previously performed by border controls are done *a posteriori*, within the Member State where the taxable person is established. In this context, how advantageous is the new transitional system? The advantages of a system similar to the one proposed by the Commission in 1987 seemed quite clear, at least from the perspective of businesses and the level of compliance costs. However, the advantages of the transitional system are more obscure. Ultimately the question which should be asked is: how beneficial, in terms of VAT, was the abolition of border controls and its substitution with an *a posteriori* control system?

Any response to this query entails a preceding analysis of the difficulties raised by the Intrastat and VIES systems.

Intrastat

As discussed *supra*, the Community statistical data collection system, known as the Intrastat system, was set up in 1993 to collect intra-Community trade data in the absence of data collected at borders. Traders are required to report, usually on a monthly basis, almost all transactions whether commercial or not (information on intra-company transactions for example, has also to be reported), which lead to an intra-Community movement of goods.

However, since its introduction Member States and businesses, particularly small enterprises, have experienced difficulties complying with the Intrastat rules. It was in view of these difficulties, that Intrastat was chosen in 1996 as a pilot project for the SLIM initiative. The assessment that the SLIM team made of Intrastat confirmed the realities of a costly and inefficient system:

> "The system is costly both to enterprises and to administrations. The statistics produced at EU level are not of sufficient quality and become available too late. Efforts have been made to overcome these problems, but all proposals for simplification are confronted with a conflict between the desire of firms to be relieved of reporting burdens and the demands of users of the statistics for detailed information."[332]

These two opposite interests have been tested in *Kieffer and Thill*. The Court concluded that barriers to the free movement of goods may be accepted if they are essential in order to obtain reasonably complete and accurate information on movements of goods within the Community.[333]

Meantime, following on from the SLIM initiative recommendations, the afore mentioned Regulation (EC) No 638/2004 of the European Parliament and of the Council of 31 March 2004 was approved. For traders the main advantages of the new Regulation seem to be

[332] In *op. cit.*, COM(96) 559, p. 3.
[333] See Chapter 4.

the following: clarity and simplicity of its rules; limitation of the scope of the Intrastat system to strictly Community statistics;[334] and simplification of the thresholds system. However, some problems remain such as the content of the data collected.[335] Additionally, the new Regulation grants Member States the freedom to choose the method for the collection of data, which has the potential to create serious discrepancies between the several Member States and also adds to traders' uncertainties and, consequently, increase compliance costs.

The new Regulation has only been applicable since 1 January 2005. A more extensive period will have to pass until it can be ascertained whether it has achieved its professed aim of improving and adapting the statistical system in order to take better account of both users' needs and the burden on information providers.

VIES

As discussed in Chapter 2, the VIES system was also set up in 1993. The abolition of customs controls and import / export documentation within the Community created the need for the establishment of another control method in order to avoid widespread VAT fraud. Under this system, taxable persons are required to report their intra-Community supplies of goods to taxable persons, including their VAT identification numbers, on recapitulative statements (normally on a quarterly basis). The same applies to taxable persons making intra-Community acquisitions of goods. The exchange of VIES data should enable tax administrations to verify if the reverse-charge mechanism has been appropriately applied, *i.e.*, if intra-Community supplies effected by each taxable person match intra-Community acquisitions by taxable persons in other Member States.

The system, however, has been seen by tax administrations and traders alike as a source of significant practical problems. Tax administrations point out that the overall system is susceptible to fraud and that both the Commission's 2000 report on administrative cooperation and the *Ad Hoc* Working Party appointed by the Council to asses the situation regarding tax fraud, confirmed this view.[336] The Commission's most recent report on VAT fraud notes that it has become clear that administrative cooperation as well as national control systems were not fully adapted to the tax arrangements introduced in 1993. It argues that:

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[334] However, Member States remaining free to compile more detailed national statistics to meet national needs.

[335] According to the Commission, the choice to maintain the content of the data to be collected is based on the results of three studies: an opinion poll of information providers in six Member States, a sample study of users of Community statistics and a study on problems with the product nomenclature in Sweden, see *op. cit.*, COM(2003) 364 final, 20 June 2003, p. 3.

[336] *Third Article 14 Report on the application of Council Regulation (EEC) No. 218/92 of 27 January 1992 on administrative cooperation in the field of indirect taxation (VAT) and Fourth Report under Article 12 of Regulation (EEC, Euratom) No. 1553/89 on VAT collection and control procedures*, Report from the Commission to the Council and the European Parliament, COM(2000) 28 final of 28 January 2000; and *Final Draft Report: - Context of the Ad Hoc Party's Mandate in the fight against fraud – Assessment of the current situation regarding tax fraud – Identification and analysis of weak points which hamper the fight against fraud, and recommendations*, Document Number 8053/00, 27 April 2000. For a detailed analysis of the phenomenon of fraud, and especially VAT fraud, see also P.C. van Duyne, "VAT fraud and the Policy of Global Ignorance", (1999) *European Journal of Law Reform*, Vol.1, No. 4, pp. 425-443.

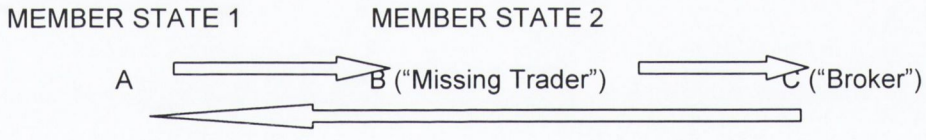
"Though the detection rate of fraud is uncertain and the exact amount of money involved difficult to quantify, the amounts are undoubtedly considerable. Some Member States have estimated such losses as up to 10% of net VAT receipts. VAT fraud has therefore become a real worry in many Member States. In addition to the loss of national revenue, this fraud jeopardises legitimate trade in certain economic sectors and distorts competition to the benefit of dishonest traders."[337]

One of the most well-known and frequent types of fraud is the so-called "carousel fraud", also known as "missing trader fraud", whereby fraudulent traders take advantage of the intra-Community arrangements in order to obtain significant amounts of VAT through a succession of transactions between traders established in different Member States.[338] As highlighted by Advocate-General Poiares Maduro recently in *Optigen, Fulcrum and Bond*,

"Endless variations on the chain transactions are imaginable [...] and in reality the same goods may be 'sent around' several different chains. Still, the problem fundamentally remains the same: a trader collects an amount paid to him as VAT but does not account for it to the tax authorities. The defaulting trader may use a 'hijacked' VAT number or it may register itself for VAT and simply disappear before the tax authorities take action."[339]

The way in which carousel fraud (in its simplest form) operates is summarised in Diagram 3.2.

**DIAGRAM 3.2 – CAROUSEL VAT FRAUD**




A makes an intra-community supply to B. As such, he does not charge VAT, but deducts related input VAT.

B supplies the goods to C, who is taxable person in the same Member State. He charges VAT to C. B is supposed to account for VAT on both the intra-community acquisition

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[337] *Report from the Commission to the Council and the European Parliament on the use of administrative cooperation arrangements in the fight against VAT fraud*, COM(2004) 260 final, 16 April 2004, p. 5.

[338] For these fraudsters carousel fraud can be a very profitable tool, as confirmed by media reports – see J. Oliver "On the run: the plumber who worked a £15m VAT fraud", in *The Guardian*, 4 March 2005. In the UK the problem of carousel fraud has been qualified by a Customs & Excise official as "the single biggest threat to the UK VAT system", with estimated losses growing £0.5 billion per year - see A. Legget, "VAT Fraud & Control of Refunds and Credits – A Strategic Approach to Tackling VAT Losses", Paper presented at *International Tax Dialogue VAT Conference, Rome, March 15-16, 2005*, available at : http://www.itdweb.org/VATConference/Pages/PapersPresentations.aspx for a detailed analysis of the scale of the problem in the UK and the strategies for tackling it adopted by Customs & Excise Commissioners.

[339] Opinion of Advocate-General on joint cases C-354/03, C-355/03 and C-484/03, [2005] ECR I-000, paragraph 8. In its decision in Bond, the Manchester VAT Tribunal provides a clear (and detailed) explanation of what is normally regarded as carousel fraud, see *Bond House Systems Limited v Commissioners of Customs & Excise*, *Bond House Systems Ltd v Customs and Excise Comrs* (2003) VAT decision 18100, paragraphs 15-18.

from A and the supply to C, but does neither. He deducts any input VAT, which he might have and before the tax authorities realise his failure to account for output VAT, B disappears.

C sells the goods back to A.

Traders, on the other hand, complain that the system is a source of practical difficulties, errors and compliance costs. The results of the consultation undertaken by the Commission regarding the place of supply of services is extremely demonstrative of the widespread view that VIES is an inefficient and costly system. On the question of whether the VIES system should be extended to (intra-Community) supplies of services, a large majority of the respondents strongly opposed the idea.[340]

The new administrative cooperation Regulation aims to resolve the problem of VAT fraud, namely through the intensification and facilitation of the level of information exchange, however only time will tell whether this will be achieved.[341] Moreover, the problems caused to traders by the VIES system – the considerable extra compliance costs it creates – have not been dealt with by this new Regulation and thus remain unresolved.

Overall critical evaluation

In 1997 the Commission published a report, prepared by PriceWaterhouse, which aimed at studying the impact for traders of the abolition of customs and fiscal controls at internal Community borders and the consequent introduction of the new VAT transitional system and the Intrastat system.[342] The report estimated that the abolition of customs and fiscal border controls had reduced the costs for intra-Community traders by approximately two-thirds. Paradoxically, however, when asked about the new system only 49% of respondents preferred the new system to the previous customs regime. This paradox can be perhaps partially explained by traders' level of expectations. In fact, as the report points out:

> "There was a widespread expectation by business that the abolition of frontiers controls would result in an abolition of the associated workload. Instead, the inconvenience of the fiscal and statistical burden workload was seen by business as not being abolished, but simply transferred from frontiers right into their own offices. This was,

[340] *Summary Report on the place of supply of services*, *op. cit.*, pp. 4-5. Despite this opposition the Commission decided to go ahead with the proposal of extending the VIES system to services, see *op. cit.*, COM(2003) 822 final, 23 December 2003.

[341] Council Regulation (EC) No. 1798/2003 of 7 October 2003, OJ L 264, 15/10/2003, p. 1. As a further step against VAT fraud, the Commission has announced its intention to present a proposal "for a new regulation on mutual assistance for the protection of the Community's financial interests against fraud and other illegal activities", see Commissioner Bolkestein answer to *Agency to combat fraud, Written Question E-0740/04 by Jose Garcia-Margallo y Marfil (PPE-DE) to the Commission*, 27 February 2004.

[342] "Dismantling of barriers. Customs and fiscal formalities at frontiers", *The Single Market review, Subsidies III: Volume 3*, Office for Official Publications of the European Communities, 1997.

understandably, perceived by many as a greater personal inconvenience than before."[343]

Similarly Ball's survey carried out in 1993 in all Member States found that 61% of respondents believed that the abolition of border controls was predominantly advantageous. However, other independent surveys were more sceptical regarding the advantages of the new system. According to Haase's survey only 18.3% of respondents believed that the abolition of border controls had reduced compliance costs.[344] Verwall and Cnossen's survey reveals that compliance costs of intra-Community transactions of firms in the Netherlands are on average 5% of the value of their intra-Community trade, which in the words of the authors, represents "a sizable border tax".[345] While admittedly this survey is limited to only one Member State, the results are perhaps indicative of a wider problem. These studies highlight the imperfections of the VAT transitional arrangements, and the costs it entails for traders. As the Commission's report states:

"It should be noted at the outset that these transitional systems were seen from their inception as no more than a very imperfect solution. By the very nature of their being transitional, they failed in a number of ways to fulfil the aims of the single market. The simpler, definitive systems originally proposed for 1993 were not, in the end, those which were accepted at the time, and only as we go to press are new proposals being tabled for the definitive systems which, it is widely hoped, will reduce the cost and complexity of compliance down to more reasonable levels."[346]

This view is confirmed by the fact that the report also shows that over two-thirds of respondents wanted to move on from the transitional to the definitive system.[347]

The impact of these compliance costs on intra-Community trade are highlighted by Verwall and Cnossen, who illustrate that the level of compliance costs has a significant negative effect on intra-Community trade intensity, which increases as firm size decreases. These conclusions are confirmed by the findings of the recently published European Tax Survey, which looked at the potential costs of lack of tax harmonisation, as follows:

— compliance costs are larger for SMEs than for larger companies;

— compliance costs are higher with companies with at least one subsidiary in another EU Member State compared with companies without subsidiaries in another Member State; and,

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[343] *Ibid*, pp. 3-4.
[344] These surveys are referred to by Verwall and Cnossen, *Europe's New Border Taxes*, Research Centre for Economic Policy (OCFEB), Research Memorandum 008, Erasmus University Rotterdam, 2001, pp. 9-13. As Verwall and Cnosse are quick to point out, these surveys display some methodological shortcomings, namely lack of transparency of the sampling procedures and low responses. However, despite these shortcomings the results are still worthy of notice.
[345] *Ibid*, pp. 13-20.
[346] "Dismantling of barriers", *op. cit.*, p. 2.
[347] There was a substantial majority in favour of the move in France, Germany, Italy and Spain, with a majority in all the others, except Ireland and Luxembourg (where the sample sizes were too small to draw general conclusions).

— compliance costs increase with the number of subsidiaries abroad.[348]

The Commission has recently indicated that one of the consequences of this state of affairs in relation to compliance costs is that a substantial part of traders seem to abstain from having VAT activities in another Member State due to the burden of having to comply with VAT obligations there.[349] This demonstrates that in practice the level of compliance costs represents a true obstacle to intra-Community trade, most particularly in the case of SMEs.

The above considerations and studies demonstrate that, unfortunately, the new tax administrative arrangements have almost all the shortcomings of the old system – unequal treatment of intra-Community and domestic transactions, high levels of compliance costs, obstacles to intra-Community trade and free movement – with some new disadvantages – VAT fraud – and advantages – tax compliance is now due in the Member State where the trader is established, thereby minimising cash-flow problems and avoiding transit delays at frontier controls. More importantly, the abolition of customs controls within the Community helped to create, within the business sector, the illusion of free movement, thereby encouraging traders to look at the entire Community territory as a potential market for their goods and services.

**(b) EIGHTH DIRECTIVE**

Despite the, already highlighted, Commission's attempts to amend it (or rather abolish it), the Eighth Directive has remained almost entirely unaltered since its approval in 1979.[350] It establishes a VAT refund procedure whose sole purpose is to ensure the exercise of the right to deduct VAT – as defined in Article 17 Sixth Directive – where the taxable person is not established in the territory of the Member State. Thus, in practice, where a taxable person incurs VAT in a Member State other than the one where it is established, it is obliged to use the Eighth Directive procedure in order to exercise his / her right to deduct input tax.

The procedure appears to be straightforward. Taxable persons are required to file an application form within six months of the end of the calendar year in which the tax became chargeable, together with the following documentation:

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[348] *European Tax Survey*, Commission Staff Working Paper, SEC(2004) 1128, 7 September 2004. Although, the study looked at all aspects of taxation, and not exclusively to VAT, the fact that the overall conclusions include VAT considerations, is indicative of the situation in relation to VAT. This is confirmed by the Commission in their proposal for a one –stop VAT scheme where it stated that "the recently published European Tax Survey conducted by the Commission in the second half of 2003 confirmed that taxable persons who have VAT obligations in a Member State where they are not established are those for which the burden of compliance is the highest", see *op. cit.*, COM(2004) 738 final, 29 October 2004, p. 2.

[349] According to the Commission "this is confirmed by a document produced by the European Consumer Centre Network in 2003 on e-commerce. This report identifies the current VAT regime as one of the reasons why operators refuse to sell goods to consumers who are living in a Member State other than the Member State of establishment of the company", see *op. cit.*, COM(2004) 738 final, 29 October 2004, p. 2.

[350] Minor amendments were introduced by the Thirteenth Directive and by the successive Accession Acts, 1986, 1994 and 2004.

— certificate from the tax authorities of the Member State where they are established, confirming their taxable status for VAT purposes – Article 3(b); and,

— original invoices or import documents – Article 3(a).

Decisions concerning applications for refund should be announced within six months of the date when the applications were filed. However, behind the apparent simplicity of these rules lies an extremely complex and costly practical application for both traders and tax administrations alike.

*Traders.* As regards traders, and according to the Commission, the most frequent complaints are, as follows:

— administrative formalities are burdensome (e.g. requests must be made in the official language of the country). In practice, traders are frequently obliged to seek professional tax advice;

— Member States fail to respect the time limit for refunds (six months from application). Traders are compelled to pay the tax in advance and bear the cost over long periods with considerable cash-flows consequences; and,

— tax administrations apply an extremely rigid interpretation of the Eighth Directive's provisions, so requests are frequently rejected based on the failure to respect formalities. In practice, there is a widespread feeling amongst traders that national tax administrations wish to discourage the use of the refund procedure.[351]

The legitimacy of these complaints is demonstrated by Court of Justice jurisprudence. The Court of Justice has on several occasions been called to decide on the interpretation of the Eighth Directive rules. The great majority of cases relate either to delays of refund payment (disrespect for the time-limit), or to tax administrations' refusal to refund. In all but one case, the Court decided against the national tax administrations.[352] As the Commission recognises:

> "The burden and the cost of the administrative formalities and the refund period mean that taxable persons who are entitled to a refund of VAT are discouraged from exercising that right."[353]

This is confirmed by both independent and Community surveys. Ball's survey carried out in 1993 in all Member States, reported that only 69% of respondents actually reclaimed the tax. The remaining 31% considered the procedure as cost ineffective. Equally, the survey carried out by Haase in 1996 in all Member States (with the exclusion of Greece) found that more than three-quarters of respondents reported difficulties with the reimbursement of VAT paid in other Member States.[354] The Commission's recent European Tax Survey, found similar results, as follows:

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[351] *Op. cit.*, COM(98) 377 final, 17 June 1998, p. 4.
[352] See Chapter 4.
[353] In *op. cit.*, COM(98) 377 final, 17 June 1998, p. 4.
[354] See Verwall and Cnossen, *op. cit.*, pp. 9-13.

— it estimated that 86,1% of large companies incurring VAT costs on their inputs in an EU Member State without being registered have difficulties coping with procedures for refunds under the Eighth Directive;

— due to the complexity or the length of the procedure it is estimated that 53.5% of large companies have not requested refunding at some point;

— furthermore, 14.2% of small and 9.9% of large companies have not carried out VAT taxable activities in another Member State where they do not have a permanent establishment because of VAT compliance requirements.[355]

*Tax administrations.* The refund procedure also causes considerable problems for national tax administrations as, in practice, the procedure has proved more difficult to operate than initially expected. As reported by the Commission:

> "Each refund request requires a physical intervention (in particular, every invoice and import document presented must be stamped and returned within one month) by the administration of the Member State of refund. The Member State must consequently allocate a significant number of officers to the completion of tasks considered to be unproductive; the purpose of which is to refund a tax collected on the national territory to taxable persons from other countries."[356]

National tax administrations also complain of the lack of effective verification as to whether an application for refund and the amount to be refunded is justified, as in practice they possess very little information with which to assess the extent of the right to deduct. For these reasons almost all Member States were authorised by the Council to apply derogation measures which would avoid the use of the Eighth Directive procedure in the cases of work on movable property, transport services and telecommunication services.[357]

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[355] See *op. cit.*, SEC(2004) 1128, 7 September 2004.

[356] In *op. cit.*, COM(98) 377 final, 17 June 1998, p. 4.

[357] These derogations are no longer in force. In relation to work on movable tangible property and transport services see the following: as regards Belgium, Council Decision 93/555/EEC of 25 October 1993, OJ L 273, 05/11/1993, p. 33; as regards Denmark, Council Decision 93/556/EEC of 25 October 1993, OJ L 273, 05/11/1993, p. 35; as regards France, Council Decision 93/557/EEC of 25 October 1993, OJ L 273, 05/11/1993, p. 37; as regards Germany, Council Decision 94/8/EC of 22 December 1993, OJ L 7, 11/01/1994, p. 13; as regards Ireland, Council Decision 93/558/EEC of 25 October 1993, OJ L 273, 05/11/1993, p. 39; as regards Italy, Council Decision 93/559/EEC of 25 October 1993, OJ L 273, 05/11/1993, p. 41; as regards Luxembourg, Council Decision 93/560/EEC of 25 October 1993, OJ L 273, 05/11/1993, p. 43; as regards the Netherlands, Council Decision 93/561/EEC of 25 October 1993, OJ L 273, 05/11/1993, p. 45; as regards Portugal, Council Decision 93/562/EEC of 25 October 1993, OJ L 273, 05/11/1993, p. 47; as regards Spain, Council Decision 94/510/EC of 27 July 1994, (OJ L 202, 05/08/1994, p. 26; as regards the United Kingdom, Council Decision 93/563/EEC of 25 October 1993, OJ L 273, 05/11/1993, p. 49. In respect of telecommunication services see the following: as regards Austria, Council Decision 97/210/EC of 17 March 1997, OJ L 86, 28/03/1997, p. 25; as regards Belgium, Council Decision 97/200/EC of 17 March 1997, OJ L 86, 28/03/1997, p. 5; as regards Denmark, Council Decision 97/201/EC of 17 March 1997, OJ L 86, 28/03/1997, p. 7; as regards Finland, Council Decision 97/212/EC of 17 March 1997, OJ L 86, 28/03/1997, p. 29; as regards France, Council Decision 97/205/EC of 17 March 1997, OJ L 86, 28/03/1997, p. 15; as regards Germany, Council Decision 97/202/EC of 17 March 1997, OJ L 86, 28/03/1997, p. 9; as regards, Greece, Council Decision 97/203/EC of 17 March 1997, OJ L 86, 28/03/1997, p. 11; as regards Ireland, Council Decision 97/206/EC of 17 March 1997, OJ L 86, 28/03/1997, p. 17; as regards Italy, Council Decision 97/207/EC of 17 March 1997, OJ L 86, 28/03/1997, p. 19; as regards Luxembourg, Council Decision 97/208/EC of 17

In this context, the recommendations regarding the Eighth Directive, which resulted from the SLIM initiative, came as no surprise. These included "studying the possibilities and the different ways of reforming the tax-refund procedures laid down by the Eighth Directive in order to make it equally easy to recover tax paid within the country and tax paid in another Member State".[358]

Following on the SLIM recommendations, the Commission presented a proposal with a view to reforming the rules governing the right to deduct VAT, which included the abolition of the Eighth Directive.[359] Although the proposal obtained large support from traders and a favourable opinion from the Parliament and the Economic and Social Committee[360] progress in the Council proved slow and five years later the proposal was still under discussion.[361] According to the Commission, one of the key issues which prevented the Council from agreeing was the fact that under the proposed system, the trader would recover the VAT in accordance with the deduction rules (in particular the tax blocking rules) of the Member State of establishment, while under the current procedure VAT is recovered in accordance with the deduction rules of the Member State where the expenses are incurred. This would have had a negative impact on VAT receipts for those Member States where VAT has been paid and they currently have a more restrictive deduction regime.

In this context, and in view of the problems highlighted *supra,* the Commission decided to put forward a new proposal for the reform of the VAT refund procedure.[362] Although reiterating the fact that the 1998 proposal was conceptually the best way of reforming the current refund procedure, it acknowledged that after six years it was unlikely that the Council would ever reach an agreement. The 2004 proposal therefore puts forward an alternative way of modernising the current procedure laid down in the Eighth Directive, without altering its fundamental principles. The main changes concern the use of electronic means for presenting the requests for refund.

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March 1997, OJ L 86, 28/03/1997, p. 21; as regards the Netherlands, Council Decision 97/209/EC of 17 March 1997, OJ L 86, 28/03/1997, p. 23; as regards Portugal, Council Decision 97/211/EC of 17 March 1997, OJ L 86, 28/03/1997, p. 27; as regards Spain, Council Decision 97/204/EC of 17 March 1997, OJ L 86, 28/03/1997, p. 13; as regards Sweden, Council Decision 97/213/EC of 17 March 1997, OJ L 86, 28/03/1997, p. 31; and finally, as regards the United Kingdom, Council Decision 97/214/EC of 17 March 1997, OJ L 86, 28/03/1997, p. 33.

[358] In *op. cit.*, COM(97) 618 final, 24 November 1997, pp. 7-8.

[359] *Op. cit.*, COM(98) 377 final of 17 June 1998.

[360] *Proposal for a Council Directive amending Directive 77/388/EEC as regards the rules governing the right to deduct value added tax (COM(98) 377 – C4-0474/98 – 98/0209(CNS))*, A4-0490/98 and *Legislative resolution embodying Parliament's opinion for a Council Directive amending Directive 77/388/EEC as regards the rules governing the right to deduct value added tax (COM(98)0377 – C4-0474/98 – 98/0209(CNS))*, OJ C 104, 14/04/1999, p. 122; Opinion of the Economic and Social Committee on the *Proposal for a Council Directive amending Directive 77/388/EEC as regards the rules governing the right to deduct value added tax and the Proposal for a Council Regulation (EC) on verification measures relating to the refund system and administrative cooperation measures necessary for the application of directive 98/xxx/EC*, (1999/C101/17), OJ C 101, 12/04/1999, p. 73.

[361] *Op. cit.*, COM(2003) 614 final, 20 November 2003, Annex 1, p. 22; and *2506th Council meeting - Economic and Financial Affairs*, Press Release Pres/03/125, 13/05/2003.

[362] *Op. cit.*, COM(2004) 728 final, 29 October 2004.

Whether the 2004 proposal will be more successful than its predecessors is still unknown,[363] however, what is undeniable is that a reform of the VAT refund procedure, and particularly of the Eighth Directive, is urgent. As it currently stands the system creates significant compliance and administrative costs with direct and indirect negative consequences, as follows:

— administrative costs act as an incentive to tax administrations to obstruct, or refuse altogether, refund claims – this significantly undermines the principle of the right to deduct VAT, a core principle of the EU VAT system;

— compliance costs are, as described above, a deterrent for companies to use the procedure, undermining the principle of the right to deduct VAT;

— administrative costs are an impediment for Member States to achieve VAT's full revenue potential;

— compliance costs can also subvert the use of other VAT rules, namely the place of supply rules, undermining the function of the whole VAT system; and,

— finally, compliance costs can also act as an obstacle to intra-Community trade, mostly to SMEs, which would rather not engage in intra-Community trade in order to avoid the use of the procedure.

### ii) CONVERGENCE OF VAT RATES

#### (1) SIXTH DIRECTIVE RATES STRUCTURE

When the Sixth Directive first came into force, it allowed Member States to establish, almost independently, their own rates structure. Member States were free to impose increased and reduced rates on the supplies of certain goods and services, without limitation on either the number of rates actually applied or upon which specific goods could be subject to these special rates.[364] With the approval of the Approximation of VAT Rates Directive, the liberty of Member States to establish their own rates structure was reduced.[365]

The provisions governing the rates structure have been subject to several subsequent amendments and a new Annex was added, Annex K.[366] However, "the situation has

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[363] This proposal has been the subject of discussion in recent ECOFIN meetings, see for example *Results of the 2688th ECOFIN Meeting*, *op. cit.*, p. 21. It is worth noting though that this new proposal seems to gather the support of national business organisations and individual traders. In fact, a consultation procedure undertaken by the Commission on the "one-stop-shop" package of proposals, which included the one on the reform of the Eight Directive, demonstrated an overwhelming support to the measure, see *Report on the Outcome of the Consultation on the "One-Stop-Scheme"*, TAXUD/D/1 D(2005), 11 August 2005, p. 5.

[364] Article 12(4) Sixth Directive, before amendments introduced by Council Directive 92/77/EEC of 19 October 1992 on the approximation of VAT rates, OJ L 316, 31/10/1992, p. 1.

[365] Not sufficiently, however, see *infra*.

[366] Council Directive 92/111/EEC of 14 December 1992 (OJ L 384, 30/12/1992, p. 47), amended Article 12(3)(a); Council Directive 94/5/EC of 14 February 1994 on the special arrangements applicable to second-hand goods, works of art, collectors' items and antiques (OJ L 60, 03/03/1994, p. 16), amended Articles 12(3)(c) and 28(2)(e); Council Directive 95/7/EC of 10 April 1995

changed little and the level of harmonisation of VAT rates has remained modest".[367] The structure under the Sixth Directive, as introduced by the Approximation of VAT Rates Directive still remains a multiple-rate system, allowing for a standard rate and one or two reduced rates in theory (two more in practice), and subject to lenient basic rules, as follows:

— The standard rate cannot be lower than 15% – Article 12(3)(a);[368]

— Member States may apply one or two reduced rates to supplies of goods/services specified in Annex H but not where they are electronically supplied – Article 12(3)(a);

— Subject to certain conditions, reduced rates may also be applied to supplies of natural gas and electricity [Article 12(3)(b)], imports of works of art, collectors' items and antiques and certain supplies of works of art [Article 12(3)(c)], and direct imports and supplies carried out in the regions of the Azores and Madeira [Article 12(6)];

— During the transition period, *i.e.*, until the entry into force of the definitive VAT system (Article 28l), Member States may maintain, under certain conditions, various special measures concerning the application of reduced rates. These include application of reduced rates lower than the authorised 5% minimum; maintenance of reduced rates for goods or services not covered by Annex H; or application of an additional reduced rate, known as the "parking rate", no lower than 12% – Article 28(2);

— Member States may also, under certain conditions, apply reduced rates on an experimental basis, to a maximum of three of the labour-intensive services listed in Annex K – Article 28(6).

The described rules illustrate that since the approval of the Approximation of VAT Rates Directive, the VAT rates, far from converging as might have been expected,[369] have the

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introducing new simplification measures (OJ L 102, 05/05/1995, p. 18), inserted Article 28(2)(h); Council Directive 96/42/EC of 25 June 1996 (OJ L 170, 09/07/1996, p. 34), deleted Article 12(3)(d) and inserted Article 28(2)(i); Council Directive 98/80/EC of 12 October 1998 on a special scheme for investment gold (OJ L 281, 17/01/1998, p. 31), deleted Article 12(3)(e); Council Directive 1999/49/EC of 25 May 1999 on the level of the standard rate (OJ L 139, 02/06/1999, p. 27), amended Article 12(3)(a); Council Directive 1999/85/EC of 22 October 1999 on the possibility of applying on an experimental basis a reduced VAT rate on labour-intensive services (OJ L 277, 28/10/1999, p. 34), inserted Article 28(6) and Annex K; Council Directive 2000/17/EC of 30 March 2000 on transitional provisions to the Republic of Austria and the Portuguese Republic (OJ L84, 05/04/2000, p. 24), inserted Article 28(2)(j) and (k); Council Directive 2001/4/EC of 19 January 2001 on the length of time during which the minimum standard rate is to be applied (OJ L 22, 24/01/2001, p. 17), amended Article 12(3)(a); Council Directive 2002/38/EC of 7 May 2002 on the arrangements applicable to radio and television broadcasting services and certain electronically supplied services (OJ L 128, 15/05/2002, p. 41), amended Article 12(3)(a); and, finally, Council Directive 2002/92/EC of 2 December 2002 extending the facility allowing Member States to apply reduced rates of VAT to certain labour-intensive services (OJ L 331, 07/12/2002, p. 27), amended Article 28(6).

[367] In *op. cit.*, COM(96) 328 final, 22 July 1996, p. 5.

[368] The date until which this minimum standard rate level will apply has been consecutively postponed. Since the approval of Council Directive 2001/4/EC of 19 January 2001 on the length of time during which the minimum standard rate is to be applied (OJ L 22, 24/01/2001, p. 17), this date stands at 31 December 2005. However, the Commission has put forward a proposal, which extends this time limit to 31 December 2010, see *Proposal for a Council Directive amending Directive 77/388/EEC on the common system of value added tax, with regard to the length of time during which the minimum standard rate is to be applied*, COM(2005) 136 final, 14 April 2005.

[369] This was in fact the Parliament's opinion. According to a research paper published in 1995 by the Parliament, Member States were "likely to face the fiscal consequences of VAT-rate approximation whether this is a result of Community legislation or of market forces. Indeed a

possibility to diverge much more under the current legal framework than in 1992, most notably due to the introduction of the labour-intensive services experiment. As reported by the Commission in 2001, despite its tentative efforts to increase convergence, "when current rates are compared with those applicable in 1997, it is apparent that rates continue to vary considerably".[370] In 1995, for example, the Commission put forward a proposal, in accordance with the second paragraph of Article 12(3)(a), on the level of standard rate to be applied from 31 December 1996 onwards.[371] This proposal suggested the adoption of a 25% upper limit in order to prevent the widening of the spread of standard rates across the different Member States. Both the Parliament and the Council rejected this suggestion and the proposal was approved with amendments, maintaining the application of a 15% minimum standard rate but making no reference to an upper limit.[372]

However, despite the controversy around the level of the standard rate, the main source of divergence continues to be the reduced rates regime. Annex 2 contains a description of the supplies of goods and services to which reduced rates may be currently applied, and under what conditions.

### (2) MEMBER STATES' APPLICATION OF SIXTH DIRECTIVE RULES

The described rules leave Member States significant freedom to establish their own rates structure. In practice Member States are free to decide on the following aspects:

— whether to apply one or two reduced rates;

— whether to apply, subject to special conditions, an extra "parking rate";

— the level of standard rate, as long as it is more than 15%;

— the level of the reduced rate(s), subject to certain conditions, which depend on each Member State's specific circumstances;

— to which goods / services from the ones listed by the Sixth Directive (which is also dependent on each Member State's specific circumstances), the reduced rates apply.[373]

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general convergence of tax systems is likely as the Single Market develops", in *Opinions for a definitive VAT system*, *op. cit.*, p. 87. This was also the view expressed by several authors and Member States' officials following the White Paper strategy, as reported by Commission staff members P. Guieu and C. Bonnet, see "Completion of the Internal Market and Indirect Taxation", (1987) *JCMS* Vol. XXV, No. 3, p. 215.

[370] In *Report from the Commission on reduced VAT rates drawn up in accordance with Article 12(4) of the Sixth Council Directive of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes – Common system of value added tax: uniform basis of assessment*, COM(2001) 599 final, 22 October 2001, paragraph 19.

[371] *Proposal for a Council Directive amending Directive 77/388/EEC on the common system of value added tax (level of the standard rate)*, COM(95) 731 final, 20 December 1995.

[372] The approval resulted in Council Directive 96/95/EC of 20 December 1996, OJ L 338, 28/12/1996, p. 89.

[373] Member States' application of the labour-intensive services experiment is a good example of the discrepancies that this optional nature of reduced rates can give rise to. Only nine (of the old fifteen) Member States submitted applications to avail of the option to apply reduced rates to labour-intensive services. Of those nine Member States each of them chose different services from the ones listed in Annex K: seven chose the housing sector, four small repair services, four

Member States' VAT rates structures

This freedom results in VAT rates in the EU remaining very disparate and highly complex. Table 3.1 lists the VAT rates currently applied in the Member States.[374]

**TABLE 3.1**

**VAT RATES APPLIED IN THE MEMBER STATES**

| | Zero Rate | Super Reduced Rate | Reduced Rate | Standard Rate | Parking Rate |
|---|---|---|---|---|---|
| Austria[375] | - | - | 10 | 20 | 12 |
| Belgium | Yes | - | 6 | 21 | 12 |
| Cyprus | Yes | - | 5 | 15 | - |
| Czech Republic | Yes | - | 5 | 19 | - |
| Denmark[376] | Yes | - | - | 25 | - |
| Estonia | Yes | - | 5 | 18 | - |
| Finland[377] | Yes | - | 8/17 | 22 | - |
| France[378] | - | 2,1 | 5,5 | 19,6 | - |
| Germany[379] | - | - | 7 | 16[380] | - |

domestic care services, three hairdressing and two window cleaning and household cleaning services. These applications were the subject of Council Decision 2000/185/EC of 28 February 2000 authorising Member States to apply a reduced rate of VAT to certain labour-intensive services (OJ L 58, 04/03/2000, p. 10), as last amended by Council Decision 2004/189/EC of 10 February 2004 extending the period of application of this Decision (OJ L 52, 21/02/2004, p. 62 and OJ L 91, 30/03/2004, p. 60). Additionally, the Commission has put forward a proposal for the extension of the experiment to two of the new Member States – *Proposal for a Council Decision authorising the Czech Republic and Poland to apply a reduced rate of VAT on certain labour-intensive services in accordance with the procedure provided for in Article 28(6) and (7) of Directive 77/388/EEC*, COM(2004) 296 final, 21 April 2004.

[374] For a more detailed analysis of the VAT rates applicable in the several Member States, the Commission has been publishing, on an annual basis, a document listing the VAT rates applied to a range of products across the EU. The latest version, dated June 2005, can be found at: http://europa.eu.int/comm/taxation_customs/resources/documents/taxation/vat/how_vat_works/rates/vat_rates_2005_en.pdf. See also the paper prepared by A. Mathis, staff member of the Directorate-General for Taxation and Customs: *VAT indicators*, Taxation Papers, Working Paper No. 2, April 2004.

[375] A special rate of 16% applies in Jungholz and Mittelberg.

[376] The Faroe Islands and Greenland are not part of the European Union; consequently, VAT (according to the Sixth Directive) is not applicable in these territories.

[377] The Aaland Island is not part of the European Union.

[378] Special rates apply in Corsica and the overseas departments (DOM):

Corsica

0.90% - certain theatrical shows and circuses, sales of live meat and charcuterie animals to persons not liable to pay tax;

2.10% - goods supplied in Corsica to which the reduced rates are applicable in mainland France;

8% - certain work on immovable property, agricultural equipment and sales for consumption on the premises, sales of electricity supplied at low voltage;

13% - petroleum products;

The standard rate applicable in Corsica is the same as in the rest of the country, *i.e.* 19.6%.

DOM

In the overseas departments, but not French Guiana, a reduced rate of 2.10% and a standard rate of 8.5% are applicable.

Goods and services supplied to or from the Principality of Monaco are regarded as having been supplied to or from France.

| | | | | | |
|---|---|---|---|---|---|
| Greece[381] | - | 4,5 | 9 | 19 | - |
| Hungary | - | - | 5/15 | 25 | - |
| Ireland | Yes | 4,4 | 13,5 | 21 | 13,5 |
| Italy[382] | Yes | 4 | 10 | 20 | - |
| Latvia | Yes | - | 5 | 18 | - |
| Lithuania | - | - | 5/9 | 18 | - |
| Luxembourg | - | 3 | 6 | 15 | 12 |
| Malta | Yes | - | 5 | 18 | - |
| Netherlands | - | - | 6 | 19 | - |
| Poland[383] | | 3 | 7 | 22 | |
| Portugal[384] | - | - | 5/12 | 21 | - |
| Slovak Republic | Yes | - | - | 19 | - |
| Slovenia | - | - | 8.5 | 20 | - |
| Spain[385] | - | 4 | 7 | 16 | - |
| Sweden | Yes | - | 6/12 | 25 | - |
| United Kingdom[386] | Yes | - | 5 | 17,5 | - |

As regards the "old" Member States, six (Greece, Spain, France, Ireland, Italy and Luxembourg) continue to apply a reduced rate lower than the minimum laid down in Article 12(3) Sixth Directive (a "super-reduced rate"); three (Belgium, Ireland and Luxembourg) still apply a reduced rate not lower than 12% (the "parking rate"); five Member States (Belgium, Denmark, Finland, Italy and Sweden) apply a zero rate on a marginal and restricted basis; while Ireland and the United Kingdom continue to make extensive use of this derogation.[387] The situation is not significantly different within the new Member States: six (Cyprus, Czech Republic, Estonia, Latvia, Malta and Slovakia) apply a zero VAT rate and all (with exception of Lithuania) have been granted

[379] For VAT purposes, the country does not include the island of Heligoland or the territory of Busingen.

[380] It has been reported in the media that the new German Government plans to increase the standard rate from 16% to 19%, see W. Horsley, "Analysis: German coalition deal", in *BBC News online*, 15 November 2005.

[381] For the departments of Lesbos, Chios, Samos, the Dodecanese and the Cyclades, and on the Aegean islands of Thassos, the Northern Sporades, Samothrace and Skiros, the rates of 4%, 8% and 18% have been reduced to 3%, 6% and 13% respectively. These rates apply to imports, intra-Community acquisitions, supplies of goods and services effected in these islands and supplies of goods from other areas of Greece to persons established on these islands. This preferential system does not, however, apply to tobacco products and means of transport.
Mount Athos is excluded from the scope of VAT.

[382] The following territories are excluded from the scope of VAT: Livigno, Campione d'Italia and the territorial waters of Lake Lugano.

[383] No information available regarding application of reduced rates of VAT.

[384] Special rates apply in Madeira and Azores:
4% - reduced rate;
15% - standard rate;
8% - parking rate.

[385] For VAT purposes, the country does not include the Canary Islands, Ceuta and Melilla.

[386] Goods and services supplied to or from the Isle of Man are regarded as having been supplied to or from the United Kingdom.

[387] The data is reported on the Commission's report on reduced VAT rates, *op. cit.*, COM(2001) 599 final, 22 October 2001. An analysis of the rates in force on 1 December 2005 shows that the situation has not improved and, if anything, it has worsened.

authorisation to introduce / maintain the application of rates which derogate from Article 12(3)(a) Sixth Directive.[388]

Member States' interpretation/application of the EU rates rules

The complexity of the system is increased by the lack of clarity of the rules set out in Articles 12 and 28 and Annex H Sixth Directive. The apparent simplicity of the rates structure rules described *supra* conceals a system susceptible to different interpretations and applications, namely in respect of the list of goods / services which may be subject to reduced rates. As the Commission recognises:

> "While superficially there may seem to be a good deal of similarity between the practices of Member States in terms of category selection, coverage of any individual category may in fact differ from Member State to Member State depending on how Member States choose to define goods or services within any given category in their own national legislation."[389]

According to the Commission, complaints, regarding uneven transposition of Annex H categories are frequent.[390] Additionally, the lack of clear definitions of the categories of goods and services, which may be subject to reduced rates, leads Member States to introduce extremely subtle distinctions. The following cases are examples of the subtleties of determining which rate applies to a specific product:

— In Belgium replacement of a front bicycle wheel is subject to a standard rate whereas replacement of the back wheel is subject to reduced rate because the labour component is greater [Sixth Directive basis, Annex K(1)].

— In France the reduced rate applying to food products only applies to chocolate under certain very complex conditions: products containing chocolate are subject to the standard or reduced rate according to their form, presentation or actual composition [Sixth Directive basis, Annex H, Category 1].

— In Portugal, fresh fish is subject to 5% rate; if it is cooked prior to being frozen is subject to 19%; and if it forms part of a ready meal to be taken away or consumed on the spot, it is subject to 12% [Sixth Directive basis, Annex H, Category 1].

— In the United Kingdom, raw and unprocessed nuts are zero-rated; so are roasted and salted nuts still in their shells; a fruit and nut mix can be zero-rated if the weight of the roasted nuts is less than a quarter of the whole; however if nuts are shelled and

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[388] Act concerning the conditions of accession of the Czech Republic, the Republic of Estonia, the Republic of Cyprus, the Republic of Latvia, the Republic of Lithuania, the Republic of Hungary, the Republic of Malta, the Republic of Poland, the Republic of Slovenia and the Slovak Republic and the adjustments to the Treaties on which the European Union is founded, Annexes V to XIV, OJ L 236, 23/09/2003, p. 808.

[389] In *op. cit.*, COM(94) 584 final, 13 December 1994, p. 14.

[390] *Report from the Commission to the Council and to the European Parliament in accordance with Article 12(4) of the Sixth Council Directive of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes – Common system of value added tax: uniform basis of assessment*, COM(97) 599 final, 13 November 1997, p. 5.

roasted or salted, or if they have been coated with chocolate or yoghurt, the standard rate applies [Sixth Directive basis, Annex H, Category 1].[391]

Symptomatic of these interpretative / application difficulties caused by the rates' rules, and in particular the rules regarding reduced rates, are the several cases brought by the Commission before the Court of Justice, all of them relating to the application of reduced rates (including the zero-rate) by Member States to supplies of goods or services. In all but one case, the Court found the Member State to be in violation of Article 12 Sixth Directive. The Court's judgments show, *prima facie*, that the rules regarding VAT rates not only leave considerable freedom to Member States to establish their own rates structure, but also are sufficiently, and perhaps suitably, unclear as to allow Member States significant liberty to choose which supplies are subject to reduced rates through the adoption of convenient interpretations of Articles 12 and 28 and of the categories listed in Annex H.[392]

Equally, the Court's decisions reflect a fundamental problem faced by companies seeking to engage in intra-community trade: it is nearly impossible to establish the VAT rate applicable to a determined supply in another Member State. As the Commission has recognised:

> "In many cases only an experienced tax expert can determine with any certainty what rate is to be applied by comparing legislation and the exact characteristics of the products in question."[393]

### (3) CRITICAL EVALUATION OF THE LACK OF RATES CONVERGENCE

The impact of the lack of rates convergence on intra-community trade should be evaluated from two different perspectives: from the perspective of private consumption, and from the perspective of businesses. The Commission's 1987 VAT proposals, and the 1991/1992 VAT legislation which followed, placed significant emphasis on the impact of the abolition of fiscal frontiers on private consumption and cross-border shopping.[394] Rates convergence was seen as fundamental if cross-border shopping was to be avoided after 1993. More than ten years later, it has become evident that the overall impact of the lack of rates convergence on cross-border shopping is relatively limited. Instead it is the impact that this lack of convergence has had, and continues to have, on businesses, that constitutes a serious obstacle to the establishment of the Internal Market.

Lack of VAT convergence and private consumption

From 1993 onwards, the Commission undertook the role of monitoring the impact of the lack of convergence of VAT rates on consumption patterns. It has done so, not solely based on its own internal research, but through the commissioning of outside experts. In 1994 the Commission contracted an outside consultant, PriceWaterhouse, to assess "the

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[391] This complex scenario is bound to confuse consumers, see M. Dibben, "Is the shop nuts to charge me VAT?", in *The Observer*, 2 October 2005, p. 12.
[392] See Chapter 4.
[393] See *op. cit.*, COM(2003) 397 final, 23 July 2003, paragraph 42.
[394] This view was shared by some authors namely Lee, Pearson and Smith, see *op. cit.*, p. 23.

effect of the abolition of fiscal frontiers [and implicitly the lack of convergence of VAT rates] on cross-border purchasing patterns". The results of this study were presented in the Commission's 1994 report on VAT rates.[395] In relation to VAT, the overall conclusion of the PriceWaterhouse study was that, generally speaking, there were no major changes in the patterns of cross-border purchasing behaviour due to differences in VAT rates alone.[396] The study pointed out that cross-border shopping was of heightened importance at the following frontiers:

— Germany / France (for domestic durable goods);

— Germany / Denmark (for domestic durable goods); and

— Luxembourg / Belgium (for jewellery and watches).

However, the study concluded, this cross-border shopping had not increased dramatically since January 1993.

Despite the results of the PriceWaterhouse study, some specific cases were brought to the Commission's attention in the years that followed,[397] as follows:

— German farmers, subject to flat-rate VAT schemes, were purchasing fertilisers and pesticides, which in Germany were subject to the standard rate, in neighbouring Member States where those products were taxed at reduced rates;

— French customers tended to buy their domestic fuel such as coal in Belgium, where the applicable rate was significantly lower;

— other cases involved sales of beverages like soft drinks and mineral water from France to Belgium or from France to Britain.

Although the Commission accepted that these were minor cases, it considered that the sum of such cases might, however, be relevant as there was always the possibility of significant regional impact. In this context, in 1996 the Commission subsidised another study by an outside consultant on the impact of tax factors on behaviour patterns.[398] The study focussed on border regions, which had been identified as "sensitive", and it was carried out by means of an exhaustive written survey and expert interviews. This study confirmed the results of the PriceWaterhouse study, *i.e.*, that VAT rates had no significant impact on consumer patterns.[399]

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[395] See *op. cit.*, COM(94) 584 final, 13 December 1994.

[396] *VAT and Excise Duties: Changes in cross-border purchasing patterns following the abolition of fiscal frontiers on 1 January 1993*, Final report prepared for the Commission, Directorate General of Customs and Indirect Taxation (DGXXI/C-3), August 1994.

[397] See *op. cit.*, COM(97) 559 final, 13 November 1997, p. 5.

[398] The study entitled *Retail strategies to benefit from indirect tax differences* was carried out by Jurgen Ratzinger, ifo Institute for Economic Research in March 1996.

[399] However, the study did confirm that where conditions for cross-border shopping were favourable, VAT-induced deflections of trade did take place. In this context, the study corroborate numerous complains of Austrian operators about VAT induced deflections of trade towards Germany (e.g. for electric appliances).

Based on these two studies the Commission concluded that "a sufficient degree of VAT rate approximation had taken place in January 1993",[400] and that "both the assessment of general trends regarding cross-border transactions and the particular results of the study provide insufficient evidence to justify major changes of the current VAT rate system."[401] The overall assessment of the adequacy of the VAT rate structure was that:

> "The present VAT rates structure is not, Community-wide, an obstacle which prevents the transitional VAT arrangements from functioning. In general the VAT rate differentials do not hamper cross-frontier purchases but there is evidence that they sometimes impact on consumer decisions in a distortive manner. Retailers increasingly tend to benefit from the existing purchasing potential beyond borders. Apart from specific regions and / or specific goods there have been no really significant broad Community-wide distortions of competition or deflection of trade brought about as a result of excessive disparities in VAT rates between Member States."[402]

The Commission's conclusions were based on the assumption that the adequacy of the current level of VAT rates convergence should be evaluated on the basis of its impact on cross-border shopping and the distortions to competition which could arise thereof. It was an erroneous assumption, which led to erroneous conclusions.[403]

As discussed *supra*, the Commission's view on the interconnection between VAT rates convergence and cross-border shopping dates back to the introduction of the Internal Market policy: during the years which followed the presentation of the White Paper the Commission argued that VAT rates convergence was fundamental if cross-border shopping was to be avoided whenever fiscal frontiers where abolished. The Commission was justified in assuming that there was a serious risk of VAT-induced deflections of trade once frontiers were open. However, several factors, not related with taxation, contributed to stop this deflection from happening on a significant scale. [404]

Probably one of the most important of those factors (if not the most important) is the almost insignificant impact that reduced rates (or zero-rates) have on prices. In fact, the labour-intensive services experiment has confirmed what economists have been arguing for a long time: that the use of reduced VAT rates (or zero-rates) does not translate into lower prices for consumers in the long term – it just legitimises higher profit margins for

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[400] In *op. cit.*, COM(94) 584 final, 13 December 1994, p. 9.

[401] In *op. cit.*, COM(97) 559 final, 13 November 1997, p. 7. Even though, it added that "it is probable that these trends will be considerably boosted by the advent of the Single Currency and by the increasing use of electronic commerce. It is therefore likely that the restrictive effects of the current VAT rate structure will become more aggravating in the future", *ibid*, p. 8.

[402] *Ibid*, p. 29.

[403] More recently the Commission has recognised the need for change to the VAT rate structure based on the impact the lack of convergence has on businesses, see *op. cit.*, COM(2003) 397 final, 16 July 2003.

[404] Both studies list several factors, categorised as follows: price-related factors, like transportation costs; non-price-related factors, like product range and quality; and obstacles, like language and distance.

retailers.[405] Price comparisons within the EU have shown that a product which is subject to a reduced VAT rate in a Member State is not necessarily less expensive in that Member State than in any other Member State which applies a standard VAT rate to the relevant product.[406]

This conclusion has, however, serious implications in terms of competition not only from the perspective of private consumers, but also from the perspective of businesses. Businesses operating in Member States which apply reduced rates have a competitive advantage over businesses working in the same trade in other Member States which apply standard rates. This clearly distorts competition. Moreover, this is just one of the ways in which the lack of VAT rates convergence has a negative impact on intra-community trade. From the businesses' perspective it not only distorts competition within the Community, but is also a true obstacle to the free movement of goods and services, and thus to the Internal Market.

Lack of VAT convergence and traders

Traders' reports and complaints to EU institutions in relation to the VAT rates structure are common. As the Commission recognised, it regularly receives reports and complaints about specific cases where VAT rates discrepancies are said to be the reason for significant distortions between operators. Many of these complaints relate to distortions of competition within a Member State, stemming from the uneven application of Annex H categories, and thus do not fall within the Commission's responsibility.[407] Others, however, relate to the impact of the VAT rates structure on intra-community trade.[408]

In its 2001 report on reduced rates, the Commission listed the traders' main complaints, as follows:[409]

— the optional nature of applying reduced rates;

— the huge variations between reduced rates and super reduced rates;

— the lack of Community definitions for categories of goods and services in Annex H, and its restrictive nature;

— the uneven way in which the reduced rates are applied, as the option exercised by one Member State does not oblige it to apply this reduced rate to all goods and services of the category or categories chosen;

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[405] A more detailed analysis of the conclusions, which can be drawn from the labour-intensive rates experience, is undertaken *infra*. These conclusions have undeniable consequences to the well-established practice of using reduced rates to attenuate the regressivity of VAT.

[406] *Comparison of prices and VAT rates for certain sectors – 1999*, source: Eurostat – EU level=100, 1999 data, in COM(2003) 397 final, 23 July 2003, Annex 2.

[407] The Commission considers, however, that even though these complaints do not fall within the Commission's responsibility, they are certainly reason for concern. In fact, under the principle of neutrality, identical foods and services cannot be taxed at different rates, as confirmed by the Court of Justice in case C-481/98, *Commission v France*, [2001] ECR I-3369, see Chapter 4.

[408] See *op. cit.*, COM(97) 559 final, 13 November 1997, pp. 8-9.

[409] See *op. cit.*, COM(2001) 599 final, 22 October 2001, paragraph 23.

— the conflict between the principle of a single rate of VAT and the possibility of applying reduced rates;

— the complexity resulting from the permanent or transitional nature of the derogations.

In light of these complaints, the Commission has recently accepted that the current rates structure has, at least partially, failed.

> "An analysis of the current structure of VAT rates and, in particular the scope of the reduced rates, has revealed two factors which may hamper the proper functioning of the internal market and create distortion of competition:
>
> - the optional nature of applying reduced rates for Member States; and
> - the lack of common definitions for the categories in Annex H."[410]

The traders' complaints regarding the current VAT rates structure confirm this analysis and seem to support (even if on a different basis) the Commission's earlier (1987) view: that a higher level of convergence would be required in order to establish the internal market. In fact, the current VAT rates structure and, more specifically, the lack of convergence of VAT rates, cause significant economic distortions from the perspective of businesses, as follows:

— increased compliance costs – the difficulty establishing the VAT rate applicable to a determined supply in another Member State, amplifies companies' compliance costs. Engaging in the most basic business transaction in another Member State entails extensive study of the rates applicable in that State and, in many situations, as discussed *supra*, the resort to external tax expert advice, creating a significant additional financial burden;

— infringement of the principle of VAT's neutrality and distorted competition – the wide disparity of VAT rates across the EU can potentially cause significant distortions of competition by infringing the principle of VAT's neutrality vis-à-vis the conditions of competition.[411]

  As described *supra*, there are strong indications that lower and reduced rates can be a factor in corporate profitability; companies trading in a Member State applying a lower standard rate, a reduced or zero rate of VAT may be able to take higher profit margins, giving them an advantage over competitors in other Member States;

  Distortions of competition can also arise from a form of VAT avoidance labelled by the Parliament's Directorate General for Research, the "place of establishment option".[412] Where transactions are taxed on the place of establishment of the business [e.g. general rule for supply of services – Article 9(1) Sixth Directive], differences in VAT rates (can) act as the decisive factor for businesses' location decisions: where companies have places of establishment in several Member States,

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[410] In *op. cit.*, COM(2003) 397 final, 23 July 2003, paragraph 30.
[411] The principle of VAT's neutrality has various corollaries, as discussed *infra*.
[412] *Options for a definitive VAT system*, *op. cit.*, p. 84.

invoices would as far as possible be issued from those in lower-taxed Member States. Additionally, some companies, namely within the services industry, take the "place of establishment option" further, and on a VAT planning motivated shift, locate themselves in Member States which apply lower rates of VAT.[413] E.g. under the E-Commerce Directive,[414] non-EU companies supplying services by electronic means to non-taxable persons within the EU, can avail of a special scheme which entails registration for VAT purposes in one of the Member States; this means there was a widespread concern that most companies would probably choose Luxembourg to locate and register for VAT purposes, as it is currently the country with the lowest level of VAT rates.[415]

— creates obstacle to intra-community trade – the difficulty determining the VAT rates applicable in other Member States, because of the high compliance costs it entails, can constitute a deterrent for traders, namely for small and medium size businesses, to engage in intra-community trade.

By increasing the compliance costs, the lack of convergence of VAT rates stops companies from fulfilling their potential in terms of competitiveness. Thus, it has a preventative impact, stopping the EU market from achieving the objectives set out in the Lisbon Strategy: "to become the most competitive and dynamic knowledge-based economy in the world".[416]

By infringing the principle of neutrality of VAT, the lack of convergence of VAT rates negates one of the basic principles of the EU VAT system, as set out in the First Directive.

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[413] The first described "place of establishment option" situation seems to be a case of VAT avoidance, while the second, a case of VAT planning. The differences between the two situations might seem insignificant, as both cases contain the same motivations (to minimise VAT payments) and similar results. However, the means used in order to achieve those objectives are substantially different: in the first situation there is a "fictitious" location of the supply; in the second situation the location of the supply corresponds to reality, even if motivated by VAT considerations.

[414] Council Directive 2002/38/EC of 7 May 2002, OJ L 128, 15/05/2002, p. 41.

[415] It has been confirmed by former Commissioner Bolkestein that Luxembourg has been the most popular "one stop shop", even though he considers that in itself the Directive has no bearing on the choice by a business of which Member State to establish itself on. Rather are the rules of Article 9 Sixth Directive, according to the former Commissioner, which encourage providers of B2C services capable of remote delivery to locate themselves where VAT rates are the lowest – see *Follow-up on the workings of Council Directive 2002/38/EC on the application of VAT to digital services, Written Question E-1984/04 by Charles Tannock (PPE-DE) and Theresa Villers (PPE-DE) to the Commission*, 2 September 2004. This position has been confirmed by the recent amended proposal on place of supply of services, which states as it main objective "to ensure taxation of services at the place of consumption and to avoid relocation of companies", see *op. cit.*, COM(2005) 334 final, 20 July 2005, p. 5. The current one-stop-shop proposal is in practice an extension of the current special scheme applicable to E-commerce operators, and thus, the question is whether, if approved, could potentially give rise to these type of difficulties, see *op. cit.*, COM(2004) 738 final, 29 October 2004. It has been suggested however that the problem will not be a choice based on rates (as the VAT rates of the country of destination will apply) but rather a choice based on the efficiency levels of the tax administrations of the several Member States. It has emerged that tax authorities which regard themselves as efficient are concerned that traders will located themselves in less efficient countries and thus the level of Revenues will go down, *i.e.*, tax administrations do not trust each other to collect their own taxes.

[416] *Lisbon European Council, 23 and 24 March 2000 – Presidency Conclusions*, paragraph 5. For a more detailed analysis of the challenge presented by the Lisbon Strategy, see *infra*.

By distorting competition within the Community, the lack of convergence of VAT rates negates one of the main EU economic principles, as set out in Article 3 EC Treaty, namely undistorted competition, and the concept of internal market.

Finally, by creating an obstacle to intra-community trade, the lack of VAT rates convergence constitutes an obstacle to the free movement of goods and services.

In order to solve some of these difficulties, namely in relation to the application of reduced VAT rates, the Commission presented in July 2003 a new proposal regarding the VAT rate structure.[417] As insistently stated in the proposal, the intention was not to change the level of VAT rates currently applied, but to review and rationalise the VAT rates structure through the introduction of amendments to the current reduced rates regime.

The proposal leaves considerably more freedom to Member States to decide their own VAT rates structure than existed under previous Commission's proposals, namely the 1987 proposals. The Commission obviously considered that by leaving increased freedom to Member States the likelihood of reaching an agreement in the Council would also increase.[418] However, discussions in the Council have proved difficult even though the latest Presidencies of the Council have all stated their intention to give priority to this proposal.[419] In order to overcome this impasse, the United Kingdom, which currently holds the Presidency, has recently put forward a compromise solution whereby some additional goods and services, not included in the Commission's original proposal, could

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[417] *Op. cit.*, COM(2003) 397 final, 23 July 2003. This is the fifth Commission formal proposal exclusively on VAT rates (excluding Commission's informal suggestions).

[418] Unfortunately, likelihood in this case does not equate to "likely". The Council initiated its formal discussions on the Commission's proposal at the ECOFIN meeting of 7 October 2003 in Luxembourg (see *Preparation of Eurogroup and Council of Economics and Finance Ministers, Luxembourg, 6-7 October 2003*, MEMO/03/191, 06/10/2003). Although the Commissioner, Frits Bolkestein, was eager to have the proposal approved before the end of the year, the Council's initial discussions seemed to indicate that reaching Member States' agreement regarding this proposal might be difficult and lengthy (see *2530th Council Meeting – Economic and Financial Affairs – Luxembourg, 7 October 2003*, C/03/274, Pres/03/274, 07/10/2003 and *Results of the Council of Economics and Finance Ministers, 25th November 2003 – financial services and taxation*, MEMO/03/241, 26/11/2003). The difficulties reaching an agreement has led the Commission to put forward proposals extending, for a period of two-years (until 31 December 2005), the labour-intensive services experiment (see *VAT: Commission decides to propose two-year extension of reduced rates on labour-intensive services*, IP/03/1693, 10 December 2003 and *Proposal for a Council Directive amending Directive 77/388/EEC to extend the facility allowing Member States to apply reduced rates of VAT to certain labour-intensive services and Proposal for a Council Decision extending the period of application of Council Decision 2000/185/EC authorising Member States to apply a reduced rates of VAT to certain labour-intensive services in accordance with the procedure provided for in Article 28(6) of Directive 77/388/EEC*, COM(2003) 825 final, 16 December 2003). These proposals have been recently approved resulting in Council Directive 2004/15/EC of 10 February 2004, OJ L 52, 21/02/2004, p. 61; and Council Decision 2004/189/EC of 10 February 2004, OJ L 52, 21/02/2004, p. 62 and OJ L 91, 30/03/2004, p. 60.

[419] This was true of both Luxembourg and the United Kingdom, which held the Presidency of the Council during the first and second half of 2005, respectively, see *Results of Council of Economic and Finance Ministers, Brussels, 6-7 December 2004*, MEMO/04/289, 08/12/2004. Previously, the Netherlands, who held the Presidency of the Council during the second semester of 2004, had also qualified the discussions on this proposal as a priority for their Presidency of the Council – *The Dutch Presidency of the Council of the European Union: Priorities*, p.11, available on: http://www.eu2004.nl/default.asp?CMS_TCP=tcpAsset&id=AB2CCD9E8D1A455FB3970D9512B88791.

be subject to reduced VAT rates.[420] It is expected that this proposal will lead to agreement in December 2005, whether this will be the case it remains to be seen.[421]

## b) EU VAT SYSTEM AS AN OBSTACLE TO THE FUNCTIONING OF THE INTERNAL MARKET

### i) EU VAT SYSTEM AS A DIRECT OBSTACLE TO THE FUNCTIONING OF THE INTERNAL MARKET: DIFFERENT CRITERIA ON NON-DEDUCTIBLE INPUT TAX

The taxable persons' right to deduct input VAT incurred on their business expenses is one of the fundamental characteristics of the VAT system introduced by the First Directive. Its essence is expressed in Article 2 of that Directive, which reads:

> "On each transaction, value added tax, calculated on the price of the goods or services, at the rate applicable to such goods or services, shall be chargeable after deduction of the amount of value added tax borne directly by the various components".

Three principles emerge from this provision, which form the foundation of the Community's VAT system of deduction, as follows:

— Integral deduction – full deduction of the tax paid is allowed, provided the goods and services bought are used for the purposes of taxable activities;[422]

— Global deduction – deduction in respect of all activities, rather than applicable to specific activities;

— Immediate deduction – this contrasts with, for example, a system whereby deduction is allowed only when purchased goods or services are actually used.[423]

The current EU VAT system, as set out in Articles 17 to 20 Sixth Directive and in the Eighth and Thirteenth Directives' provisions is largely based on the application of these principles,[424] despite providing for several exceptions. Amongst those exceptions are some of the rules which limit the right to deduct input tax.

#### (1) GENERAL LIMITS TO RIGHT TO DEDUCT

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[420] See *Preparation of Eurogroup and Economic and Finance Ministers Council, Brussels 7 and 8 November*, MEMO/05/406, 7 November 2005.

[421] See *Results of the 2688th ECOFIN Meeting*, *op. cit.*, p. 21.

[422] This principle precludes Member States from applying systems of partial deduction, as confirmed by the Court of Justice in *Commission v France*, case 50/87, [1988] ECR 4797.

[423] Connected with this principle is the issue of deductibility of the so-called "preparatory activities". In this matter the Court has consistently reiterated that a taxable person is entitled to deduct the VAT payable by him on goods or services supplied to him for the purposes of being used in connection with taxable transactions, even where for reasons beyond his control they were not used for that purpose, or those taxable transactions did not take place, see cases C-37/95, *Ghent Coal Terminal*, [1998] ECR I-1; C-110/98, *Galbafrisa and Others*, [2000] ECR I-1577; and C-400/98, *Breitsohl*, [2000] ECR I-4321.

[424] The first two principles relate to the scope of the right to deduct and are reflected mostly in paragraphs 2, 3 and 4 of Article 17 Sixth Directive. The third relates to its origin and is reflected in paragraph 1 of Article 17 of the same directive. The Court has ruled that both paragraphs 1 and 2 of Article 17 have direct effect, see case C-150/99, *Stockholm Lindopark*, [2001] ECR I-493.

Article 17(2) Sixth Directive provides that taxable persons can deduct VAT paid on input transactions "insofar as the goods and services [acquired] are used for the purposes of his taxable transactions".[425] Implicit to this provision are two general limitations to the right to deduct, as follows:

— the non-deductibility of input tax incurred in relation to goods and services used for the purposes of exempt activities;[426] and,

— the non-deductibility of input tax incurred in relation to goods and services used for non-business purposes.

Exempt activities

The non-deductibility of input tax in relation to exempt activities, which has been interpreted as entailing the establishment of a link between the goods and services, on which VAT has been charged to the taxable person (input transaction), and the goods and services supplied by the taxable person (output transaction),[427] undoubtedly constitutes a limitation to the right to deduct. However, it does not represent an exception to the principle of integral deduction but rather stems from it. The essence of the right to deduct, and more particularly the principle of integral deduction, is the correlation between input tax and output tax. Therefore, where there is no output tax, this correlation can no longer be established and the *ratio* behind the right to deduct ceases to apply.[428]

Non-business expenditure

The non-deductibility of input tax in relation to non-business expenditure should equally be regarded as a limitation to the right to deduct which cannot be qualified as an exception to the principle of integral deduction. In fact, this limitation stems primarily from the very nature of EU VAT as a tax on consumption: where taxable persons incur expenditure which is not business related they are acting as consumers rather than as

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[425] Paragraphs 3 and 4 of Article 17 extend further the scope of the right to deduct to include situations where the input VAT has been incurred by a taxable person established outside the territory of the country, referring the regulation of the matter to the Eighth and Thirteenth Directives.

[426] Article 11(2) of the Second Directive referred specifically to the non-deductible nature of expenditure incurred for the purposes of exempt activities or activities not subject to VAT.

[427] In most cases, the establishment of this link will be a straightforward operation; however, this is not always the case, namely in cases involving apportionment of tax, *i.e.*, where the taxable person engages both in activities in respect of which tax is deductible and activities in respect of which tax is not deductible (Article 17(5) Sixth Directive). In *Midland Bank*, case C-98/98, [2000] ECR I-4177, the Court of Justice ruled that "Article 17(2), (3) and (5) Sixth Directive must be interpreted as meaning that the existence of a direct and immediate link between a particular input transaction and a particular output transaction or transactions giving rise to entitlement to deduct is necessary before the taxable person is entitled to deduct input VAT and in order to determine the extent of such entitlement." Previously in *BLP*, the Court had already indicated its willingness to extend the application of the concept of "direct and immediate link" to the interpretation of the right to deduct rules, see case C-4/94, *BLP Group*, [1995] ECR I-983. The concept is a jurisprudential construction originally introduced in relation to Article 2 Sixth Directive as a test to determine the existence of a link between supply and consideration – see cases 154/80, *Dutch Potato*, [1981] ECR 445; 102/86, *APDC*, [1988] ECR 1443; C-16/93, *Tolsma*, [1994] ECR I-743; C-258/95, *Julius Fillibeck Sohne*, [1997] ECR I-5577; and C-172/96, *First National Bank Chicago*, [1998] ECR I-4387.

[428] There are several exceptions to this rule. Article 17(3) Sixth Directive, for example, extends the scope of the right to deduct to input tax incurred for the purpose of some exempt activities, namely where these constitute exports or are part of international trade. Equally an exception to this rule is the application by some Member States, namely Ireland and the United Kingdom, of zero-rates, which, in practice, constitute exemptions from the right to deduction.

traders, and as such should bear the VAT costs. This limitation is also coherent with the right to deduct *ratio,* as in these circumstances not only is there no output tax (as in the case of exempt activities) but moreover, there is actually no correlation with an output transaction. Finally, this limitation is fundamental in an area which is particularly vulnerable to tax fraud.

The above limitations constitute general limitations to the right to deduct, which are coherent with the principles of EU VAT and which are essential to the efficient functioning of the tax. However, the EU VAT system and mostly Member States' domestic VAT systems, include several other limitations which should at best be regarded as exceptions to the principle of integral deduction, and at worst as contraventions of both this principle and the principle which it ensures: the principle of fiscal neutrality.

### (2) SPECIFIC LIMITS TO RIGHT TO DEDUCT

#### (a) ARTICLE 17(6) SIXTH DIRECTIVE

Article 17(6) Sixth Directive reads:

> "Before a period of four years at the latest has elapsed from the date of entry into force of this Directive, the Council, acting unanimously on a proposal from the Commission, shall decide what expenditure shall not be eligible for a deduction of value added tax. Value added tax shall in no circumstances be deductible on expenditure which is not strictly business expenditure, such as that on luxuries, amusements or entertainment.
>
> Until the above rules come into force, Member States may retain all the exclusions provided for under the national laws when this Directive comes into force."

This provision contains three distinct, yet interdependent, rules, as follows:

— a limitation to the right to deduct in respect of expenditure which is "not strictly business";

— an instruction to the European institutions regarding the harmonisation of the rules on non-deductible expenditure; and,

— an authorisation for Member States to maintain their rules regarding non-deductible expenditure until such harmonisation comes into effect, known as the "standstill clause".

Not strictly business expenditure

Article 17(6) adds a further limitation to the two aforementioned limitations to the right to deduct: the non-deductibility of input tax in respect of expenditure which is "not strictly business expenditure". This limitation is fundamentally different from the limitation regarding non-business expenditure. As opposed to the limitation regarding non-business expenditure, the limitation regarding not strictly business expenditure does not stem from the nature of EU VAT, or the essence of the right to deduct. Rather it constitutes an exception to the principle of integral deduction, which is guided by practical

concerns. In fact, two practical concerns lie behind this limitation: firstly, the difficulties determining in some cases and as regards some types of expenditure, the extent to which they constitute business expenditure; and secondly, as a consequence of the first concern, the serious risk of tax evasion by passing consuming expenditure as business expenditure. In this context, the limitation regarding the non-deductibility of not strictly business expenditure can be regarded as essentially an anti-evasion measure.

The measure, however, creates serious difficulties, namely because it shifts the practical concern of how to determine the extent to which expenditure can be qualified as business expenditure, to another practical concern which is how to determine which expenses should be qualified as not strictly business. Instead of providing a general criterion to resolve this impasse, Article 17(6) opts for indicating some of the expenses which should be regarded as not strictly business "luxuries, amusements or entertainment". However, this provides little help, not solely because the list is exemplificative, which is clearly indicated by the use of the expression "such as", but equally, because the terms themselves are not entirely clear. For example, a trader organises an afternoon of golf for clients in order to promote its business – should this be seen as entertainment for the purposes of Article 17(6)?[429] Is it strictly business or not strictly business expenditure?

These difficulties were to be dealt with soon after the entry into force of the Sixth Directive, and the measure was seen as temporary until the approval of measures which would harmonise the rules on non-deductible expenditure. However, as discussed *infra* twenty-seven years since the entry into force of the Sixth Directive, these harmonising measures have not yet been adopted and there is little hope that they will be in the near future. In this context, Member States have been left to interpret and apply the concept of "not strictly business expenditure" freely, which has lead to severe discrepancies between the various domestic VAT legislation regimes as regards the type of expenditure which is deductible, and to what extent.

Harmonisation of rules on non-deductible expenditure

According to Article 17(6) the rules regarding non-deductible expenditure were to be harmonised before the end of 1983 at the latest, *i.e.*, four years after the entry into force of the Sixth Directive. With a view to fulfilling the provision's deadline, the Commission presented a proposal for a Twelfth Directive on expenditure not eligible for deduction of VAT at the beginning of 1983.[430] Subject to certain conditions, this proposal basically excluded from the right to deduct expenditure relating to the following goods and services:

— passenger cars;

— transport services / business travel;

[429] An affirmative answer to this question seems to be actually given in the 1998 Proposal on the rules governing the right to deduct VAT, where it can be read that, "expenditure on amusement and entertainment would cover expenditure designed to give (potential) clients a positive image of the taxable person and his business and expenditure defrayed solely to encourage clients to do business and employees to perform their duties", *op. cit.*, p. 15.

[430] See *op. cit.*, COM(82) 870 final, 25 January 1983.

— accommodation, food or drink;

— entertainment, amusement and luxuries.

Following on Parliament's recommendations, in February 1984 the Commission presented an amended version of the proposal,[431] which included two significant changes, as follows:

— introduction of a four-year transition period in the case of expenditure on passenger cars and transport services; and

— introduction of a "safeguard clause" whereby a taxable person may deduct input tax on expenditure relating to most goods and services listed in the proposal[432] if he is able to show that that expenditure was incurred exclusively for business purposes.

Despite the amendments introduced, the proposal failed to be approved by the Council. According to the Commission, some delegations felt that the exclusions provided for were too wide-ranging, while others were opposed to its very purposes in spite of the mandatory nature of Article 17(6).[433] In this context, the Commission finally decided to withdraw the proposal in November 1996.[434] However, in June 1998, the Commission put forward a new proposal as regards the rules governing the right to deduct VAT.[435] This new proposal dealt with two subjects, as follows:

— deduction of the VAT paid in a Member State where the taxable person is not established, which would entail the abolition of the Eighth Directive; and,

— expenditure which is not eligible for full deduction.[436]

As regards the expenditure which is not eligible for full deduction, the new proposed rules did not differ substantially from the rules included in the Twelfth Directive proposal (post 1984 amendments). The limitations to the right to deduct applied basically to the same categories of goods and services, *i.e.*, passenger cars, accommodation, food, drink, entertainment, amusement and luxuries.[437] However, only expenditure in respect of

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[431] *Amendments to the Proposal for a Twelfth Directive relating to the common system of value added tax: expenditure not eligible for deduction of value added tax*, COM(84) 84 final, 16 February 1984.

[432] Excluded from this safeguard clause would be expenditure incurred in relation to entertainment, amusement and luxuries.

[433] *Second report from the Commission to the Council on the application of the common system of value added tax, submitted in accordance with Article 34 of the Sixth VAT Directive 77/388/EEC of 17 May 1977.*

[434] *Withdrawal of certain proposals and drafts from the Commission*, OJ C 2, 04/01/1997, p. 2. According to the Commission the withdrawal was also the logical consequence of the adoption in July 1996 of the work programme for the introduction of a definitive VAT system.

[435] See *op. cit.*, COM(98) 377 final, 17 June 1998.

[436] As regards the first aspect, this proposal was already referred to above when discussing the current system in relation to "inter-jurisdictional issues".

[437] Excluded from this new proposal was expenditure on the transportation, which accordingly would be fully deductible under the general right to deduct rules. Equally different is the fact that this proposal, as opposed to the amended proposal for a Twelfth Directive, does not include a "safeguard clause".

entertainment, amusement and luxuries would be blocked from the right to deduct,[438] whilst other goods and services would be basically deductible at a 50% rate.

Similarly to what occurred in relation to the Twelfth Directive, the Council failed to reach an agreement in relation to this proposal. According to the Commission, the budgetary impact for some Member States of this proposal was the principal difficulty preventing its approval, and the Council urged for a more flexible approach. Although the Commission has opted not to withdraw this proposal (yet), over seven years since its presentation it seems unlikely it will ever become legislation. [439]

In this context, the Commission has recently decided to put forward a new proposal to, at least, harmonise the scope of the expenses for which exclusions of the right to deduct may apply.[440] Under this 2004 proposal Member States would be able to apply exclusions from the right to deduct to, as follows:

— motorised road vehicles, boats and aircraft;

— travel, accommodation, food and drink;

— luxuries, amusements and entertainment.

According to the Commission, this proposal would oblige Member States to abolish the tax blockings applied to goods and services other than those identified within the proposal. However, for goods and services identified in the proposal, it would provide Member States full flexibility of reviewing their national restrictions which they do not currently have under the standstill clause.[441]

Whether the 2004 proposal will have a more successful destiny than the proposal for a Twelfth Directive or the 1998 proposal, remains to be seen. In the meantime, Member States remain free to interpret the concept of "not strictly business", and what is somewhat more problematic, to take full advantage of the standstill clause.

Standstill clause

The Second Directive allowed Member States to maintain and introduce limitations to the right to deduct on VAT expenditure incurred in relation to goods and services, which were "capable of being exclusively or partially used for the private need of the taxable person or his staff".[442] Member States made use of this provision in significantly diverse manners, and according to the Commission "in moving over to the system provided in the Sixth Directive, have to a considerable extent simply retained in their legislation the exclusions for which they had already opted when the common VAT system was set

[438] B. Terra and J. Kajus question this block, namely the Commission's examples of what should constitute 'expenditure on luxuries', see *A Guide to European VAT Directives – Introduction to European VAT Directive and other taxes*, Vol. 1, 2004, p. 836.
[439] On this aspect, B. Terra and J. Kajus comment that "the history of the never adopted Twelfth Directive shows that Member States are reluctant to give up their national provisions on expenditure not eligible for deduction", *ibid*, p. 845.
[440] In *op. cit.*, COM(2004) 728 final, 19 October 2004.
[441] *Ibid*, p. 8.
[442] Article 11(4) Second Directive.

up".[443] The possibility to maintain these exclusions was given by Article 17(6) standstill clause, which allows Member States to maintain in force the limitations to the right to deduct which were provided for under their national laws when the Sixth Directive came into force.[444]

Similarly to the rule on the non-deductibility of input tax in respect of expenditure which is "not strictly business expenditure", the standstill clause was meant as a temporary, transitional measure until the introduction of harmonising rules on non-deductible expenditure within a four years period. However, as described *supra*, these harmonising rules were never approved, thus giving rise to questions over the validity of the standstill clause, namely whether the standstill clause was only valid during the four-year period, or whether it is valid until the entry into force of harmonising measures, regardless of the four-year deadline.

The Court was finally called to decide upon the issue in *Royscot Leasing*, concluding that, Article 17(6) of the Sixth Directive authorised Member States to retain the exclusions of right to deduct VAT under the standstill clause, even though the Council had not decided, before the expiry of the period laid down in the first subparagraph, which expenditure should not be eligible for deduction of VAT.[445]

The Court's judgment put a definitive end to any doubts on the validity of the standstill clause. Member States are thus free to maintain any exclusions or limitations to the right to deduct which were introduced before the entry into force of the Sixth Directive. This freedom is, however, subject to some restrictions, which are not imposed by the Sixth Directive provisions, but rather by the Second Directive. In fact, exclusions or limitations introduced prior to the entry into force of the Sixth Directive would have been introduced when the Second Directive was in force, and thus would have to respect its provisions, *i.e.*, the right to deduct could only be limited (or excluded) where expenditure was incurred in relation to goods and services, which were "capable of being exclusively or partially used for the private need of the taxable person or his staff".

### (b) "CYCLICAL ECONOMIC REASONS" AND DEROGATIONS

The situation described *supra* regarding the consequences of Article 17(6) Sixth Directive and the lack of harmonising measures regarding expenditure which is not eligible for deduction, is further aggravated by the "cyclical economic reasons" clause, and Member States' widespread recourse to derogations.

"Cyclical economic reasons"

Article 17(7) Sixth Directive provides that Member States may, for cyclical economic reasons, and subject to consultation with the VAT Committee – under Article 29 Sixth

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[443] In *op. cit.*, COM(82) 870 final, 25 January 1983, p. 2.

[444] Article 17(6) of the initial proposal for a Sixth Directive did not include a standstill clause and, in fact, the wording of the Twelfth Directive proposal's rules (prior to amendments) is reminiscent of its wording. For a detailed description of the legislative history which led to the final wording of Article 17(6) Sixth Directive see B. Terra and J. Kajus, *A guide to the Sixth VAT Directive*, *op. cit.*, pp. 58-60.

[445] Case C-305/97, [1999] ECR I-6671, see Chapter 4.

Directive – exclude totally or partially the right to deduct in relation to all or some capital goods or other goods.[446] Apart from raising serious questions in relation to its effectiveness,[447] this provision seems to be rather vague and broad, and thus somehow dangerous. In fact, the term "cyclical economic reasons" is suitably vague enough to include almost any economic justification, and the expression "all or some capital goods or other goods", suggests that the limitations to the right to deduct can be introduced in relation to any type of goods, and to more than one type – the reference to capital goods seems to be merely indicative.

Additionally, there are the issues of accountability and legal certainty – the activities of the VAT Committee are neither published officially, nor publicly available. The official justification for this lack of publicity is that the VAT Committee is a mere advisory body, whose guidelines have no legal force, cannot be invoked in court by parties in litigation and Member States are not obliged to apply them.[448] However, in the case of Article 17(7), consultation of the VAT Committee is the only formal requirement imposed to Member States before introducing measures, which will limit or exclude altogether the right to deduct in relation to certain goods, and thus have a significant impact upon the domestic VAT system of Member States involved, in both the EU VAT system and ultimately also in the functioning of the Internal Market. In this context, it seems unreasonable that publication is denied in relation to documents such as Member States' requests and the Committee's response opinions.[449]

Fortunately, according to the Commission, Member States have rarely resorted to this provision. In their Second Report on the functioning of the VAT system, the Commission

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[446] Furthermore, according to Article 17(7) Member States may, in order to maintain identical conditions of competition, instead of refusing deduction, tax the goods manufactured by the taxable person himself or which he has purchased in the country or imported, in such a way that the tax does not exceed the value added tax which would have been charged on the acquisition of similar goods.

[447] As pointed out by B. Terra and J. Kajus, see *A guide to the Sixth VAT Directive*, *op. cit.*, p. 130.15.

[448] In November 2000 the Commission was questioned by a member of the European Parliament on why the guidelines of the VAT Committee were not made public, see Commissioner Bolkestein's answer on behalf of the Commission, *Written Question E-3729/00 by Michel Hansenne (PPE-DE) to the Commission*, OJ C 174E, 19/06/2001, p. 128. More recently the Council has approved a proposal for a Regulation which includes the VAT Committee's guidelines, see Council Regulation (EC) No. 1777/2005 of 17 October 2005, OJ L 288, 29/10/2005, p. 1. However, this Regulation does not include the VAT Committee's other activities, such as its activities as a consultation body under Article 17(7) Sixth Directive.

[449] In 2000 the question of access to the minutes of the VAT Committee was put before the Court of Justice of First Instance in the case of *Elder & Elder* – Case T-36/00, [2001] ECR II-607. The case concerned a request by Mr. & Mrs. Elder to the Commission, for access to minutes of the VAT Committee in relation to a possible consultation by the United Kingdom prior to enacting in 1994 and 1997 legislation based on Article 4(4) Sixth Directive. The Commission refused the request on the basis that the disclosure of those minutes would undermine the protection of confidentiality as requested by the legal person that supplied the information and the protection of the institution's interest in the confidentiality of its proceedings. In February 2001, the Court ordered the Commission to produce to the Court the minutes from the VAT Committee to which access had been refused to the applicants. By order of May 2001, the President of the First Chamber of the Court of First Instance ordered the removal from the register of this case.

noted that only Italy had consulted with the VAT Committee twice regarding the exclusion for cyclical reasons.[450] More problematic is Member States' recourse to derogations.

Derogations

Article 27 Sixth Directive allows Member States to introduce measures which derogate from the Directive's provisions under specific circumstances and pending an authorisation from the Council. As acknowledged by the Commission, the widespread use of this provision by Member States has had an extremely negative impact upon the overall functioning of the EU VAT system. However, few areas of this system have been as much a target for derogations as the provisions relating to the right to deduct, namely Article 17 Sixth Directive.[451]

Although there are only six Council Decisions authorising Member States to introduce measures derogating from Article 17 which are currently in force,[452] there are over twenty Council Decisions which have ceased to have effect.[453] Several of these authorised Member States to limit, or more rarely, to exclude, the right to deduct expenditure in relation to specific goods or services, namely vehicles, fuel, accommodation, food, hospitality, entertainment, and more generally, goods and services where private use of those goods and services accounts for more than 90% of their use.[454]

Although approved under Article 27's procedure, the contents of some of these authorisations have been questioned in light of the principles of the EU VAT system, and already the Court has twice been called to decide on the validity of Council Decisions which authorised Member States to introduce limitations or exclusions on the right to deduct expenditure.[455] In both cases, it is interesting to note that the Council Decisions

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[450] *Op. cit.* The first time requesting an exclusion until 31 December 1985 of the right to deduct VAT in respect of the purchase or importation of motor vehicles and of the purchase of fuels and lubricants for use therein. The second time to request an extension of this exclusion until 31 December 1987.

[451] Other areas of the EU VAT system, which have been the target of several Member States' derogations include the following: subjection to VAT (Article 2); territorial application (Article 3); place of supply of services (Article 9); taxable amount (Article 11); persons liable to payment of tax (Article 21); and obligations under the internal system (Article 22).

[452] These are, as follows: as regards Austria, Council Decision 2004/866/EC of 13 December 2004, OJ L 371, 18/12/2004, p. 47; as regards Germany, Council Decision 2004/817/EC of 19 November 2004, OJ L 357, 02/12/2004, p. 33; as regards the United Kingdom, Council Decision 86/356/EEC of 21 July 1986 (OJ L 212, 02/08/1986, p. 35), Council Decision 97/375/EC of 9 June 1997 (OJ L158, 17/06/1997, p. 43), as last amended by Council Decision 2003/909/EC of 22 December 2003 (OJ L342, 30/12/2003, p. 49) and Council Decision 98/198/EC of 9 March 1998 (OJ L 76, 13/03/1998, p. 31), as last amended Council Decision 2004/855/EC of 7 December 2004 (OJ L 369, 16/12/2004, p. 61); and finally, as regards Denmark and Sweden, Council Decision 2000/91/EC of 24 January (OJ L 28, 03/02/2000, p. 38), as last amended by Council Decision 2003/65/EC of 21 January 2003 (OJ L 25, 30/01/2003, p. 40).

[453] The great majority of these derogations ceased to have effect whenever the period for their application expired.

[454] It is interesting to note that, despite the significant number of authorisations granted for limitation or exclusion of the right to deduct specific expenditure, they relate only to three Member States: France, Germany and United Kingdom.

[455] Joint cases C-177/99 and C-181/99, *Ampafrance and Sanofi*, [2000] ECR I-7013, on the validity of Council Decision 89/487/EEC of 28 July 1989 (OJ L 239, 16/08/1989, p. 21); and C-17/01, *Sudholz*, [2004] ECR I-00, on the validity of Council Decision 2000/186/EC of 28 February 2000 (OJ L 59, 04/03/2000, p. 12). The Court had already been called to decide previously on the validity of a Council Decision authorising a Member State to introduce derogating measures in the case of *Direct Cosmetics*, case 138/86, [1988] ECR 3937. This case however related to Decision 85/369/EEC of 17 May 1977 (OJ L 199, 31/07/1985, p. 60) which authorised the United Kingdom to

under litigation authorised Member States to introduce measures, which did not depart radically from the rules put forward on the proposal for the Twelfth Directive. However, the Court found these measures to be, in one case partially, and in the other totally, invalid.[456]

### (c) CRITICAL EVALUATION OF LACK OF UNIFORM CRITERIA FOR NON-DEDUCTIBLE INPUT TAX

The legal framework described *supra* (namely regarding the "standstill clause", the "cyclical economic reasons clause", the derogations, and ultimately, the lack of harmonisation as regards non-deductible expenditure) led to the current situation where there is a wide discrepancy amongst Member State domestic VAT systems in the applicable criteria to determine which expenditure, if any, is excluded, partially or totally, from the right to deduct. Annex 3 highlights the rules regarding non-deductible input tax currently applicable in the twenty-five Member States.[457]

In 1983 when presenting the proposal for a Twelfth Directive the Commission noted that "the situation is not consistent with the requirements of a uniform basis of assessment and a non-discriminatory system of taxation".[458] Today, whether the rules contained in that proposal would be ideal is arguable, namely in light of the Court of Justice's judgment in *Ampafrance and Sanofi*. However, what seems incontestable is that the current situation is not consistent with the requirements of an Internal Market as it gives rises to serious difficulties for traders, which have a clearly negative impact and directly impair the functioning of such a market. In fact, the following consequences arise from the current legal framework:

— inequality between traders established in different Member States, thus distortion to competition within the Internal Market – traders established in a Member State in which tax is fully deductible (except for the general limitations) are in a beneficial situation in comparison with traders established in Member States which limit or exclude the right to deduct in relation to expenditure on specific goods or services;

— inefficiencies within the Internal Market by increasing compliance costs for businesses engaging in intra-community trade – due to the disparities between Member States' domestic legislation, it is somewhat difficult for businesses engaging in intra-community trade to establish which expenditure is deductible in other Member States without resource to external tax experts. This is particularly problematic in the

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introduce a measure derogating from Article 11A Sixth Directive rather than Article 17. In any case, the Court found this Decision to be valid.

[456] See Chapter 4.

[457] The contents of that Annex was based on information supplied by the Member States' tax authorities and compiled by the European Commission between October 2003 and February 2004, *VAT in the European Community – Application in the Member and Accession States, facts for use by administrations / traders information networks etc...*, TAXUD/C/3/ID. However, information as regards some Member States was unavailable, which in itself highlights the difficulties faced by traders engaging in intra-Community trade when attempting to access the criteria applicable to non-deductible input tax in other Member States.

[458] In *op. cit.*, COM(82) 870 final, 25 January 1983, p. 2.

case of Eighth Directive refunds, as the refund is subject to the rules on deductible input tax applicable in the Member State of refund;

— additionally, further inefficiencies within the Internal Market by creating economic drawbacks for industries which are specifically affected by limitations to the right to deduct. As reported by the Commission, the fact that certain Member States limit the right to deduct in relation to expenditure on specific goods or services has economic drawbacks for the industries involved in the trade of those goods or services, e.g., the motor vehicle industry and the hotel and catering industry.[459]

As opposed to the situation in relation to inter-jurisdictional issues and rates of VAT, the current rules regarding non-deductible input tax do not constitute an obstacle to the establishment of the Internal Market. However, they do give rise to serious difficulties which have a negative impact in the functioning of that market. In this context, the creation of an efficiently functioning Internal Market demands their alteration.

### ii) EU VAT SYSTEM AS AN INDIRECT OBSTACLE TO THE FUNCTIONING OF THE INTERNAL MARKET: VAT TREATMENT OF PUBLIC SECTOR BODIES

Public sector bodies have a diversified nature, engaging in different type of activities from policing to the provision of health and education services.[460] This diversified nature signifies that in practice it is almost impossible to establish a single VAT treatment for public sector bodies. For this reason, and due to conceptual and political considerations, the VAT treatment of public sector bodies under the Sixth Directive is rather complex,[461] determined by the interaction of three different provisions: Articles 4(5) and 13A, and Annex D.

None of these provisions have ever been amended since the entry into force of the Sixth Directive, and thus the VAT treatment of public sector bodies has remained unaltered for the past thirty-seven years.[462] This treatment can be summarised into three basic rules, as follows:

— Where public legal entities engage in activities as public authorities, they are not regarded as taxable persons, under Article 4(5) Sixth Directive; thus, these activities are outside the scope of VAT.

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[459] See *op. cit.*, COM(82) 870 final, 25 January 1983, p.2.

[460] M. Aujean, P. Jenkins and S. Poddar, divide government activities into three groups: redistribution of income and wealth; provision of public goods and services; and, provision of other goods and services which are similar to those supplied by the private sector, see "A new approach to application of VAT to public sector bodies", *The Tax Journal*, Issue 506, 28 June 1999, pp. 13-14.

[461] Symptomatic of the complexity of applying VAT to the public sector is the fact that this topic is one of the tax policy subjects discussed at the First Global International Tax Dialogue Conference on VAT, which was held in Rome in March 2005. The International Tax Dialogue is an initiative of the IMF, OECD and World Bank to encourage and facilitate discussion of tax matters among national tax officials and international organisations. Information on this network can be found on http://www.itdweb.org.

[462] See S. D. Coleclough's comments on the need for a reform of the Sixth Directive in general, and the VAT treatment of governmental bodies in particular, "The Sixth Directive and the Need for Reform", (1995) *BTR* 4, pp. 378-384.

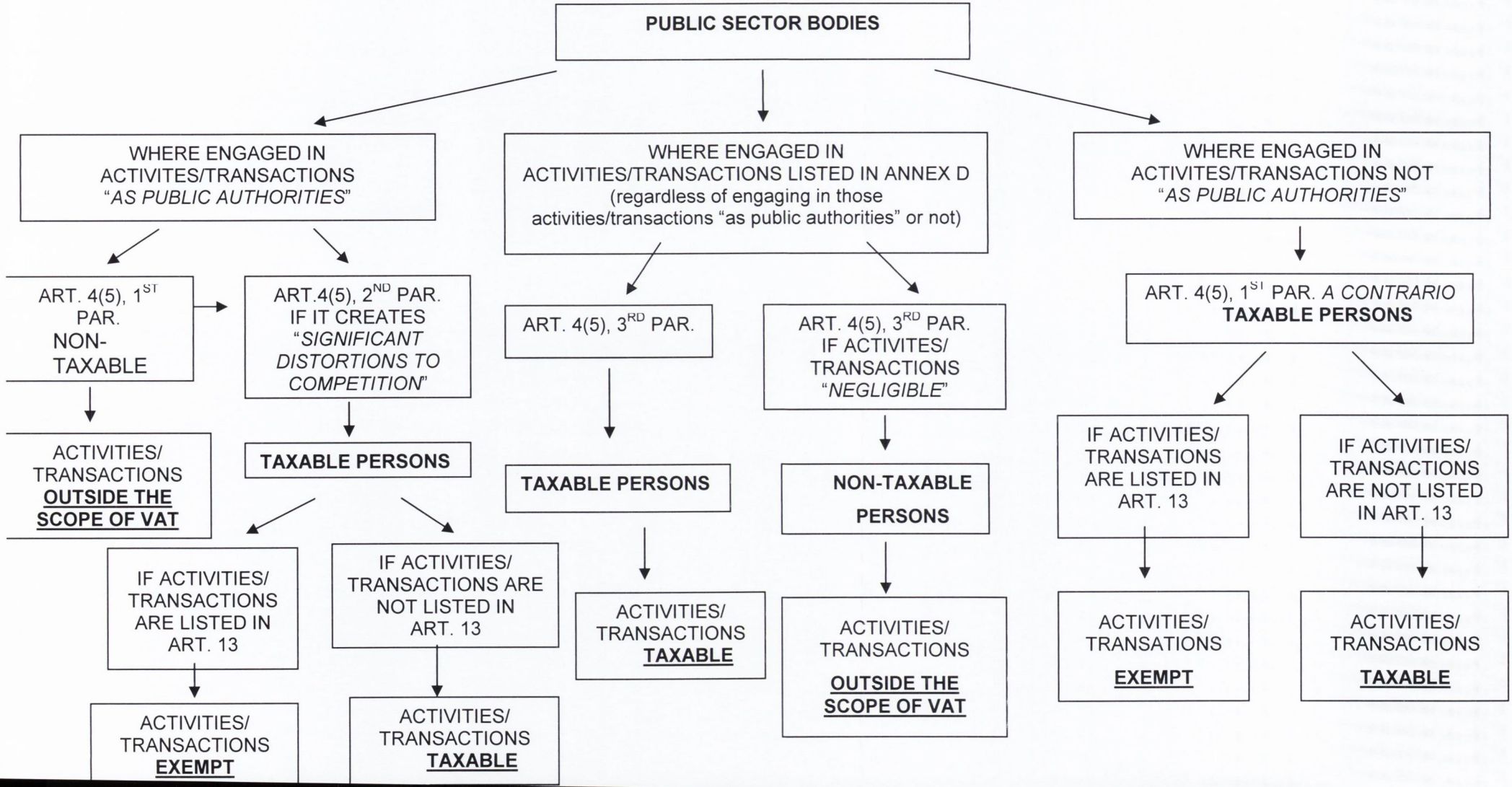
— However, where public bodies engage in supplies listed in Annex D they are regarded as taxable persons, and therefore those supplies are within the scope of VAT and taxable, provided that they are not carried out on such a small scale as to be negligible.

— Additionally, where public bodies are taxable persons their activities might still be regarded as exempt under Article 13A Sixth Directive.

Despite this apparent clarity, as demonstrated by the outline in Diagram 3.3 the application of these basic rules to particular cases is far from straightforward.

**DIAGRAM 3.3**

# CURRENT VAT TREATMENT OF PUBLIC SECTOR BODIES



### (1) CONCEPT OF TAXABLE PERSON: ARTICLE 4(5) AND ANNEX D OF THE SIXTH DIRECTIVE

When trying to establish the VAT treatment applicable to a particular activity / transaction undertaken by a public sector body, the first step is to determine whether the public sector body in question is a taxable person. However, this can prove to be a very difficult task.

Public sector bodies engaged in activities / transactions as public authorities

The first two paragraphs of Article 4(5) read as follows:

> "States, regional and local government authorities and other bodies governed by public law shall not be considered taxable persons established in respect of the activities or transactions in which they engage as public authorities, even where they collect dues, fees, contributions or payments in connection with these activities or transactions.
>
> However, when they engage in such activities or transactions, they shall be considered taxable persons in respect of these activities or transactions where treatment as non-taxable persons would lead to significant distortions of competition."

Under this provision where States, regional and local government authorities and other bodies governed by public law engage in activities or transactions as public authorities, they are not regarded as taxable persons in respect of those activities or transactions. However, this rule does not apply where its application would lead to a significant distortion of competition.

The application of this provision has given rise to many complications, notably due to the fact that the terms used are unclear and susceptible to different interpretations. In fact, many difficulties have arisen over determining when a public legal entity is engaging in activities or transactions "as public authority" or what is meant by "other bodies governed by public law".[463] Moreover, similar complications have arisen from the interpretation and application of the *open clause* included in the second paragraph. Its objective is to introduce an element of flexibility into the rigid rule of paragraph one, however, in practice, the expression "significant distortions of competition" has also caused difficulties of interpretation and application, and consequently the paragraph has rarely been applied.

Public sector bodies engaging in activities / transactions listed in Annex D

Paragraph three of Article 4(5), reads as follows

> "These bodies shall be considered taxable persons in relation to the activities listed in Annex D, provided they are not carried out on such a small scale as to be negligible."

The activities listed in Annex D include telecommunications, the supply of water, gas and electricity and certain broadcasting activities. Where public sector bodies engage in

[463] See Chapter 4.

these activities they are regarded as taxable persons, unless they are "negligible". Yet, the circumstances under which the activities carried out should be regarded as "negligible" are again far from clear.

In practice, the Directive's provisions leave a large number of possibilities for differing interpretations and applications. The main difficulty rests in the fact that the VAT classification of a particular public sector body as a taxable person, a non-taxable person, or a "mixed VAT status" person – *i.e.*, a legal person which in respect of some activities is a taxable person and in respect of others is not – and thus, the VAT treatment of the activities it performs, is dependent upon these interpretations and applications.

In fact, where the public sector body is a non-taxable person, the activities and / or transactions in which it engages will be outside the scope of VAT; where the public sector is a taxable person, the activities and / or transactions will be subject to VAT. However, even where the public sector body is a taxable person under Article 4(5) and Annex D Sixth Directive, the activities / transactions in which they engage, although subject to VAT are not necessarily taxable.

### (2) EXEMPTIONS: ARTICLE 13A OF THE SIXTH DIRECTIVE

Public sector bodies' activities, even where subject to VAT, might not be taxable. Having determined the taxable status of a particular public sector body, the second step in order to determine the VAT treatment of its activities is to establish whether those activities are listed in Article 13A Sixth Directive. This provision lists the exemptions applicable to certain activities in the public interest, also known as "merit" goods and services. Although many of these exemptions also apply to services supplied by charity organisations, cultural bodies, etc, they extend to the activities of public bodies, as follows:

— the supply by the public postal services [paragraph 1(a)];[464]

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[464] The Commission has put forward a proposal to amend the VAT treatment of the postal services, by making them taxable, see *op. cit.*, COM(2003) 234 final, 5 May 2003. However, the proposal was the target of some criticisms by the European Parliament, see *Report on the proposal for a Council Directive amending Directive 77/388/EEC as regards value added tax on services provided in the postal sector (COM(2003) 234 – C5-0227/2003 – 2003/0091(CNS))*, A5-0122/2004, 11/03/2004. Further to the Opinion of the European Parliament the Commission decided to amended proposal, see *op. cit.*, COM(2004) 468 final, 8 July 2004. The amended version of the proposal would extend the possibility of applying reduced rates of VAT to postal services in order to avoid or limit the price increases to a minimum. However, despite these amendments the discussions in the Council have proved slow and the approval of this proposal seems unlikely as some Member States, namely the United Kingdom, have strongly opposed it. On 7 January 2004, during the Prime-Minister questions and answers' session in the Parliament, the English Prime Minister Tony Blair confirmed that his government would continue to oppose any move from VAT exemption for postal services. In Ireland the move has not been without controversy either, as shown by the number of written questions addressed by Irish members of the European Parliament to the Commission on the contents and consequences of the proposal. There has been a total of 4 written questions, as follows: *VAT on postal services, Written Question E-1667/03 by Proinsias De Rossa (PSE) to the Commission*, 19 May 2003, OJ C783E, 27/03/2004, p. 34; *Exemption from VAT on postage for charities, Written Question E-2401/03 by Avril Doyle (PPE-DE) to the Commission*, 10 July 2003; *Consultation with charities with regard to the proposal relating to the imposition of VAT on postal services, Written Question E-3631/03, by Proinsias De Rossa (PSE) to the Commission*, 5 December 2003; and *VAT on postal services, Written Question E-0922/04 by Proinsias De Rossa (PSE) to the Commission*, 16 March 2004.

— hospital and medical care and closely related activities undertaken by bodies governed by public law or, under social conditions comparable to those applicable to bodies governed by public law, by hospitals, centres for medical treatment or diagnosis and other duly recognised establishments of a similar nature [paragraph 1(b)];

— the supply of services and of goods closely linked to welfare and social security work, including those supplied by old people's homes, by bodies governed by public law [paragraph 1(g)];

— the supply of services and goods closely linked to the protection of children and young persons by bodies governed by public law [paragraph 1(h)];

— children's or young people's education, school or university education, vocational training or retraining, including the supply of services and goods closely related thereto, provided by bodies governed by public law [paragraph 1(i)];

— certain cultural services and goods closely linked thereto supplied by bodies governed by public law [paragraph 1(n)];

— activities of public radio and television bodies other than those of commercial nature [paragraph 1(q)].

As a result, where a particular public sector body is a taxable person, its activities, or part of them, might be exempt under Article 13A – where they are listed in this provision – or taxed where they are not listed in Article 13A. However, these exemptions, as with Article 4(5) Sixth Directive, entail a difficult interpretation and application, and have given rise to significant case-law from the Court of Justice.[465]

### (3) CRITICAL EVALUATION OF THE VAT TREATMENT

The current VAT treatment of public sector bodies gives rise to serious inefficiencies at both economic and legal levels. As public sector bodies do not, as a rule, engage in intra-Community transactions these inefficiencies are normally perceived as being of a domestic nature. This view, however, fails to take account of the indirect effects of some of these inefficiencies regarding the functioning of the Internal Market, namely the effects in terms of distortion of competition. Moreover, these inefficiencies should be contextualised in the demands of the EMU and the Lisbon Strategy. In this light, it is argued that the current VAT treatment of public sector bodies constitutes an indirect obstacle to achieving the full potential of the Internal Market.

#### (a) ECONOMIC INEFFICIENCIES

The economic inefficiencies created by the current legal situation on the VAT treatment of public sector bodies relate to two factors: restrictions to the deduction of input tax in respect of their activities which are outside the scope of VAT and exempt; and more broadly, the application of exemptions itself.

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[465] See Chapter 4.

Apportionment of tax

The most obvious difficulty which arises from the current VAT treatment of public sector bodies is the fact that it creates apportionment of tax situations. In fact, as highlighted *supra* public sector bodies' activities / transactions have a mixed VAT treatment under the Sixth Directive: they might be outside the scope of VAT under Article 4(5) 1st paragraph; exempt under Article 13A; or taxable under Article 4(5) 2nd paragraph, Annex D or Article 13A *a contrario*. As a result, a particular public sector body might engage at the same time in activities which are exempt, taxable and outside the scope of VAT activities. As input VAT will not be deductible in respect of exempt and outside the scope activities in many occasions this will give rise to complex apportionments of input tax. In practice, this means that where apportionment of tax is required compliance costs will rise significantly, as more time and resources will be devoted to compliance work.

Definitional / interpretative problems

The complexity of the VAT system applicable to public sector bodies unavoidably gives rise to definitional and interpretative problems. Similarly to determining the VAT rates applicable to specific products, establishing whether a particular public body activity is within or outside the scope of VAT, exempt or taxable, can prove to be an extremely difficult task. Demonstrative of these problems is the extensive case-law from the Court of Justice on the interpretation of the Sixth Directive's rules which govern the VAT treatment of public bodies.[466]

As with the issues of apportionment of tax highlighted *supra*, definitional and interpretative problems have the effect of increasing compliance costs as more time and resources will be devoted to establishing the correct VAT treatment of each activity undertaken by that public sector body.

Self-supplies vs. outsourcing

One of the most serious problems, which the current VAT treatment of the public sector bodies gives rise to, is the fact that it encourages self-supplies. The reason is clear: in the case of self-supplies, the public bodies only have to pay VAT on the purchase of goods or services involved, where there is outsourcing of services to a private entity, VAT will be charged on the full price. As public bodies will not be able to deduct input VAT in respect of outside the scope and exempt activities, the VAT charged on outsourced activities will represent an extra cost, whilst where there is a self-supply this extra cost will be avoided.

The problem, however, is that according to recent literature there seems to be evidence that contracting out government services is economically more efficient and saves taxpayers' money, with some commentators suggesting twenty per cent savings. Although several economic commentators have focussed particularly on refuse collection, some studies indicate that the private sector is found to be more efficient in other areas,

[466] See Chapter 4.

such as fire protection, cleaning services and waste-water treatment.[467] In this context, the VAT treatment of public sector bodies has a distortive impact. As when deciding between carrying out the activity themselves and outsourcing the services to the private sector, public sector bodies will take into consideration VAT costs, instead of solely basing their decision upon economic efficiency criteria.

In order to avoid these distortions, some Member States – Denmark, Finland, Sweden, the Netherlands and the United Kingdom[468] – have decided to finance the VAT costs of public sector bodies through a refund outside the VAT regime. These refund schemes vary considerably,[469] however, there are basic common features, namely their aim to create a level playing field between self-supply of services and outsourcing. The refund schemes generally apply to local governments but VAT compensation at central government level is also available.

Overall, studies seem to demonstrate that these schemes are having an impact on public sector bodies' choices: in Member States where refund schemes apply, the level of outsourcing of governmental activities is higher.[470] However, despite their undeniable advantages these schemes also give rise to difficulties, as follows:

— inclusion or exclusion of non-national VAT – only in the Netherlands is refund given for non-national costs. This creates inequality between national and non-national suppliers, as the level playing field, which is the aim of the refund is only achieved in relation to national suppliers;

— inclusion or exclusion of exempt activities – in the Netherlands and the United Kingdom, the refund is only given for VAT costs on outside the scope activities, whilst in Denmark, Finland and Sweden the refund also applies in relation to exempt activities. Both options have disadvantages: excluding exempt activities from the refund scheme signifies that in relation to these activities VAT considerations will continue to influence the choice between self-supplies and outsourcing; on the other hand, the inclusion of exempt activities within the scope of the scheme will lead to an unequal treatment between private and public suppliers (since Article 13A's exemptions also apply to private suppliers);

— inequality amongst Member States – the existence of these schemes in only some of the Member States creates inequality within the Community. In fact, although public sector bodies of different Member States will typically not be in direct competition, the private enterprises offering outsourcing governmental services might be, and in this context private companies established in Member States which have a refund

[467] For a detailed overview of these studies see M.C. Wassenaar and R.H.J.M. Gradus, *Contracting out: the importance of a level playing field*, Research Centre for Economic Policy (OCFEB), Research Memorandum 0108, Erasmus University Rotterdam, August 2001, pp. 7-9.
[468] Norway has also a similar scheme.
[469] Generally a global distinction can be made between open and closed models – for a more detailed view of the several types of refund schemes applied see M. Aujean, P. Jenkins and S. Poddar, *op. cit.*, pp.14-15; and M.C. Wassenaar and R.H.J.M. Gradus, *op. cit.*, pp. 11-15.
[470] M.C. Wassenaar and R.H.J.M. Gradus, *op. cit.*, Tables 1 and 2.

scheme in place will be at a competitive advantage to private companies established in Member States which do not have a refund scheme in place.

These special refund schemes have been regarded as a purely financial operation and as a budgetary expenditure, and, as such, the Commission has considered them as falling outside the scope of the EU VAT system.[471] This approach, however, has serious shortcomings, not only because it represents an admission of failure of the common VAT system in dealing with the activities of public sector bodies, but equally because it means that the negative consequences of applying these schemes in terms of the functioning of the Community market will not be dealt with at Community level.[472]

Tax cascading

Another serious problem which emerges from the non-deductibility of the majority of public sector bodies' activities is the possibility of tax cascading.[473] In fact, where the service supplied by the public sector body is an intermediate step in the production, the VAT levied until then becomes a hidden cost (as it cannot be deducted) and tax cascading occurs. According to some economic commentators this is especially true in the case of public services.[474] Moreover, avoiding tax cascading effects is one of the main principles of commodity taxation[475] and, as discussed *supra*, was one of the basic reasons behind the introduction of a Community VAT system.[476]

Although no connection has been directly established between tax cascading effects and the introduction of VAT refund schemes, presumably these schemes would also prevent the occurrence of tax cascading. However, the disadvantages of these schemes already discussed above, namely regarding the inequality they create amongst Member States, apply *mutatis mutandis* here.

Erosion of VAT base – break of VAT chain

Directly connected with the problem of tax cascading is the question of the erosion of the VAT base and the break in the VAT chain, which exemptions give rise to. Although it is widely accepted within economic literature that VAT efficiency levels are directly related to its taxable base,[477] the VAT-base within the Community system is largely diminished by

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[471] The compatibility of these refund schemes with the Sixth Directive's provisions has been the subject of a Parliamentary Question. Commissioner Bolkestein replied on behalf of the Commission that the scheme does not conflict with the Sixth Directive, see *Common VAT system – Eighth Directive*, Written Question P-2861/99, 7 January 2000, OJ C 225E, 08/08/2000, p. 211.

[472] A simpler and more efficient solution would seem to be to treat public sector bodies similarly to private sector bodies as suggested by A.A. Tait, *op. cit.* See also S. Poddar, who seems to conclude that full taxation is the only policy which avoids all the problems and difficulties caused by the current EU VAT treatment, "Application of VAT to Public Bodies", Paper presented at *International Tax Dialogue VAT Conference, Rome, March 15-16, 2005*, available at : http://www.itdweb.org/VATConference/Pages/PapersPresentations.aspx

[473] Also known as "multiple taxation", see G. De Wit, *op. cit.*, pp. 49-54.

[474] See P. Gottfried and W. Wiegard's economic analysis in "Exemption versus zero rating – A hidden problem of VAT", (1991) *Journal of Public Economics*, Vol. 46, No. 3, p. 323.

[475] As highlighted by E.H. Davis and J.A. Kay, see "Extending the VAT Base: Problems and Possibilities", (1985) *Fiscal Studies*, Vol. 6, No. 1, p. 4.

[476] See Chapter 2.

[477] Having a broad-based tax – "exclude as little as possible" – was one of the recommendations put forward by G. De Wit for a United States of America VAT system, based on his experiences as a lawyer advising businesses on VAT matters in Europe, see *op. cit.*, p. 50 et seq.

the resort to exemptions.[478] The VAT treatment of public sector bodies is demonstrative of this fact, with a considerable (if not the major) part of their activities being excluded from the VAT base, either because they are outside the scope of the tax, or because they are exempt.

Moreover, some authors have contested that the more exemptions are granted, the more other sectors of the economy will be tempted to claim exemptions for themselves, thus, even further eroding the tax base.[479]

Merit goods / services and regressivity of tax

Traditionally, the exclusion of certain activities from the tax base – either through regarding these as outside the scope of VAT, through exemption or through the application of zero-rates – is justified by governments on the basis of one, or more, of the three following reasons:

— to diminish the regressivity of VAT – to avoid a VAT structure which bears too heavily on the poor;[480]

— to encourage the consumption of merit goods / services – items whose consumption is perceived as politically desirable; and,

— to avoid practical and administrative problems – the so-called "difficult-to-tax" transactions.

These reasons are not mutually exclusive, and although the third reason does not apply in respect of outside the scope activities and exemptions applicable to public sector bodies, several of these can be justified under both the first and the second reasons.[481] The effectiveness of this tactic however is far from clear. Firstly, due to the fact that in order to achieve both objectives, *i.e.*, diminish the regressivity of VAT and encourage the consumption of merit goods / services, the exclusion from the tax base has to be reflected in consumer prices, and it is far from obvious whether this actually happens or not. In fact, recent experiences with reduced VAT rates seem to indicate that this is not the case.[482] Secondly, and specifically in relation to the impact upon the regressivity of

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[478] In 1985 E.H. Davis and J.A. Kay estimated that due to the extensive use of zero rating and exemptions within the United Kingdom VAT legislation, VAT only covered just over half of all consumer expenditure, *op. cit.*, pp. 1-2.

[479] See A. A. Tait, *op. cit.*, p. 50.

[480] Although there are some dissident voices, there is a widespread view that VAT (like all consumption taxes) is in essence a regressive tax and thus reduces the real consumption of low-income households by a greater percentage than for high-income households. For an analysis on the myths and realities of the regressivity of VAT see G.N. Carlson and M.K. Patrick, "Addressing the Regressivity of a Value-Added Tax", in (1989) *National Tax Journal*, Vol. XLII, No. 3, pp. 339-351.

[481] Classical examples of the so-called "difficult to tax" transactions are insurance services, financial services and transactions in immovable property, all of which are exempt under Article 13B Sixth Directive.

[482] In October 1999 the Council approved a Directive which authorised Member States to apply reduced rates of VAT to labour-intensive services – Council Directive 1999/85/EC of 22 October 1999, OJ L 277, 28/10/1999, p. 34. The Directive was part of an experiment known as the "labour-intensive services experiment", whose aim was to test the impact of reduced rates of VAT on job creation. In June 2003 the Commission presented a report evaluating the results of the experiment - *Experimental application of a reduced rate of VAT to certain labour-intensive services*, Report from the Commission to the Council and to the European Parliament, COM(2003) 309 final, 2 June

VAT, it is widely accepted by economic commentators that indirect taxes are not an effective means of pursuing distributional goals.[483]

Finally, two additional points regarding the economic effects of the current VAT treatment of public sector bodies. First, in light of the all-time goal of the efficient allocation of resources by Governments, it is worth noting that all the difficulties highlighted here place extra costs and economic inefficiencies upon bodies, which by nature are funded by the taxpayer. Moreover, these costs should also be put in the context of the Stability Pact's criteria and the Lisbon Strategy.[484]

Secondly, it is also important to note that some of the problems highlighted here, which arise from the VAT treatment of public sector bodies, apply equally in relation to the private bodies benefiting from the same exemptions. The relevance of the problem for some of these private bodies is demonstrated by the fact that in its 1997 report on reduced rates the Commission admitted that some exempt bodies, like charities, had put forward requests advocating the application of reduced VAT rates, instead of exemptions for their supplies.[485] Although recognising the advantages that such a shift would bring

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2003; and *Evaluation report on the experimental application of a reduced rate of VAT to certain labour-intensive services*, Commission Staff Working Paper, SEC(2003) 622, 2 June 2003. The report confirmed that the impact of reduced rates of VAT on prices was minimal: in fact when conducting price surveys, Member States found that reduced rates of VAT were reflected in consumer prices only partially or not at all and that at least part of the VAT reduction was used to increase the margins of service providers. Where the VAT reduction had been passed on to the consumer Member States found that this was only a temporary measure and prices would subsequently increase. Similar findings resulted from the Irish 2000 experiment with a lower rate of VAT: in January 2001, the Irish Government reduced the rate of VAT from 21% to 20%. In a speech in December 2000, the Finance Minister clearly stated that the objective, in light of the high levels of inflation which had been experienced, was to lower consumer prices: "The government expects to see the VAT reduction passed on to the consumer and not absorbed in higher retail margins. If this does not occur, the wisdom of further VAT cuts will be placed in doubt. We will be monitoring the situation and I hope consumers will be vigilant in seeing that the VAT reduction is passed on to them". In 2002, the government decided to raise the rate of VAT from 20% to 21%. In a speech in December 2001, the Finance Minister stated that the lower rate of VAT had not been passed on to consumers: "I had reservations about cutting that rate last year. I said that I would be looking to see if it was fully passed on. I am not convinced that this was the case." – quoted in the Commission's evaluation report, *op. cit.*, p. 26.

[483] E.H. Davis and J.A. Kay provide a somehow amusing example which effectively illustrates the shortcomings of using the VAT structure as a mean to diminish the natural regressivity of the tax, concluding that "exclusions [from VAT base] are in general of more benefit to rich than poor households", *op. cit.*, pp. 11-12. A.A. Tait expresses the same opinion stating that "it is clear that exemptions, zero-rating, and multiple rates are inefficient ways to tackle the potential regressivity of the VAT. It is also clear that if the tax were actually levied on the exempt commodities, the yield could certainly be used to compensate low-income house-holds", *op. cit.*, p. 218.

[484] As B. Genser and P. Winker highlighted in 1997, "fiscal consolidation is one primary target of all EU member countries in order to meet the fiscal discipline criteria of the Maastricht treaty. This not only implies cutting fiscal spending, but also levying taxes most efficiently. The important loopholes under general discussion are the erosions of the income tax base, giving rise to consolidating tax policy measures following a 'tax cut cum base broadening' strategy. There is much less discussion on loopholes in general commodity taxation through VAT exemption", in "Measuring the Fiscal Revenue Loss of VAT Exemption in Commercial Banking", (1997) *FinanzArchiv*, Vol. 54, No. 4, pp. 563.

[485] As highlighted by M.C. Wassenaar and R.H.J.M. Gradus an additional problem created by the application of VAT refund schemes for public sector bodies arises from the fact that no compensation of VAT costs is given to private suppliers performing the same exempt activities as public bodies. This may lead to significant efficiency losses as decision-making of these suppliers is also distorted by the effect of VAT, see *op. cit.*, p. 18. This difference in treatment between public and private sector bodies has given rise to a recent dispute between the United Kingdom

for exempt bodies, namely in terms of deduction of input tax, the Commission refused the requests arguing that the application of reduced rates to these supplies would be contrary to the basic goal of simplifying the VAT system and reducing compliance costs.[486]

Moreover, the application of exemptions to private bodies may give rise to additional problems, such as the significant loss of revenue[487] and increase in administrative costs for tax administrations.[488]

### (b) LEGAL INCONSISTENCIES

From a legal point of view the Sixth Directive treatment of public sector bodies is also defective. The treatment of these public bodies in respect of many of their activities as

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Government and the country's voluntary sector leaders: charity organisations have reportedly been lobbying the United Kingdom Government to remove the burden of irrecoverable VAT, but the Government argues that removing the burden is neither a principled nor practical option, see A. Benjamin, "Tax Relief – Charities spurn call to 'move on'", in *The Guardian*, 16 July 2003.

[486] See *op. cit.*, COM(97) 559 final, 13 November 1997, p. 17.

[487] Whether or not public sector bodies are taxable is rather irrelevant from a strictly revenue point of view, as the payments on one side of the account will be balanced by collections on the other side, thus it can be said that it is merely a bookkeeping operation. However, the loss of revenue in relation to private sector bodies might be extremely relevant, particularly in the case of exemptions applicable to financial services, see the economic analysis of B. Genser and P. Winker, *op. cit.*, pp. 563-585.

[488] The existence of exemptions applicable to the private sector, with the consequent restrictions to the right to deduct, gives rise to an interesting but economically prejudicial paradox, creating two types of taxable persons: the ones who are trying to include their activities within the scope of an exemption, and the ones trying to exclude their activities from the scope of the exemption. The reason behind this phenomenon is quite simple: for a taxable person which is partially or totally exempt, and thus cannot deduct the totality of his / her input tax, there are two potential ways to minimise their VAT costs, either by minimising their input VAT or by maximising their output tax, *i.e.*, either by having less VAT charged to them, or by having more taxable activities. In this context, traders which are partially or totally exempt will seek to argue, either that part of their activities are taxable, or that the services / goods which they acquired are exempt – often they will seek to argue both. The costs of these "discussions" between traders and tax administrations have never been quantified (and would probably constitute a difficult task). However, based on the frequency in which this type of issues arise, and the length of time which they often take to resolve, it would seem that the time and resources which have to be allocated to deal with these type of issues, and thus the administrative costs involved, would not be insignificant. This view draws support from the numerous cases which have arrived (and continue to arrive) to the Court of Justice involving exemptions, particularly in relation to insurance transactions, financial services and immovable property. See in relation to insurance transactions, cases C-349/96, *Card Protection Plan (CPP)*, [1999] ECR I-973; C-240/99, *Skandia*, [2001] ECR I-1951; C-8/01, *Assurandor-Societetet,* , [2003] ECR I-00; C-308/01, *GIL Insurance and Others*, [2004] ECR I-00; and C-472/03, *Arthur Andersen*, [2005] ECR I-000. As regards financial services, cases 8/81, *Becker*, [1982] ECR 53; 255/81, *Grendel,* , [1982] ECR 2301; 70/83, *Kloppenburg*, [1984] ECR 1075; 207/87, *Weissgerber*, [1988] ECR 4433; C-281/91, *Muys' en De Winter's*, [1993] ECR I-5405; C-2/95, *SDC*, [1997] ECR I-3017; C-16/00, *Cibo Participations*, [2001] ECR I-6663; C-235/00, *CSC Financial Services*, [2001] ECR I-10237; C-77/01, *EDM*, [2004] ECR I-00; and C-305/01, *MKG-Kraftfahrzeuge-Factoring*, [2003] ECR I-6729; C-169/04 *Abbey National*, [2005] ECR I-000`. Finally, in relation to immovable property, cases 73/85 *Dieter and Kerrut*, [1986] ECR 2219; 173/88, *Henriksenl*, [1989] ECR 2763; C-63/92, *Lubbock Fine*, [1993] ECR I-6665; C-468/93, *Gemeente Emmen*, [1996] ECR I-1721; C-346/95, *Blasi*, [1998] ECR I-481; C-381/97, *Belgocodex*, [1998] ECR I-8153; C-12/98, *Amengual*, [2000] ECR I-527; C-409/98, *Mirror Group*, [2001] ECR I-7175; C-108/99, *Cantor Fitzgerald*, [2001] ECR I-7257; C-150/99, *Stockholm Lindopark*, [2001] ECR I-493; C-326/99, *'Goed Wonen'*, [2001] ECR I-6831; C-269/00, *Seeling*, [2003] ECR I-4101; C-315/00, *Maierhofer*, [2003] ECR I-563; C-275/01, *Sinclair Collis*, [2003] ECR I-5965; C-376/02, *Stichting 'Goed Wonen'*, [2005] ECR I-000; C-428/02, *Fonden Marselisborg*, [2005] ECR I-000; C-269/03, *Vermietungsgesellschaft Objekt Kirchberg*, [2004] ECR I-00; and C-284/03, *Temco*, [2004] ECR I-0, C-184/04, *Uudenkaupungin kaupunki*, [2005] ECR I-000. The Commission has recently decided to determine the extent of the problem by issuing a call for tender on a contract entitled "Study to increase the understanding of the economic effects of the VAT exemption for financial and insurance services". According to the Commission the objective is for the final report to "serve as a basis for discussion with Member States on options for modernising the existing VAT provisions", see OJ S149-148284, 04/08/2005.

non-taxable persons implies that they are *de facto* treated as final consumers. This seems inappropriate from a conceptual point of view, not solely because final consumers are by nature physical persons,[489] but equally because the goods / services supplied to public sector bodies are unavoidably going to be used as inputs to the activities which they are engaged in.

This leads to the conclusion that the treatment of public sector bodies as final consumers is contrary to the principle of VAT as a tax on consumption, a fundamental principle of the EU VAT system.[490]

Additionally, the restrictions imposed upon public sector bodies regarding the deduction of input tax create tax cascading and encourage self-supplies, therefore contravening the principle of right to deduct and the principle of fiscal neutrality, which are fundamental principles of the EU VAT system.[491]

## 3) NEW CHALLENGES FACING THE EU VAT SYSTEM

The difficulties which have been highlighted *supra* as regards some areas of the current EU VAT system have to be put in the context of the new challenges facing the EU, namely Economic and Monetary Union, the Lisbon Strategy and the process of EU enlargement.

### a) ECONOMIC AND MONETARY UNION

In 1999 the European Union enter the third and final stage of the Economic and Monetary Union with the introduction of the Euro and the irrevocable establishment of conversion rates for the euro vis-à-vis the currencies of the participating Member States.[492] As the European Union faces this new level of integration the question which should be asked, in the context of the EU VAT system is: what are the implications of this new challenge?

Benefits of the Euro

According to the Commission one of the main benefits of the introduction of the Euro is the "reaping of full benefits of the EU's single market".[493] In fact, there is the expectation that a single currency will constitute a natural complement to the Internal Market, allowing it to function more efficiently and making it more conducive to growth namely through the

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[489] As highlighted by M. Aujean, P. Jenkins and S. Poddar, *op. cit.*, p. 15.
[490] P. Gottfriend and W. Wiegard, based on economic analysis, go so far as to state that " contrary to common belief, VAT no longer equals a consumption tax when exemptions are granted", in *op. cit.*, p. 308.
[491] As implicitly acknowledged by Advocate-General Jacobs in the recent *Waterschap Zeeuws Vlaanderen* case: "It is inherent in the existence of exceptions to the VAT system that they will interfere to some extent with the application of the principles of neutrality and of equality of treatment. Whatever the merits of the decision to treat public bodies as final consumers, it forms an integral part of the Directive. In that and in comparable situations, the treatment of taxable persons and persons excluded from the VAT system will inevitably be different", case C-378/02, *Waterschap Zeeuws Vlaanderen*, [2005] ECR I-000, paragraph 38 of the Advocate-General's Opinion.
[492] However the process of transition to the Euro was only completed on 28 February 2002 when the former national currencies lost their status as legal currency.
[493] See http://europa.eu.int/comm/economy_finance/euro/benefits/benefits_2_en.htm.

elimination of exchange rate fluctuations and of various transactions costs, enhanced competition and price transparency.[494]

The distortions to competition and the increased business costs, which as demonstrated *supra* are caused by the current EU VAT system, constitute an obstacle to achieving these objectives and therefore impede traders and consumers from taking full advantage of the economic advantages emerging from the EMU. Consequently, in the context of the EMU, dealing with the problems caused by the current EU VAT system has become (increasingly) imperative.

Stability and Growth Pact

The Stability and Growth Pact is regarded as one of the pillars of the Economic and Monetary Union aimed at ensuring budgetary discipline and low public debts within the Euro-zone after the entry into force of the third stage of the EMU. Adopted in 1997,[495] the Pact strengthened the Treaty provisions already in force as regards fiscal discipline in the EMU – Articles 99 and 104 EC Treaty – as well as the provisions included in Protocol on the Excessive Deficit Procedure annexed to the Treaty. Under these provisions the following budgetary rules apply:

— Member States' budget deficits cannot exceed 3% of Gross Domestic Product; and

— Government debt cannot exceed 60% of Gross Domestic Product.

Under the Pact, the Commission will trigger the excessive deficit procedure whenever a Member State exceeds the public deficit criterion in accordance with the rules established in Council Regulation (EC) No. 1467/97 of 7 July 1997.[496] This procedure can ultimately lead to the imposition of sanctions and fines by the Council.

Despite being subject to constant criticisms,[497] the Pact continued to be implemented by the Commission and in 2004 new excessive deficit procedures were initiated against nine Member States.[498] In September 2004 the Commission finally initiated the official

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[494] Prior to the introduction of the Euro, one of the main arguments in favour of a single currency was its link with the single market: "The Single Market will provide underlying economic support for Monetary Union and the euro will provide added value and efficiency to the Single Market", in *Action Plan for the Single Market*, *op. cit.*, CSE(97) 1 final, 4 June 1997, pp. 1-2. This idea was also captured vividly in the Commission's often used slogan, "one market, one money".

[495] See *Resolution of the European Council on the Stability and Growth Pact*, Amsterdam, 17 June 1997, OJ C236, 02/08/1997, p. 1.

[496] OJ L 209, 02/08/1997, p. 6.

[497] The Pact has been the subject of controversy ever since it was approved; however, the controversy deepened in 2002, as several countries struggled to respect the deficit limits imposed by the Pact. In October 2002 the then head of the Commission, Romano Prodi, expressed his opinion to the French newspaper *Le Monde* that the Pact was "stupid" and "rigid". The Pact was immediately nick-named by the media as "stupidity pact", see "Budget rules are 'stupid', Prodi says", *BBC News*, 21 October 2002; "Farewell to the stupidity pact", *The Economist*, 22 October 2002; S. Castle, "'Stupidity Pact' crumbles as euro's foundation stone", *The Independent*, 23 October 2002. The controversy continued into 2003 and 2004, see "Budget compromise attracts EU ire", *BBC News*, 25 November 2005; S. Schifferes, "How to save the EU Stability Pact", *BBC News*, 5 December 2003; Q. Sommerville, "Stability Pact squabbles shake the euro", *BBC News*, 6 January 2004.

[498] These include both "old" and "new" Member States, with some being outside the Euro-zone, as follows: Greece, Czech Republic, Cyprus, Hungary, Malta, Poland, Slovakia, the Netherlands and the United Kingdom. However, not all of these resulted in formal recommendations to the Council under Article 104 of the EC Treaty. In fact, recommendations were only adopted as regards

process of reforming the Pact by setting up its views in a Communication to the Council and the European Parliament.[499] Following the Commission's Communication the Council delivered a report to the European Council outlining its proposals for "strengthening and clarifying the implementation of the Stability and Growth Pact". The report however, which was endorsed by the European Council in March 2005,[500] does not include substantive reforms, but rather procedural ones, with the 3% and 60% reference values being maintained.[501]

In this context, it is (particularly) imperative that all measures be taken in order to maximise efficiency within public finances. As highlighted *supra*, the current EU VAT system constitutes a clear obstacle to achieving this objective and, consequently, the need to attain it imposes extra pressure and urgency on the reform of the EU VAT system.

Tax sovereignty: last instrument of economic policy

In economic terms, it is traditionally said that the Member States have three main instruments of economic policy: exchange rate policy, monetary policy and fiscal policy. With the introduction of the Euro two of these instruments are excluded, the other limited. In fact, the possibility of using the exchange rate policy and monetary policy, if limited before, is now inexistent. On the other hand, the access to fiscal policy is severely limited by the budget deficit restrictions imposed by the Stability and Growth Pact. This leaves Member States with little else other than the tax policy as an economic policy instrument, and as such fiscal sovereignty has become even more important to Member States.[502]

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Greece and Hungary as the Commission felt that these countries "had not made the necessary efforts to bring their budget deficits under control", in *Stability Pact and Convergence programmes*, Council of Economics and Finance Ministers Meeting, Press release 15-2005, 14 January 2005. Additionally, there are still ongoing procedures initiated during 2002 and 2003 against France, Germany and Portugal. In the cases of France and Germany these procedures have been particularly controversial and were at the core of a recent decision from the Court which opposed the Commission to the Council – see case C-27/04, *Commission v Council*, [2004] ECR I-000. For an in-depth analysis of the Court's decision see D. Doukas, "The Frailty of the Stability and Growth Pact and the European Court of Justice: Much Ado about Nothing?", (2005) *Legal Issues of Economic Integration*, Vol. 32, Is. 3., pp. 293-312. Information on ongoing excessive deficit procedures can be obtained from Commission's Directorate-General for Economic and Financial Affairs website:
http://europa.eu.int/comm/economy_finance/about/activities/sgp/procedures_en.htm.

[499] See *Strengthening economic governance and clarifying the implementation of the Stability and Growth Pact*, COM(2004) 581 final, 3 September 2004. For a detailed overview of the several proposals, which have been put forward with a view to reforming the Stability Pact, see M. Buti, S. Eijffinger and D. Franco, "Revising the Stability and Growth Pact: Grand Design or Internal Adjustment?", *European Economy*, European Commission Economic Papers, No. 180 – January 2003.

[500] See *European Council Brussels 22 and 23 March 2005 – Presidency Conclusions*, paragraph 3 and Annex II, available at:
http://ue.eu.int/ueDocs/cms_Data/docs/pressData/en/ec/84335.pdf.

[501] See D. Doukas, *op. cit.*, pp. 310-312.

[502] Even before the introduction of the Euro, authors highlighted the problem of fiscal sovereignty in face of the establishment of an EMU. A.J. Easson in 1993 pointed out that "the fiscal implications of EMU are obvious and considerable. Of the three main instruments of economic policy, Member States will soon relinquish all control over exchange rate policy and will gradually, over the next five years or so, lose much of their control over monetary policy. They will thus be left with fiscal policy alone, yet the requirements of the Internal Market are such that a substantial degree of convergence of fiscal policies is also required. Moreover, there is a clear linkage between fiscal

In this context, reaching unanimous Member States' agreement in relation to reforms of the EU VAT system, which will limit their power / freedom to establish their own VAT structure, will be particularly difficult.

Thus the EMU represents an immense challenge for the EU VAT system: on one hand taking full advantage of the benefits of the Euro and respect of the Stability and Growth Pact criteria demand an immediate reform of the EU VAT system; on the other hand the fact that tax sovereignty will virtually be the last instrument of economic policy left to Member States, most likely implies that agreement on such reform will be almost impossible to achieve.

### b) THE LISBON STRATEGY

In March 2000 the European Council held a special meeting in Lisbon to agree on a new strategy for the European Union in order to strengthen employment, economic reform and social cohesion as part of a knowledge-based economy. From this meeting emerged a new strategic goal for the next decade (2010): "to become the most competitive and dynamic knowledge-based economy in the World, capable of sustainable economic growth with more and better jobs and greater social cohesion".[503] In order to achieve this goal, the Council established an overall strategy aimed at, amongst others objectives, "stepping up the process of structural reform of competitiveness and innovation and completing the internal market".[504]

Five years since the approval of the Lisbon Strategy – as it is known – the EU institutions remain committed to its goal and objectives as reiterated by the Brussels European Council meeting held in March 2004 which stated that "the continuing validity and relevance of the Lisbon process is not in doubt".[505] This commitment was also significantly reinforced from the recently published report from the High Level Group, chaired by Wim Kok, set up to carry out an independent mid-term review of the Strategy. The report concluded that although some of the targets will be missed, the ambition to achieve the strategic goal is "needed more than ever".[506] The results of this report have

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and monetary policy, with the result that decisions taken within the framework of the EMU must necessarily have an impact upon national fiscal policies", *op. cit.*, pp. 18-19.

[503] *Lisbon European Council 23 and 24 March 2000 – Presidency Conclusions*, paragraph 5, available at: http://europa.eu.int/european_council/conclusions/index_en.htm.

[504] *Ibid*, paragraph 5. See also paragraphs 14 to 23.

[505] *Extracts from Presidency Conclusions on the Lisbon Strategy by Theme*, European Councils: Lisbon (March 2000) to Brussels (June 2004), available at: http://europa.eu.int/comm/lisbon_strategy/pdf/thematic_lisbon_conclusions.pdf.

[506] *Facing the Challenge – the Lisbon Strategy for Growth and Employment*, Report from the High Level Group chaired by Wim Kok, November 2004, pp. 12-13, "The case for Lisbon" – available at: http://europa.eu.int/comm/lisbon_strategy/pdf/2004-1866-EN-complet.pdf.
Following the Kok Report, the new President of the European Commission, Jose Manuel Durao Barroso, and the European Council, have declared their commitment to making the Lisbon Strategy a priority – see *European Council – Speaking Points by President-Designate Barroso: Lisbon Strategy*, Brussels, 4-5 November 2004, and *Brussels European Council, 4-5 November 2004 – Presidency Conclusions*, available at: http://europa.eu.int/european_council/conclusions/index_en.htm.

been effective in convincing the European Council that "urgency is called for" and on the need for the "relaunch the Lisbon Strategy without delay".[507]

The implications of the Lisbon Strategy for the EU VAT system are clear:[508] VAT obstacles to intra-community trade which prevent the establishment of the Internal Market, which directly and indirect impair the efficient functioning of the Internal Market, and which distort competition, have to be removed if the strategic goal is to be achieved.

### c) EU ENLARGEMENT

In May 2004 ten new Member States joined the European Union, as follows: Czech Republic, Cyprus, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia. Additionally, there are two so-called acceding countries, Bulgaria and Romania, due to join the European Union in 2007; and two candidate countries, Croatia and Turkey. Overall, within a few years the European Union will have expanded from fifteen Member States to potentially twenty-nine. Such a sizeable enlargement will have various implications in terms of the EU VAT system.

Benefits of the enlargement

Similarly to the Economic and Monetary Union, enlargement of the European Union constitutes a great opportunity not only for economic growth across Europe, but also for achieving the ultimate goal of the Lisbon Strategy. However, the difficulties which the current EU VAT system poses to those engaging in intra-Community trade, namely in terms of costs, and the distortions to competition which emerge from that system, constitute an obstacle to fulfilling these opportunities and taking full advantage of the economic benefits which may emerge.

In this context, dealing with the problems caused by the current EU VAT system has also become imperative if all Member States (both current and future) want to take full advantage of the opportunities which may emerge from the enlargement.

VAT *acquis communitaire* and legislative procedure

Countries joining the European Union have to bring their legislation in line with the *acquis communitaire*, *i.e.*, with the body of Community legislation in force. VAT is no exception to this rule. In practice, this signifies that acceding Member States have to conform to the existing body of EU VAT rules and although this can prove to be a difficult political and

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[507] See *Brussels European Council,* 22 and 23 March 2005*, op. cit.*

[508] The connection between the Lisbon Strategy and the reform of the EU VAT system has been established more than once at official level, most notably in the recent Communication from the Commission entitled *The Contribution of Taxation and Customs Policies to the Lisbon Strategy*, Implementation of the Community Lisbon Programme, COM(2005) 532 final, 25 October 2005. See also a Communication from the Commission on the consolidation and extension of the Lisbon Strategy reflecting the need to amend VAT rules in relation to e-commerce and electronic invoicing, *Realising the European Union's potential: Consolidating and Extending the Lisbon Strategy*, Communication from the Commission, Contribution of the European Commission to the Spring European Council, Stockholm 23-24th March 2001, COM(2001) 79 final, Vol. I, 7 February 2001. Finally, the Kok Report also made specific reference to the need to minimise VAT compliance costs and the importance of establishing a one-stop-shop, *op. cit.*, p. 28.

budgetary task for countries involved, the 2004 Act of Accession demonstrates that there is a willingness to do achieve this.[509]

However, achieving agreement on amendments to EU VAT rules after accession might prove to be a much more difficult task. On one hand, and as discussed in Chapter 1, under Article 93 of the EC Treaty, approval of VAT legislation requires the unanimity of the Council – achieving the unanimous agreement of fifteen Member States has proven to be extremely difficult, achieving the unanimous agreement of twenty-nine Member States might prove impossible. On the other hand, the political willingness to compromise, which existed prior to accession, might not be there post-accession.

In this context, it would seem that the wisest approach would be to undertake the much needed reform of the EU VAT system prior to further enlargement, not only in view of the fact that a reform is imperative in order to take full advantage of the opportunities which can emerge, but also because a reform post-enlargement might be much more difficult to achieve. Unfortunately, the opportunity for reform prior to the 2004 enlargement has been missed. The challenge is then not to miss the opportunity for reform prior to future enlargements.

[509] The 2004 Act of Accession did include several authorisations for measures derogating from the Sixth Directive, namely as regards the application of VAT rates and exemptions. However, a considerable part of these are temporary, OJ L236, 23/09/2003, p. 808. Additionally, as regards the acceding and candidate countries, the Commission's 2003 report seems to indicate that although alignment with VAT *acquis communitaire* has not yet been completed, considerable progress has been made in this area, see *Continuing Enlargement*, Strategy Paper and Report from the European Commission on the progress towards accession by Bulgaria, Romania and Turkey, COM(2003) 676 final, 5 November 2003, pp. 25, 29 and 34.

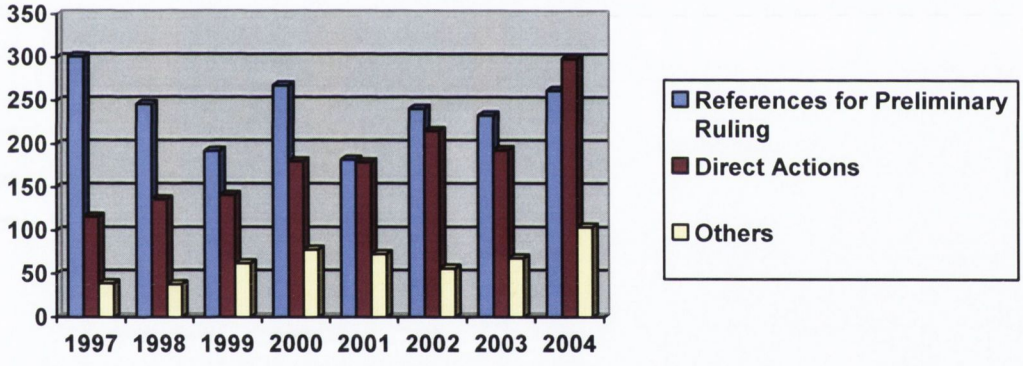
# CHAPTER 4

# THE ROLE OF THE COURT OF JUSTICE IN THE CONTEXT OF THE EU VAT SYSTEM

## 1) JUDICIAL PROCEEDINGS LEADING TO COURT OF JUSTICE INTERVENTION ON VAT CASES

In all areas of Community law, Court of Justice jurisprudence has mostly arisen in the context of references from national courts for preliminary rulings – under Article 234 of the EC Treaty – and also in the context of direct actions, including infringement actions under Article 226 and 227 of the EC Treaty and reviews of legality under Article 230 of the EC Treaty.[510] In fact, as shown by Chart 4.1 below, and according to the Court's internal statistics, between 1997 and 2004, preliminary references and direct actions, represented over two-thirds of the Court's activity.[511]

**CHART 4.1 – Nature of the Court of Justice Proceedings 1997-2004 – All areas**[512]




The area of VAT is no exception to these findings, however, as Chart 4.2 below demonstrates, there are a few substantial distinctions, as follows:[513]

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[510] Although, direct actions include these three different procedures, in practice only the infringement action initiated by the Commission under Article 226 and the reviews of legality under Article 230 account for this high percentage of direct actions. Infringement actions initiated by Member States under Article 227 EC Treaty are extremely rare.

[511] It is interesting to note that for the first time in 2004 direct actions represented a higher number of the Court of Justice's proceedings than references for preliminary rulings.

[512] "Others" includes appeals, appeals concerning interim measures and interventions, opinions /rulings, and special forms of procedure. Figures obtained from *Statistics concerning the activity of the Court of Justice*, Court of Justice Annual Reports, 2002, 2003 and 2004, which can be obtained from http://curia.eu.int/en/instit/presentationfr/index.htm.

[513] A strict comparison between the figures included in Chart 4.1 and the ones in Chart 4.2 is not possible, as the figures in Chart 4.2 were not based on the Court's statistical information and reflect solely the number of judgments delivered by the Court during this period. Thus, one series of joint cases is taken as one case, and it also does not take into account orders terminating proceedings by judicial determination. However, an overall comparison is still useful, and it provides a general overview of the differences and different emphasis within the area of VAT.

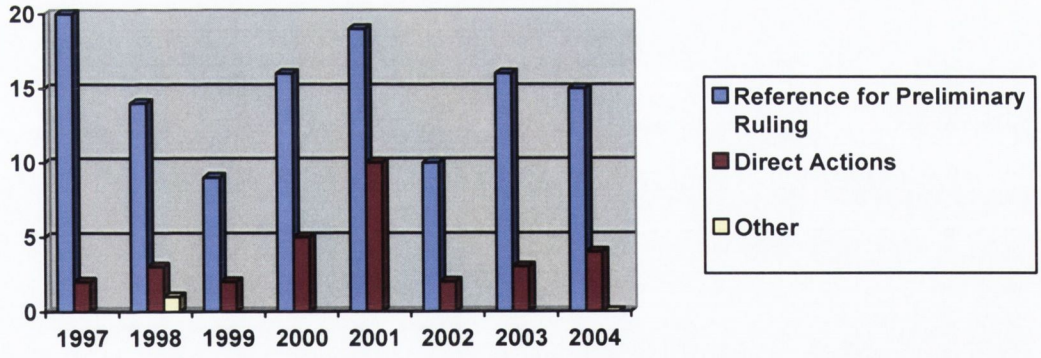
— the emphasis on references for preliminary ruling is even greater in the area of VAT, representing over 80% of the overall Court's judgments during this period;

— the number of judgments arising from proceedings other than references for preliminary rulings or direct actions, namely appeals, is almost inexistent.

The figure regarding the percentage of the Court's judgments in the area of VAT, which arise from references for preliminary ruling, is particularly significant. It has often been noted that this procedure has constitutional significance, enabling the Court to ensure the uniformity and effectiveness of EC law. Words such as "fundamental" and "intriguing" have been used to qualify it, and it has been described as a 'keystone to the twin pillars (of direct effect and supremacy) of the Community legal order'.[514] This is certainly true for the area of VAT. The cooperation of the national courts, expressed through the references for preliminary rulings, has been most fundamental to the advancement of the Court of Justice jurisprudence in the area of VAT. Without it the Court would never have had the opportunity to jurisprudentially develop the EU VAT system.

Equally interesting to note is the fact that, although not reflected in Chart 4.2, as opposed to what happens in other areas of Community law – where many of the direct actions are reviews of legality under Article 230 of the EC Treaty – in the area of VAT, all direct actions take the nature of infringement actions initiated by the Commission under Article 226 of the EC Treaty.

**CHART 4.2 – Nature of the Court of Justice Proceedings 1997-2003 – VAT**




## 2) COURT OF JUSTICE JURISPRUDENCE ON VAT

In the last nearly forty years the Court of Justice has developed an extremely vast body of case-law in relation to VAT and as such, it would be impossible to undertake an analysis of the Court's jurisprudence on all areas of VAT within the framework of this thesis. Thus, only a few areas have been focussed upon. The areas selected coincide with the ones chosen in Chapter 3. The objective is to determine whether the practical difficulties highlighted in Chapter 3, arising from these areas of the EU VAT system, have been

[514] See S. Douglas-Scott, *op. cit.*, pp. 225 *et seq.*

resolved or at least minimised by the jurisprudence of the Court, and equally whether it is reasonable to expect it to do so.

### a) EU VAT SYSTEM AS AN OBSTACLE TO THE ESTABLISHMENT OF THE INTERNAL MARKET

#### i) INTER-JURISDICTIONAL ISSUES

##### (1) PLACE OF SUPPLY

As highlighted in Chapter 3, the interaction of the place of supply rules set out in the Sixth Directive is extremely complex and gives rise to various complications. The Court has attempted to add some clarity to this uncertain scenario, namely in relation to the place of supply of services, through extensive jurisprudence. Although this has been accomplished to a limited extent, the Court's jurisprudence demonstrates that a significant number of the problems raised are only superficially interpretative and the real problem lies within the legal system itself. A typical example of this is the Court's jurisprudence regarding Article 9(2)(e) Sixth Directive, the so-called reverse-charge mechanism, and its abusive use by traders in order to avoid the Eighth Directive's refund procedure.

The effectiveness of the Court's jurisprudence in resolving the problems raised by the place of supply of services system will be assessed through the systemic analysis of the Court's decisions in relation to two different aspects of the system, as follows:

— the use of the fixed establishment criterion; and,

— the reverse-charge mechanism.

###### (a) FIXED ESTABLISHMENT

In the Sixth Directive's place of supply system the fixed establishment criterion has a central role in determining the place of supply of services.[515] However, its use gives rise to some difficulties, as follows:

— the concept of fixed establishment itself is problematic;

— the interconnection between this criterion and the other criteria provided for in Article 9 Sixth Directive, namely the "place where the customer has established his business", is unclear; and,

— where a taxable person makes a supply and has more than one establishment (e.g. a business establishment in one Member State and a fixed establishment in another) it might be difficult to acertain which establishment has actually made the supply.

These difficulties can be converted into the following three questions:

1. what can be regarded as a fixed establishment?
2. when should the fixed establishment criterion be used?

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[515] See Articles 9(1) and 2(e), and 26(2) Sixth Directive.

3. when are services supplied from the fixed establishment?

In its jurisprudence the Court has attempted to provide answers to these questions.[516]

What can be regarded as a fixed establishment?

The Court referred for the first time to the concept of fixed establishment in *Berkholz*.[517] The case concerned the installation and operation of gaming machines on board ferries. The taxpayer, Berkholz, was in the business of installing and operating gaming machines, juke boxes and similar machines. Most of these machines operated in cafes and restaurants; however, some were installed and operated on board ferries owned by the Deutsche Bundesbahn (the German railway company). These ferries travelled regularly between Germany and Denmark. Although these machines were maintained, repaired and replaced at regular intervals by Berkholz employees, Berkholz did not maintain a permanent staff on board the ferryboats.

Although the German tax authorities estimated that approximately 65% of the turnover on the gaming machines was obtained while the ferries were outside German territorial waters, they charged VAT on Berkholz's entire turnover on the grounds that under Article 9(1) Sixth Directive the place of supply of all services of the machines was the taxpayer's principal place of business, which was in Germany. Berkholz contended that the services provided for the machines on board the ferries should be regarded as being supplied from a fixed establishment. Consequently, while the establishments (*i.e.* the ferries) were outside German territory, the place of supply of the services provided would not be Germany, and thus those services could not be subject to German VAT.

The Court did not give a definite answer as to whether these gaming machines on board ferries should be regarded as fixed establishments leaving the question to the national court to respond. However, it did provide guidelines as to the concept of fixed establishment. In order to be regarded as a fixed establishment for the purposes of the Sixth Directive an establishment must be "of a certain minimum size and both the human and the technical resources necessary for the provision of the services [must be] permanently present." It went on to add that "it does not appear that the installation on board a seagoing ship of gaming machines, which are maintained intermittently, is capable of constituting such an establishment".[518]

Some years later the Court delivered its judgment in *DFDS*.[519] Although this is a significant judgment in terms of fixed establishment, paradoxically, it does not relate directly to Article 9 but to Article 26 Sixth Directive. The judgment establishes important interpretative guidelines in relation to the interconnection between the fixed establishment criterion and the other Article 9(1) criteria, as well as indicating which activities the fixed establishment has to perform in order for the services to be considered to have been

[516] For an in-depth analysis of the jurisprudence of the Court in relation to fixed establishment, see I. Roxan, "Locating the Fixed Establishment in VAT", (1998) *BTR* 6, pp. 608-632; and, B. Terra, *The Place of Supply in European VAT*, Kluwer Law International, 1998, pp. 109-153.
[517] Case 168/84, [1985] ECR 2251.
[518] *Ibid*, paragraph 18.
[519] Case C-260/95, [1997] ECR I-1005.

supplied from there. However, it is also relevant from the point of view of the concept of fixed establishment, insofar as it further clarifies the scope of this concept, as set out in *Berkholz*.

DFDS A/S was a Danish tour operator. It sold package tours to passengers and travel agents in the United Kingdom through a wholly-owned subsidiarity, DFDS Ltd, pursuant to an agency agreement. Under this agreement DFDS Ltd would receive 19% commission on all fares it sold. It was also reimbursed by DFDS A/S for all its advertising expenses. The agreement imposed a series of obligations on DFDS Ltd, including exclusivity. All documentation issued to the customers was in the name of DFDS A/S.

The United Kingdom tax authorities considered that DFDS Ltd should be regarded as a fixed establishment of DFDS A/S, and thus concluded that the latter was liable to pay VAT in relation to the package tours sold by DFDS Ltd in United Kingdom. DFDS A/S, on the other hand, argued that DFDS Ltd was merely acting as an intermediary for DFDS A/S and therefore, the place of supply of the services supplied by DFDS Ltd was Denmark. This was advantageous for DFDS A/S since Denmark exempted from VAT the services of travel agents (including tour operators).

The question referred to the Court of Justice by the United Kingdom High Court was essentially whether DFDS Ltd could be regarded, for the purpose of the Sixth Directive, as a fixed establishment of the parent company or as an intermediary acting for it?

Although, the treatment of travel agents and tour operators is governed by Article 26 Sixth Directive, the place of supply provision under that Article is identical to the one lay down in Article 9(1) Sixth Directive.

The Court ruled that,

> "Article 26(2) of the Sixth Council Directive [...] is to be interpreted as meaning that, where a tour operator established in one Member State provides services to travellers through the intermediary of a company operating as an agent in another Member State, VAT is payable on those services in the latter State if that company, which acts as a mere auxiliary organ of the tour operator, has the human and technical resources of a fixed establishment."[520]

The Court's conclusion that DFDS Ltd should be regarded as a fixed establishment further clarifies the scope of the concept of fixed establishment.[521] The fact that DFDS Ltd is a separate legal entity from DFDS A/S is not sufficient to conclude that it is an independent agent. Where the agent acts as a mere auxiliary organ to the parent company, and where it has the characteristics, in terms of human and technical resources, of a fixed establishment it is regarded as such for the purposes of the Sixth Directive.

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[520] *Ibid*, last paragraph.
[521] Or rather enlarges it, see B. Terra, *The Place of Supply in European VAT*, *op. cit.*, p. 139.

The Court of Justice's next step in demarcating the concept of fixed establishment is given in *ARO*.[522] ARO Lease BV was a Dutch company whose business was the leasing of passenger cars. Although the majority of its customers were established in the Netherlands, some were established in Belgium. ARO had no offices or premises in Belgium and in most cases the Belgium-based customers were introduced to ARO by a self-employed Belgian intermediary (typically car dealers), who would receive a commission for its services. The customer would select a car from a dealer in Belgium, ARO would then purchase that car and enter into a leasing agreement with the customer. The leasing agreement would be drawn up at ARO's offices in the Netherlands.

ARO had always paid Dutch VAT in respect of the cars leased to Belgium customers. However, in 1993, the Belgium tax authorities took the view that these leases should be liable to Belgian VAT on the grounds that they were being supplied from a fixed establishment. In their opinion, the presence of a fleet of vehicles in Belgium was sufficient in order to infer the presence of a fixed establishment from which the services were being supplied. The Court disagreed. In order for an establishment to be recognised as a fixed establishment for the purposes of Article 9 Sixth Directive, it "must possess a sufficient degree of permanent and a structure adequate, in terms of human and technical resources, to supply the services in question in an independent basis."[523]

This formulation is slightly different from the one used by the Court in *Bekholz*. The reference to human and technical resources on a permanent basis is maintained, however the Court introduces two new requirements: it must have an adequate structure, and supply the services on an independent basis.

In 1996, before the Court delivered its judgment on *ARO* a similar question reached the Court. The case involved the lease of passenger cars by a Luxembourg company, Lease Plan Luxembourg, to Belgium customers. The circumstances of the case were similar to the ones described for *ARO*.[524] The Court reiterated its position, alluding to its judgment in *ARO*.[525]

Following the decisions in *ARO* and *Lease Plan* it seemed that the controversy surrounding the concept of fixed establishment had been dealt with by the Court in a definitive manner. However, this proved not to be the case and the concept of fixed establishment has been again the subject of controversy in the recent *RAL* case.[526] Similarly to *Berkholz*, the case concerned the exploitation of gaming machines, the difference being that in *RAL* the machines were not installed on board ferries, but rather in amusement arcades located in the UK.

Until 2000 the RAL Group supplied gaming machines from its "amusements arcades" located in the UK and VAT was accounted for on the net takings from the gaming machines' supplies. However, on that date, the RAL Group – following advice from their

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[522] Case C-190/95, [1997] ECR I-4383.
[523] *Ibid*, paragraph 16.
[524] Case C-390/96, *Lease Plan*, [1998] ECR I-2553.
[525] *Ibid*, paragraph 24.
[526] Case C-452/03, [2005] ECR I-000.

external tax advisers – set a restructuring scheme. The principal purpose of this scheme was to ensure that the place of supply of the gaming machines services would be deemed to be Guersey, *i.e.*, outside the territory of the Community for VAT purposes.[527] In order to achieve this objective any physical presence in the UK (apart from the actual gaming machines) was avoided. It is evident from the description of RAL Group's new structure that the scheme was constructed around the existing Court's jurisprudence regarding the concept of fixed establishment: by avoiding any physical presence in the UK, RAL presumably fail to fulfil the criteria established by the Court in *Berkholz* and *ARO*.[528] This understanding would seem to be further supported by the Court's judgment in *Berkholz*, as it also concerned gaming machines.

This was not however the Opinion of the Advocate-General Poiares Maduro. He considered that in *Berkholz* and *ARO* the Court only required the presence of a minimum size of establishment: "no more and no less than the resources necessary for the provision of services of a permanent nature". He took the view that the Court "did not make the permanent presence of *all* possible human and technical resources, *possessed by the supplier himself*, in a certain place, a precondition for concluding that the supplier has a fixed establishment there", and consequently it was his belief that this amounted only to the adoption of a "minimum-requirements test".[529] In his opinion, RAL Group's amusement arcades in the UK satisfied this test. His conclusion was based on the external perception of customers, namely the fact that the gaming machines were "permanently installed on premises exclusively dedicated, through the use of the commercial concept of 'amusement arcade', to the creation of a unique congenial environment for players", and that "such premises have regular opening hours, like any other business establishment, and there are staff permanently attending to customers and looking after the premises".[530]

Unfortunately, the Court opted not do deal with the problem of whether RAL's amusement arcades should be regarded as fixed establishments. Instead it chose to apply Article 9(2)(c), concluding that the gaming services supplied by RAL should be regarded as "entertainment and similar activities" for the purposes of the first indent of that

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[527] It was accepted by the VAT Tribunal that the purpose of the restructuring was to avoid VAT, see *RAL (Channel Islands) Ltd, RAL Ltd, RAL Services Ltd, RAL Machines Ltd v Customs & Excise Commissioners* (2002) VAT Decision 17914, paragraph 199. The Advocate-General Poiares Maduro implicitly adopted the same view by consistently referring to the restructuring scheme as a "tax avoidance scheme". However, the language used by the Court of Justice is slightly more cautious, see paragraph 12 of the judgment. For an analysis of this case in light of the Court's combat to VAT avoidance, see *infra*.

[528] This reasoning is confirmed by a letter from RAL Group's external tax advisers addressed to the RAL Group, where they recommend that "all decisions relating to CICo [CI] must be made in Guersey [...] in VAT terms CICo [CI] must have sufficient resources to enable it to carry out is business and it will need access to relevant expertise. This can be either by way of employees or by the directors entering into contracts with third parties to provide the services they require", Decision 17914, paragraph 27.

[529] Case C-452/03, [2005] ECR I-000, paragraph 41. This position might come as somewhat surprising in light of the Court's reluctance to accept the existence of fixed establishments in previous cases, see *Berkholz*; *Faaborg-Gelting*; *ARO*; and *Lease Plan Luxembourg*. The sole exception to this approach being *DFDS*.

[530] Case C-452/03, [2005] ECR I-000, paragraph 45.

provision.[531] By doing so the Court fail to clarify whether it would have supported the Opinion of the Advocate-General as regards his interpretation of the concept of fixed establishment.[532]

When should the fixed establishment criterion be used?

Article 9(1) Sixth Directive reads,

> "The place where the service is supplied shall be deemed to be the place where the supplier has established his business or has a fixed establishment [...]"

The article establishes two different criteria for determining the place of supply of services: the place where the supplier has established his business and the place where the supplier has a fixed establishment.[533] The use in the provision of the word "or" could lead to the assumption that they constitute alternative criteria of equal value, *i.e.*, none has primacy over the other. However, the Court has rejected this interpretation.

In the *Berkholz* case the Court adopted the view that the place where the supplier has established his business is the "primary point of reference" for determining the place of supply of services. Another establishment can only be referred to "if the reference to the place where the supplier has established his business does not lead to a rational result for tax purposes or creates a conflict with another Member State".[534] It goes on to say that "services cannot be deemed to be supplied at an establishment other than the place where the supplier has established his business unless that establishment is of a certain minimum size and both the human and technical resources necessary for the provision of the services are permanently present",[535] *i.e.*, unless the establishment is a fixed establishment.

It stems from this decision that the fixed establishment criterion should only be applied where two conditions are met, as follows:

- there is a fixed establishment; and,
- the use of the place where the business is established does not lead to a rational result for tax purposes or creates a conflict with another Member State.[536]

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[531] The Court's decision to apply Article 9(2)(c) in this case comes as a surprise in light of its previous jurisprudence and is not without controversy. In fact, it is interesting to note that the possible applicability of the first indent of Article 9(2)(c) was never addressed in *Berkholz*, even though the services supplied by Berkholz were similar to those supplied by the RAL Group. For an analysis of the Court's apparent inconsistency in this matter, see R. de la Feria, "'GAME OVER' for Aggressive VAT Planning?: *RAL v Commissioners of Customs & Excise*", (2005) *BTR* 4, pp. 394-401.

[532] The concept of fixed establishment was briefly discussed in the recent Advocate-General Leger's Opinion in *FCE Bank*, case C-210/04, [2005] ECR I-000. The case concerned supplies of services by FCE Bank, established in the UK, to one of its permanent establishments in Italy, and whether these transactions should be subject to VAT under Article 2(1) Sixth Directive. As regards the definition of fixed establishment the Advocate-General seem to go back to the accepted definition prior to *RAL*, see paragraph 26 of the Opinion.

[533] Similar constructions can be found in Article 9(2)(e) and 26(2) Sixth Directive.

[534] Case 168/84, [1985] ECR 2251, paragraph 17.

[535] *Ibid*, paragraph 18.

[536] I. Roxan refers to a "double-test for the use of a fixed establishment the place of supply", in *op. cit.*, p. 611. Interestingly, in *RAL* the Court seems to have extended the application of part of this test, namely the "rational result for tax purposes", to the application of all place of supply of services

The Court established in *Berkholz* a *de facto* hierarchy amongst Article 9(1)'s place of supply criteria. This position has been consistently reiterated by the Court in all subsequent cases involving fixed establishment claims.[537]

In *DFDS* the Court provided some guidelines regarding the meaning of the second condition, namely of the expression "does not lead to a rational result for tax purposes".[538] DFDS Ltd fulfilled the conditions in order to be regarded as a fixed establishment, so the problem was whether the use of the place where the supplier has established its business criterion would lead to an irrational result for tax purposes or create a conflict with another Member Sate. The Court, following the opinion of Advocate-General La Pergola, considered that the use of this criterion would lead to distortions of competition and thus to an irrational result for tax purposes.

> "Consideration of the actual economic situation is a fundamental criterion for the application of the common VAT system. The alternative approach for determining the place of taxation of the services of travel agents, based on the fixed establishment from which these services are supplied, is specifically intended to take account of the possible diversification of travel agents' activities in different places within the Community. Systematic reliance on the place where the supplier has established his business could in fact lead to distortions of competition, in that it might encourage undertakings trading in one Member State to establish their business, in order to avoid taxation, in another Member State which has availed itself of the possibility of maintaining the VAT exemption for the services in question."[539]

Thus, the Court concluded that the fixed establishment criterion should be applied in *DFDS*.[540]

The issue of the rationality of using the place where the supplier has established his business criterion was again raised by Advocate-General Fennelly in *ARO*. However, the Court concluded in this case, that the first condition for the use of the fixed establishment criterion, *i.e.*, the existence of a fixed establishment, was not fulfilled and thus, was not necessary to take into consideration issues of rationality.[541]

So far the circumstances under which the use of the place where the supplier has established its business criterion would lead to a conflict with another Member Sate have

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rules, see paragraph 33 of the Court's judgment. For an analysis of the Court's reasoning and its consequences, see R. de la Feria, *op. cit.*

[537] See, for example, case C-231/94, *Faaborg-Gelting Linien*, [1996] ECR I-2395.

[538] Case C-260/95, [1997] ECR I-1005.

[539] *Ibid*, paragraph 23. The Court's reference to the "actual economic situation" has led authors to argue that the Court has applied the so-called principle of economic reality to this case, as a method of combating aggressive VAT planning, or VAT avoidance, see H. van Kesteren, "Economic Reality versus Abuse of Rights", Paper presented at conference on *Topical Developments in VAT Law*, organised by the Irish Centre for European Law, Dublin, 15 July 2005.

[540] *Ibid*, paragraph 24.

[541] This approach has been questioned by Moses J. in *Customs & Excise Commissioners v Chinese Channel (Hong Kong) Ltd*, [1998] STC 357 where he observed that: "the cynic might observe, however, that in every case where the court has emphasised the priority of the main place of business test, the court has also found that no fixed establishment existed. It remains to be seen what the court would decide to be the appropriate test where they find that there was a fixed establishment from which the supply was provided".

not yet been the subject of a Court's decision. It has been suggested, however, that such a conflict would only arise if there was a conflict as to where the supplied had, in fact, established his business.[542]

When are services supplied from the fixed establishment?

The expression in Article 9(1) Sixth Directive "from which the service is supplied" indicates that it is fundamental for the application of the fixed establishment criterion to establish whether there is a connection between the fixed establishment and the services supplied. In essence the problem is to determine which activities the fixed establishment has to perform in order for the services to be considered to have been supplied from there.

In *DFDS* the Court concluded that in light of the factual circumstances of the case, the services supplied by DFDS A/S to United Kingdom customers, had been supplied by DFDS Ltd, DFDS A/S's fixed establishment. However, the Court did not elaborate on what activities would have to be performed by the fixed establishment in order to conclude that the services had been supplied from there. Advocate-General La Pergola discussed the issued briefly. He concluded that the services had been supplied by DFDS Ltd because the contracts were signed in the United Kingdom, payments were made in British currency, and DFDS Ltd would deal with eventual complaints. In its judgment the Court does not make reference to any of these points, only referring to the need to take into account "the actual place where the tours are marketed".[543]

The place where the contracts were signed was also used in *ARO* as an important element which pointed to the fact that the services had been supplied from ARO in the Netherlands, as opposed to a fixed establishment in Belgium.

Overall, the conclusion as to whether the services are supplied from a fixed establishment will depend on the factual circumstances of each case. However, it is clear from *DFDS* and *ARO* that the place were the contracts are signed and the place where the services are marketed are, from the Court's point of view, good indicators as to where the services are actually supplied from.

Assessment of the Court's jurisprudence

The Court's jurisprudence in relation to fixed establishment has been the object of several criticisms, namely that "it creates more questions than it resolves" and that it shows that the Court is "result-driven".[544] The problem seems to be that the Court in all cases, bar one (*DFDS*), refused to accept the existence of a fixed establishment, siding with the tax authorities when concluding that the place of supply of services is the place where the supplier has its business.

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[542] See I. Roxan, *op. cit.*, p. 626.
[543] Paragraph 22 of the judgment.
[544] See B. Terra, *The Place of Supply in European VAT*, *op. cit.*, pp. 109-153.

In fact, the Court's jurisprudence has raised some important questions, for example, the role of independency in the concept of fixed establishment,[545] and the use of place where the contracts are signed and the services marketed as indicators as to whether services are supplied from a fixed establishment.[546] However, it would appear that overall the Court has successfully answered the problems raised by the use of the fixed establishment criterion for determining the place of supply of services. It has clarified the concept of fixed establishment, set out guidelines as to where the fixed establishment criteria should be used, and it has indicated which type of activities are necessary in order to conclude that the services have been supplied by a fixed establishment.

This opinion seems to be shared by the Commission. In its proposal regarding the place of supply of services rules, the Commission accepts that the Court of Justice's jurisprudence has successfully clarified the meaning of "fixed establishment", and thus extra legislative clarification is unnecessary.[547] As referred to by the Commission, this view is confirmed by the results of the public consultation it undertook prior to presenting the proposal.[548]

However, the Commission's view was expressed before *RAL*.[549] *RAL* essentially has not only shown the inadequacies of the place of supply services rules, but equally how the Court's jurisprudence as regards the fixed establishment criterion can be easily manipulated. Moreover, the Court's ruling, and the opinion of Advocate-General Poiares Maduro, raises serious questions over previous jurisprudence on fixed establishment, namely it demonstrates that the Court is willing to abandon guidelines set up in previous rulings, where the application these guidelines leads to an outcome, which is not favoured by the Court. In essence, *RAL* summarises the current legislative and jurisprudential situation within the VAT area by demonstrating the shortcomings of providing jurisprudential solutions to the difficulties arising from the current legislative rules.

### (b) REVERSE-CHARGE MECHANISM

The application of the main place of supply of services rule – *i.e.* the place where the supplier has established his business or has a fixed establishment, Article 9(1) Sixth Directive – to certain services, like services of consultants or advertising services, was regarded from the outset as problematic by the Commission.[550] These concerns are reflected in Article 9(2)(e) Sixth Directive, which provides that the place of supply of certain services is deemed to be the place where those services are supplied. This rule, known as the reverse-charge mechanism, has proved to be one of the key features of the

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[545] In the *DFDS* case the Court concluded that the services supplied by DFDS Ltd were supplied from a fixed establishment, because DFDS Ltd was not an independent agent of DFDS A/S. However, in the *ARO* case the Court defended that there was no fixed establishment based on, amongst other reasons, the establishment's lack of independence.
[546] As referred by I. Roxan, these indicators can be easily manipulated, *op. cit.*, p. 627.
[547] See *op. cit.*, COM(2003) 822 final, 23 December 2003, p. 9.
[548] *Summary Report on the place of supply of services*, *op cit.*
[549] Case C-452/03, [2005] ECR I-000.
[550] As highlighted in the explanatory memorandum to the Sixth Directive proposal, *op. cit.*, COM(73) 950, 20 June 1975.

place of supply of services system. However, its application has given rise to some difficulties, namely the following:

— the interconnection between the paragraph 2(e) rule and the main place of supply rule in paragraph 1 is unclear;

— the services listed in the several indents of paragraph 2(e) are somewhat ambiguous and lend themselves to different interpretations; and,

— more recently, the scope of the reverse-charge mechanism itself has been questioned, *i.e.*, under which circumstances would the services listed in Article 9(2)(e) be subject to the reverse-charge mechanism.

The Court has attempted to resolve these difficulties through extensive case-law.

Interconnection between paragraph 2 and paragraph 1

The interconnection between paragraph 2 and paragraph 1 of Article 9 Sixth Directive has given rise to considerable controversy. The problem lies in whether the rules contained in paragraph 2 should or should not be regarded as exemptions to the general rule in paragraph 1, and as such, interpreted restrictively.

The Court referred for the first time to the relationship between these two paragraphs in *Berkholz,*[551] when it stated that,

> "Article 9(2) sets out a number of specific instances of places where certain services are deemed to be supplied, whilst Article 9(1) lays down the general rule on the matter."[552]

However, it was not until *Trans Tirreno*[553] that the Court gave more specific guidance as to interconnection between the rules in paragraph 2 and the main rule in paragraph 1. The case concerned the interpretation of Article 9(2)(b) Sixth Directive.

Trans Tirreno Expresso was an Italian transporter company, which was in the business of carrying passengers and goods by ship between the Port of Livorno, on the Italian mainland, and Olbia, in Sardinia. The Italian tax authorities were seeking to charge VAT on Trans Tirreno in respect of the whole distance covered by the ship, including the part of the route which passed through international waters. Trans Tirreno disputed the right of the Italian State to charge VAT in respect of the part of the route which passed through international waters, arguing that Article 9(2)(b) Sixth Directive precluded VAT from being charged on journeys which took place outside the national territory.

The Court ruled that Article 9(2)(b) did not preclude a Member State from applying its VAT legislation to transport operations effected between two points within its national territory, even where part of the journey is completed outside its national territory, provided that it does not encroach upon the tax jurisdiction of other States. Underlying

[551] Case 168/84, [1985] ECR 2251.
[552] Paragraph 14 of judgment.
[553] Case 283/84, [1986] ECR 231.

the Court's decision was its approach to the interconnection between Article 9(1) and Article 9(2):

> "Article 9(1), by way of derogation from the strict principle of territoriality, lays down the general rule that the service is deemed to be supplied at the place where the supplier has established his business or has a fixed establishment from which the service is supplied.
>
> Article 9(2) provides for certain derogations from that general rule for specific services where the fiction that the services are supplied at the supplier's place of business is inappropriate and it lays down other criteria defining the place at which those services are deemed to be supplied."[554]

The Court's ruling did not totally clarify matters. It failed to provide any guidance as to the interpretative consequences of qualifying Article 9(2) rules as "derogations" and "exceptions" – the questions of whether Article 9(1) took interpretative precedent over Article 9(2) and whether Article 9(2) rules were to be interpreted restrictively remained unanswered.

Some years latter the Court delivered its judgment in *Hamann*.[555] The case concerned the interpretation of the old Article 9(2)(d) Sixth Directive, which then read,

> "in the case of hiring out of movable tangible property, with the exception of all forms of transport, which is exported by the lessor from one Member State with a view to its being used in another Member State, the place of supply of the service shall be the place of utilisation."[556]

The issue was whether the hiring out of sailing yachts was to be regarded as the hiring out of movable tangible property – and thus subject to Article 9(2)(d) – or whether these yachts should be considered as means of transport – therefore falling within the scope of Article 9(1). The Court, following the view taken by the Advocate-General, concluded that sailing yachts should be regarded as "means of transport". In its ruling the Court seems to provide some additional guidelines on the interconnection between Article 9(1) and Article 9(2), and namely on underlying interpretative principles. The Court started by reiterating the position already expressed in *Trans Tirreno*, "Article 9(2) of the Sixth Directive lays down a number of exceptions to this general rule [Article 9(1)]".[557] It then went on to conclude that:

> "In view of the reasons for the exclusion of all forms of transport from the exception laid down in Article 9(2)(d) of the Sixth Directive and the fact that exceptions to the general rule laid down by the Sixth Directive must be interpreted narrowly, ocean-going sailing yachts, even if used by the hirers for sporting purposes, must thus be

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[554] Paragraphs 15-16 of the judgment.
[555] Case 51/88, [1989] ECR 767.
[556] This rule was deleted by the Tenth Council Directive 84/386/EEC of 31 July 1984, OJ L 208, 03/08/1984, p. 58.
[557] Paragraph 12 of the judgment.

regarded as forms of transport within the meaning of the aforesaid provision of the Sixth Directive."[558]

This passage of the ruling seems to clearly indicate that the Court considers Article 9(2) rules to constitute exceptions to the main rule in Article 9(1), and as such to be interpreted strictly. However, this reading of the Court's ruling is not without controversy. According to Advocate-General Fennelly the Court of Justice's ruling in *Hamann* provided "no intimation of the priority, as a matter of interpretative principle, of the first paragraph over the second."[559]

The Advocate-General's reading of the Court's ruling in *Hamann* reflected the need for clear and final guidance from the Court in relation to the interconnection between paragraph 1 and paragraph 2 of Article 9. This was finally provided in *Dudda*.[560]

The case concerned the interpretation of Article 9(2)(c) Sixth Directive. The plaintiff, Mr. Dudda, was in the business of supplying sound-engineering services for concerts and similar events. Although his business was established in Germany, most of these events took place abroad, namely in other Member States. The German tax authorities sought to subject Mr. Dudda's total turnover to German VAT. Mr. Dudda rejected this, claiming that the turnover from the services supplied in respect of events outside Germany should not be subject to German VAT. In his view, these services were supplied at the venue of the respective events and not, as alleged by the German authorities, at his place of business in Germany.

The German national court referred the case to the Court of Justice asking whether the sound-engineering services supplied by Mr. Dudda should be regarded as "cultural, artistic, entertainment or similar services" within the meaning of Article 9(2)(c) Sixth Directive.

Written observations were submitted by the German and Italian Governments and by the Commission. The German Government referred to the legislative history of Article 9 Sixth Directive and to the Court of Justice judgments in *Trans Tirreno* and *Berkholz* to defend that the Article 9(2) rules constituted derogations to the general rule in Article 9(1) and as such should be interpreted strictly. Whenever doubts arose as to the classification of an activity within the scope of the derogating provision, the general rule should apply. The Italian Government on the other hand argued that it should be left to national legislation to determine which services should be regarded as ancillary to artistic services for VAT purposes.

The Commission took an opposite approach arguing that the terms used in Article 9(2)(c) are Community-law terms, which must be uniformly interpreted so as to avoid instances of double or non-taxation resulting from divergent national interpretations. Paragraphs (1) and (2) of Article 9 of the Directive should not be seen as setting out a general rule subject to specific exceptions. They have a shared object: to specify the place of supply

[558] Paragraph 19 of the judgment
[559] Advocate-General Fennelly Opinion in the *Dudda* case, paragraph 28.
[560] C-327/94, [1996] ECR I-4595.

of services. Paragraph (2) should therefore be seen as providing a *lex specialis* in respect of the various specialised services to which it applies, with paragraph (1) providing for a residual *lex generalis*. Thus, a deliberate policy of reading Article 9(2) in a restrictive fashion would be a mistake.

The Court, following the opinion of Advocate-General Fennelly, agreed with the Commission, considering that the sound-engineering services supplied by Mr. Dudda were within the scope of Article 9(2)(c) Sixth Directive. As regards the relationship between Article 9(1) and Article 9(2) it stated:

> "[T]he Court has already held that Article 9(2) sets out a number of specific instances of places where certain services are deemed to be supplied, whereas Article 9(1) lays down the general rule on the matter [...]
>
> It follows that, when Article 9 is interpreted, Article 9(1) in no way takes precedent over Article 9(2). In every situation, the question which arises is whether it is covered by one of the instances mentioned in Article 9(2); if not, it falls within the scope of Article 9(1).
>
> Accordingly, it is necessary to determine the scope of Article 9(2) in the light of its purpose..."[561]

Following the Court's ruling in *Dudda*, it seems that the controversy surrounding the interconnection between paragraph 2 and paragraph 1 of Article 9 Sixth Directive has been settled. The rules in paragraph 2 should be regarded as *lex specialis*, which should be interpreted not narrowly but rather in light of their objectives. This approach has been confirmed by the Court in latter cases.[562]

Interpretation of the services listed in paragraph 2(e)

The interpretation of the services listed in Article 9(2)(e) Sixth Directive has been the subject of several rulings of the Court. Interestingly, all cases relate to the interpretation of only two of the (currently) twelfth indents of Article 9(2)(e):[563] the second indent regarding "advertising services"; and the third indent concerning "services of consultants, engineers, consultancy bureaux, lawyers, accountants and other similar services, as well as data processing and the supplying of information". In all cases the question posed to the Court has been whether specific services should be regarded as included within the scope of these indents, and thus subject to the reverse-charge mechanism, or whether

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[561] Paragraphs 20-22.

[562] See for example case C-429/97, *Commission v France*, [2001] ECR I-637, paragraph 41; and C-452/03, *RAL*, [2005] ECR I-000.

[563] In the original version of Article 9(2)(e) only seven types of services (corresponding to seven indents) were listed. The last five indents have been inserted by consecutive amendments to the rule, as follows: indent eight was introduced by Tenth Council Directive 84/386/EEC of 31 July 1984 on the hiring out of movable property, OJ L 208, 03/08/1984, p. 58; the tenth indent was inserted by Council Directive 1999/59/EC of 17 June 1999 as regards telecommunications services, OJ L 162, 26/06/1999, p. 63; the eleventh and twelfth indents were inserted by Council Directive 2002/38/EC of 7 May 2002 on tax arrangements applicable to radio and television broadcasting services and certain electronically supplied services, OJ L 128, 15/05/2002, p. 41; and, finally, the ninth indent was introduced by Council Directive 2003/92/EC of 7 October 2003 on the place of supply of gas and electricity, OJ L 260, 11/10/2003, p. 8.

they should fall within the scope of the general place of supply of services rule in Article 9(1).

The first time the Court was asked to decide on the interpretation of the services listed in Article 9(2)(e) was in so-called "advertising cases". In March 1992, the Commission brought actions against four Member States – France, Luxembourg, Ireland and Spain – regarding their narrow interpretation of the concept of "advertising" for the purposes of Article 9(2)(e).[564] The case against Ireland was removed from the Court Registry, following the issue of a Statement of Practice by the Irish Revenue Commissioners.[565] The cases against the other three Member States, however, proceeded.

In all cases the Commission basically claimed that Member States, by excluding a series of economic transactions from the concept of "advertising services" for the purposes of Article 9(2)(e) Sixth Directive, had failed to fulfil its obligations under that Directive. Furthermore, it considered that the situation was liable to jeopardise the uniform application of VAT and legal certainty, and could potentially lead to double taxation or non-taxation as a result of different interpretations in respect of services provided across borders.

The Court agreed with the Commission, ruling in all cases that by excluding certain economic activities from the definition of advertising services, within the meaning of Article 9(2)(e), France, Luxembourg and Spain, had failed to fulfil its obligations under the Directive.

Following the "advertising cases" the Court has been asked on two other occasions to decide on the scope of "advertising services" for the purposes of Article 9(2)(e) Sixth Directive. However, as it will be argued, the focuses of these cases were not, strictly speaking, the interpretation of the concept of "advertising services", but rather under which circumstances would advertising services fall within the scope of the reverse-charge mechanism, and as such they will be analysed *infra*.

A few years after the "advertising cases" the Court was once again called to decide upon the correct interpretation of the services listed in Article 9(2)(e) Sixth Directive, this time on the interpretation of the third indent of that subparagraph. This was in *Linthorst*,[566] which concerned the supply of services by veterinary surgeons.

Mr. Linthorst was part of a partnership of veterinary surgeons established in the Netherlands. The partnership, treated under the Dutch legislation as a single taxable

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[564] Cases C-68/92, *Commission v France*, [1993] ECR I-588; C-69/92, *Commission v Luxembourg*, [1993] ECR I-5907; C- 70/92, *Commission v Ireland*, removed from the Court register; and, C-73/92, *Commission v Spain*, [1993] ECR I-5997.

[565] Statement of Practice VAT/3/1992. The Commission had argued that the Irish authorities in contravention of Article 9(2)(e) operated a distinction between services involved in or forming an intrinsic part of an advertising campaign and ancillary supplies of goods and other activities connected with and indissociable from such a campaign. The Statement of Practice would seem to disregard such a distinction, establishing that "as a matter of practice, advertising services include all services actually carried out by advertising agencies which have the aim of promoting a product, a business or a person, for example, media publicity, promotional launches and other publicity events."

[566] Case C-167/95, [1997] ECR I-1195.

person, had supplied veterinary services to taxable persons (cattle holders) in Belgium. The services, which did not include supplies of medicines, related to animals in Belgium and were performed in Belgium. The cattle holders were solely established in Belgium.

A dispute arose between Mr. Linthorst's partnership and the Dutch tax authorities as to where these services were deemed to have been supplied. The Dutch tax authorities maintained that the services had been supplied in the Netherlands, pursuant to Article 9(1) Sixth Directive. The veterinaries claimed that the services' place of supply was Belgium. They argued first, that the derogation provided for in the third or fourth indent of Article 9(2)(c) Sixth Directive should be applied and that, as a result, the place where the services in question were supplied was the place where they were physically carried out. Alternatively, they submitted that the third indent of Article 9(2)(e) Sixth Directive should apply, and consequently the place of supply was the place where the customers had established their places of business.

As regards the applicability of the reverse-charge mechanism, the veterinaries contended that veterinary services should be considered as "similar services" within the meaning of the third indent of Article 9(2)(e).[567] Advocate-General Fennelly expressly rejected this argument, as did the Court. In its ruling the Court stated that:

> "It should be noted that the only common feature of the disparate activities mentioned in that provision is that they all come under the heading of liberal professions. Yet, as the German Government rightly observed, if the Community legislature had intended all activities carried out in an independent manner to be covered by that provision, it would have defined them in general terms.
>
> Moreover, if the legislature had intended that provision to cover the medical profession generally, as an activity typically carried out in an independent manner, it would have included it in its list [...].
>
> It is appropriate to add that, whereas veterinary surgeons' duties sometimes involve advisory or consultancy aspects, that fact is not enough to bring the principal and habitual activities of the profession of veterinary surgeon within the concepts of 'consultants' or 'consultancy bureaux' or to cause them to be regarded as 'similar'.
>
> It must therefore be held that the typical duties of a veterinary surgeon do not fall within the third indent of Article 9(2)(e) of the Sixth Directive."[568]

A year after issuing its ruling on *Linthorst*, the Court was again called to interpret the third indent of Article 9(2)(e) Sixth Directive in *von Hoffmann*[569].

The case concerned the arbitration services provided by Professor von Hoffmann, a Law Professor at the University of Trier, Germany. Professor von Hoffmann had served as an

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[567] The third indent of Article 9(2)(e) Sixth Directive reads: "services of consultants, engineers, consultancy bureaux, lawyers, accountants and other similar services, as well as data processing and the supplying of information".
[568] Paragraphs 20-23 of the judgment. The Court also rejected the applicability of Article 9(2)(c), see paragraph 24 of the judgment.
[569] C-145/96, [1997] ECR I-4857.

arbitrator at the International Chamber of Commerce, which was based in Paris. He was a member of a number of international arbitration tribunals which settled disputes between commercial undertakings. The proceedings of the arbitral tribunals and the pronouncement of their awards all took place in Paris. The parties to the arbitrations all had their places of business outside Germany.[570] The members of the tribunal received payment not from the parties but through the International Chamber of Commerce. The German tax authorities claimed that the fees paid to Professor von Hoffmann by the International Chamber of Commerce were subject to German VAT. Professor von Hoffmann disagreed arguing that the arbitration services were deemed to have been supplied in France, by virtue of the German provision which transposes Article 9(2)(e) Sixth Directive.

The question referred to the Court of Justice was whether Article 9(2)(e) Sixth Directive, and namely the third indent, was to be interpreted as including the services of an arbitrator. The Advocate-General considered that it should, the Court disagreed.

The Court first established that the services of an arbitrator could not be regarded as services of consultants, engineers, consultancy bureaux, lawyers or accountants. It then considered that they could not be regarded either as "similar services" for the purposes of Article 9(2)(e), third indent. It thus concluded that:

> "On a proper construction, Article 9(2)(e), third indent, of the Directive does not refer to the services of a member of an arbitration tribunal."[571]

The most recent case involving the interpretation of the third indent of Article 9(2)(e) is *Levob*,[572] which concerned a "package supply" relating to software services. This package supply included the following services: supply to a consumer of standard software previously developed; subsequent customisation of that software to the purchaser's specific requirements. The Court was asked whether this package should be treated as a single supply for VAT purposes and if so, whether this single supply should be regarded as "data processing and supply of information", within the meaning of Article 9(2)(e), third indent. The Court considered that the package supply should be regarded as a single supply of services for the purposes of Articles 2(1) and 6(1) Sixth Directive, even where separate prices were paid. Moreover, following the Opinion of Advocate-General Kokot, with the support of the Netherlands' Government and the Commission, the Court considered that this single supply should indeed be regarded as within the scope of the third indent of Article 9(2)(e).

The Court's interpretation of the services listed in Article 9(2)(e), namely of the second and third indent, provides some guidance as to the Court's approach to the problem. The Court's judgments in the "advertising cases" and in *Levob*, in particular, confirm the Court's position regarding the rejection of a narrow interpretation of Article 9(2)(e).

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[570] The order for reference did not say whether the parties were established inside or outside the Community, or both.
[571] Paragraph 26 of the judgment.
[572] Case C-41/04, [2005] ECR I-000.

However, as it will be discussed *infra*, the case-law on this subject is symptomatic of a more serious problem, which is beyond the Court's reach.

Scope of paragraph 2(e)

Substantively different from the problem analysed *supra* is the issue regarding the scope of Article 9(2)(e) Sixth Directive.[573] The problem here is not whether specific economic activities should be regarded as one of the services listed in that provision – in fact, it is assumed they are – but rather whether some of those services would fall within the scope of Article 9(2)(e) and thus, the reverse-charge mechanism. The problem has recently been raised in two cases concerning advertising services: *SPI*[574] and *Design Concept*[575].

In *SPI* the French Conseil d'Etat asked the Court of Justice whether the notion of "advertising services" mentioned in Article 9(2)(e) Sixth Directive applied only to services supplied directly and invoiced by the supplier to a taxable advertiser or whether it applied also to services supplied indirectly to the advertiser and invoiced to a third party (such as an advertising agency) who in turn invoices them to the advertiser. The case concerned Syndicat des producteurs independents (SPI), a professional organisation representing the interest of French film producers including producers of advertising films. Following a series of disputes between some of its members and the French tax authorities, SPI challenged the administrative practice adopted by the tax authorities. It claimed that by excluding from the scope of Article 9(2)(e) the supply of advertising films through advertising agencies the French tax authorities were acting in a contrary manner to that same Article.

The Court, following the Opinion of the Advocate-General, considered that "nothing in the wording of that provision justifies the conclusion that a direct contractual relationship must exist between the supplier and the advertiser".[576] It thus concluded that:

> "[T]he second indent of Article 9(2)(e) of the Sixth Directive must be interpreted as applying not only to advertising services supplied directly and invoiced by the supplier to a taxable advertiser but also to services supplied indirectly to the advertiser and invoiced to a third party who in turn invoices them to the advertiser."[577]

Soon after *SPI*, questions regarding the scope of Article 9(2)(e) Sixth Directive were again raised in *Design Concept*. The case concerned the services supplied by Design Concept, a company established in Luxembourg. Design Concept had been commissioned by the Luxembourg Ministry of Economic Affairs to organise display stands for the Ministry at a trade fair, known as HORECA, in Belgium. In order to carry out its commission, Design Concept contracted with Flanders Expo, a Belgian company, for the supply of various services, which included the construction of two stands at the fair, the

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[573] Even though they are very similar in terms of the practical implications: in both cases the issue is whether Article 9(2)(e) Sixth Directive applied or not to a given service.
[574] Case C-108/00, [2001] ECR I-2361.
[575] Case C-438/01, [2003] ECR I-5617.
[576] Paragraph 14 of the judgment.
[577] Paragraph 22 of the judgment.

cleaning of those stands while the fair was in progress, and the provision of staff to transport the material displayed.

When Flanders Expo submitted its invoice for the services which it had provided, it included Belgian VAT. Design Concept, however, refused to pay the sum corresponding to the Belgian VAT, arguing that the services which had been supplied to it were advertising services within the meaning of Article 9(2)(e), and that VAT was therefore payable in Luxembourg, the place where it, as the customer, was established. Flanders Expo brought an action in Luxembourg to recover the disputed sum, claiming the services supplied did not qualify as advertising services for the purposes of Article 9(2)(e), and thus should be subject to the general rule contained in Article 9(1) Sixth Directive.

The Cour de cassation of Luxembourg referred the matters to the Court of Justice, raising two issues, as follows:

— whether Article 9(2)(e) applied to advertising services supplied indirectly to an advertiser and invoiced to a third party who in turn invoices them to the advertiser; and,

— whether Article 9(2)(e) applied to advertising services if the recipient of those services does not produce goods in the price of which the cost of those services is to be included.

The nature of the services supplied by the Flanders Expo was not under dispute, as the issues raised by the Luxembourg court were founded upon the assumption that the services supplied were "advertising services" within the meaning of Article 9(2)(e).[578]

As regards the first issue, the Court referred to its recent ruling in *SPI*:

> "In accordance with the case-law of the Court, the second indent of Article 9(2)(e) of the Sixth Directive must be interpreted as applying not only to advertising services supplied directly and invoiced by the supplier to a taxable advertiser, but also to services supplied indirectly to the advertiser and invoiced to a third party who in turn invoices them to the advertiser."[579]

As for the second issue, the Court, following the Opinion of the Advocate-General, concluded that:

> "The fact that the advertiser does not produce goods or services in the price of which the cost of the advertising services may be included is not relevant for the purpose of determining the place where the services are supplied to the intermediate customer."[580]

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[578] The nature of the services supplied by Flanders Expo had given rise to a considerable number of observations from Design Concept, the French Government and the Commission. The Court, however, decided to answer solely to the issues raised by the Luxembourg court, see paragraph 14 of the judgment.
[579] Paragraph 17 of the judgment.
[580] Paragraph 29 of the judgment.

In both *SPI* and *Design Concept*, the Court was not asked to rule on the nature of the services in question, rather on the scope of Article 9(2)(e) Sixth Directive and on both occasions it adopted the wider approach.[581] Following the Court's rulings on these cases, it would appear that the following situations should be regarded as within the scope of the reverse-charge mechanism, as follows:

— where the services listed in Article 9(2)(e) are supplied indirectly and invoiced to a third party; and,

— where the recipient of the service does not produce goods or services in the price of which the cost of the services may be included.

Assessment of the Court's jurisprudence

The analysis of the case-law undertaken *supra* demonstrates that some of the difficulties raised by Article 9(2)(e) Sixth Directive have been successfully dealt with by the Court. The issues regarding the interconnection between paragraph 1 and paragraph 2 of Article 9 have been settled, and the Court has provided definitive guidelines in relation to the correct interpretative approach to paragraph 2(e) – in light of its objectives rather than narrowly. However, what the case-law equally demonstrates is that there seems to be an identifiable pattern amongst the cases regarding the interpretation of Article 9(2)(e), which is indicative of other, non-interpretative, problems.

*Linthorst*, *von Hoffman* and *SPI* concerned disputes between taxpayers and the tax administrations of the Member States where they were established: the taxpayers claimed that the supplies under dispute were within the scope of Article 9(2)(e) Sixth Directive, and thus subject to the reverse-charge mechanism, while the tax administrations argued that those supplies should be regarded as within the scope of Article 9(1) of that Directive.

The "advertising cases" arose within the framework of enforcement actions, in which the Member States involved – France, Luxembourg and Spain – were found in breach of Article 9(2)(e) Sixth Directive for excluding from the scope of that Article certain economic transactions, *i.e.*, for adopting a narrow interpretation of the reverse-charge mechanism.

Finally, *Design Concept* involved two taxpayers: Flanders Expo, a Luxembourg company, which claimed that the supplies under dispute were deemed to have been supplied in Luxembourg, under Article 9(1) and Design Concept, a Belgium company, which claimed that the services which it had received were deemed to have been supplied in Belgium, under the reverse-charge mechanism.

What are the common features in all these cases?

— in all cases which involved Member States' Governments / administrations,[582] those administrations favoured a narrow interpretation of Article 9(2)(e);

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[581] In doing so, it again reiterated its view on the relationship between paragraph 1 and 2, and namely that paragraph 2 should not be interpreted narrowly.
[582] The only case in which Member States' administrations were not involved was *Design Concept*.

— in all cases which involved taxpayers, all but one (Flanders Expo in *Design Concept*), claimed that the services under dispute should fall within the scope of Article 9(2)(e); and

— all cases related to intra-community transactions – even though the reverse-charge mechanism also applies where the customers are established in a third country.

How can these common features be explained?

The position adopted by the Member States' administration is easily explained: Member States seek to tax the total turnover of traders established in their own territory, in this way maximising their tax revenues. This approach would be particularly important to Member States which are traditionally "services-exporters". The position adopted by the taxpayers in relation to the interpretation of Article 9(2)(e) is less obvious, and can only be explained in the context of VAT administrative arrangements applicable to intra-community transactions. For traders the use of Article 9(1) for intra-community transactions carries two potentially negative effects, as follows:

— the risk of double taxation;

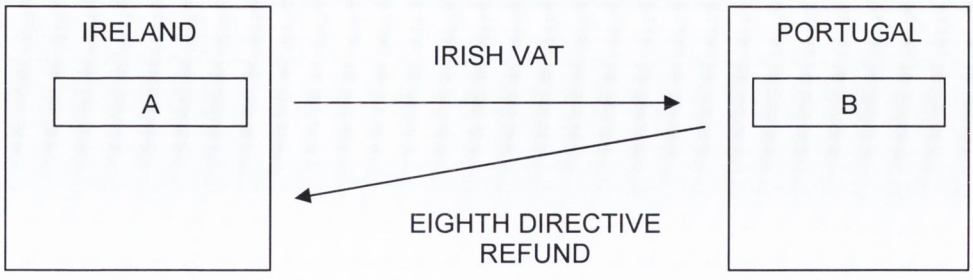
— the need to use the Eighth Directive refund procedure.

The risk of double taxation is in essence an interpretative problem, which arises mostly in situations where it is not totally clear whether the services fall or do not fall within the scope of Article 9(2)(e). The tax administration of the Member State where the customer is established might consider the service to be deemed to be supplied in their country, in which case the same service will be subject to VAT in the Member State where the supplier is established – by virtue of Article 9(1) – and in the Member State where the customer is established – by virtue of Article 9(2)(e). The Commission specifically highlighted this problem in the advertising cases, stating that the exclusion of certain economic activities from the scope of Article 9(2)(e), second indent, was liable to jeopardise the uniform application of VAT and legal certainty, and might lead to double taxation or non-taxation as a result of differing interpretations in respect of services provided across borders.

The need to use the Eighth Directive refund procedure, however, cannot be qualified as an interpretative problem. The situation can be better explained through a practical example.

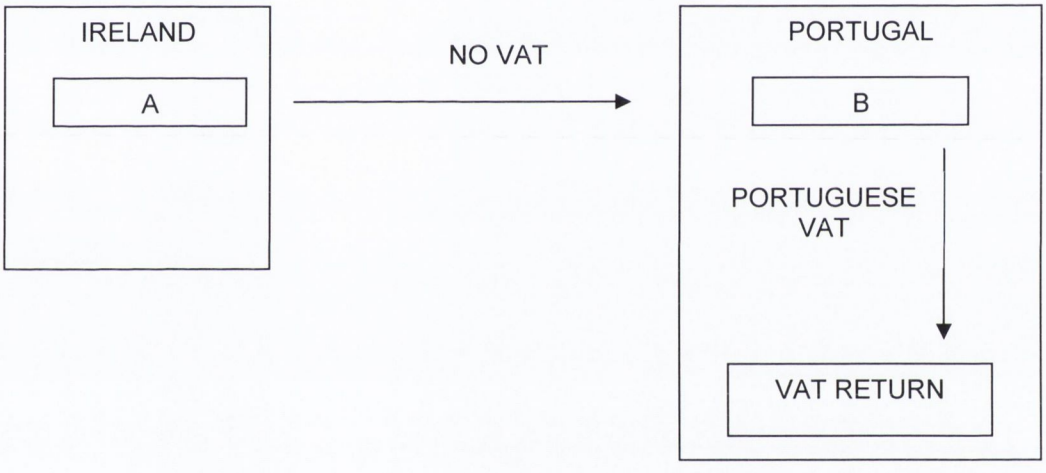
A is a trader established in Ireland. In the course of its business it supplies services to B, a Portuguese trader. B is not registered for VAT purposes in Ireland and is a fully taxable person.

DIAGRAM 4.1 – WHERE SERVICES FALL WITHIN THE SCOPE OF ARTICLE 9(1)




A will charge VAT (Irish) on its supplies of services to B. As a fully taxable person, B is entitled to deduct its input tax, and namely the tax it was charged by A. However, as in this case the input tax is Irish, B will not be able to deduct the tax on its VAT return. B will either suffer the burden of tax or claim a refund of the VAT paid from the Irish authorities, under the Eighth Directive procedure.

DIAGRAM 4.2 – WHERE SERVICES FALL WITHIN THE SCOPE OF ARTICLE 9(2)(e)




A will not charge VAT on its supplies of services to B. B will self-charge Portuguese VAT on the transactions, under the reverse-charge mechanism, and as a fully taxable person, B will be able to deduct that tax, under the Portuguese rules for deduction of input tax, *i.e.*, the amount of VAT due on those supplies will be regarded by B as both output and input tax.

As the example demonstrates, where services are deemed to be supplied in the Member State where the supplier is established [Article 9(1)] it is likely that the taxable person acquiring the services will only be able to recover the VAT charged through the Eighth Directive procedure. Where the services fall within the scope of Article 9(2)(e), the person acquiring the services will be able to account for, and recover, the VAT through its normal VAT return.

The problems which arise in the context of the application of the Eighth Directive procedure have already been highlighted in Chapter 3. However, the Court of Justice case-law on the interpretation of Article 9(2)(e) Sixth Directive reveals exactly how

significant the problem is, showing the lengths that traders are willing to go to in order to avoid the use of that refund procedure. The awareness and acknowledgment of the problem is so widespread that in *SPI*, Advocate-General Jacobs considered the avoidance of the Eighth Directive procedure as an argument in favour of adopting a wider approach to the second indent of Article 9(2)(e) Sixth Directive:

> "[I]f the advertiser is established outside the Community or in a Member State other than France, he cannot deduct the VAT on his internal VAT return. The advertiser will therefore be left with the burden of VAT from the competent French authorities. When Article 9(2)(e) of the Sixth Directive was adopted, there was no Community mechanism for obtaining such refunds. A refund mechanism has subsequently been established by the Eighth Directive, but that mechanism is considerably slower and more cumbersome than a direct deduction on the advertiser's internal return."[583]

In light of this, it seems unavoidable to conclude that some of the problems which arise from the interpretation of Article 9(2)(e) Sixth Directive, namely the interpretation of the services listed therein and the scope of that provision, cannot be dealt with in an efficient and definitive way by the Court. This is due to the fact that the nature of these problems is only superficially interpretative – the true nature of the problems is legislative and lies within the essence of the transitional VAT system: the inability for traders established in a Member State to deduct VAT incurred in another Member State in their internal VAT returns. This conclusion is reinforced by the analysis of the Court of Justice case law on the Eighth Directive provisions.

### (2) TAX ADMINISTRATIVE ARRANGEMENTS

#### (a) EIGHTH DIRECTIVE REFUNDS

The analysis undertaken *supra* on the jurisprudence of the Court of Justice in relation to Article 9(2)(e) Sixth Directive and the applicability of the reverse-charge mechanism demonstrated the extent to which traders seek to maximise the use of this procedure in order to avoid the Eighth Directive refund procedure. The obvious question which stems from this analysis is why do traders wish to avoid the Eighth Directive procedure? This question was already partially answered in Chapter 3 where the difficulties which arise from application of this procedure were highlighted. However, an analysis of the Court of Justice case-law on the interpretation of the Eighth Directive provisions provides additional insights into the extent of these difficulties and into the way in which the Court has attempted to resolve them.

The Court of Justice's cases regarding the Eighth Directive can be divided into two groups, as follows:

— cases concerning the interpretation of the Directive's substantive provisions focussing namely on the scope of the right to refund – Articles 2 and 5; and,

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[583] Paragraph 30 of the Advocate-General Jacobs' Opinion.

— cases regarding the interpretation of the Directive's adjective provisions, *i.e.*, provisions which lay out the formal requirements of the refund procedure, namely time-limits for refund and required documentation – Articles 3 and 7.

Scope of the right to VAT refund

The first time the Court of Justice was called to decide on the scope of the right to VAT refund was in *Etienne Debouche*[584]. The case concerned the interpretation of Article 3 Eighth Directive on the documentation requirements in order to obtain the refund. However it had considerable implications in terms of the scope of the right to refund, and namely regarding the interpretation of Article 5 of that Directive.

Mr. Debouche, a lawyer established in Belgium, hired a car from a leasing company established in the Netherlands, which he used exclusively in Belgium for professional purposes. Belgium had availed of the possibility provided for in Article 28(3)(b) Sixth Directive, in conjunction with Annex F thereof, to exempt the services supplied by lawyers from VAT. These services, however, were subject to tax in the Netherlands. Mr. Debouche submitted an application to the Netherlands authorities for the refund of VAT which he had been charged on the cost of hiring the car. Annexed to the application were the original invoices and a certificate, issued by the Belgian authorities, stating that Mr. Debouche "is not subject to value added tax in Belgium because he is a supplier of services exempted pursuant to Article 28(3)(b) Sixth Directive and Annex F thereof." The Netherlands authorities rejected Mr. Debouche's application. Mr. Debouche then brought an action against the Netherlands authorities claiming that he was a taxable person within the meaning of Article 3(b) Eighth Directive and that, according to Article 5 of that Directive, entitlement to a refund was governed by the deduction rules of the Member State of refund, so that the Netherlands' provisions, under which lawyers were entitled to deduct input VAT, should be applicable to him.

The Court disagreed. It concluded that:

> "Article 3(b) of the Eighth Directive is to be interpreted as meaning that the fact that a lawyer benefits, pursuant to Article 28(3)(b) of the Sixth Directive and Annex F thereto, from an exemption in the Member State to issue the certificate mentioned therein and he is not, accordingly, entitled to a refund of the VAT charged on services supplied to him in a Member State in which he is not established and in which services supplied by lawyers are not exempted."[585]

Although the Court's ruling was formally on the interpretation of Article 3(b) Eighth Directive, the decision had considerable implications in terms of the scope of the right to refund under this Directive: effectively, the Court denied the right to VAT refund, where the taxable person's activities are regarded as exempt in the Member State

[584] Case C-302/93, [1996] ECR I-4495.
[585] Paragraph 20 of the judgment.

establishment, even where the Member State of refund regards those same activities as taxable.[586]

The scope of the right to VAT refund under the Eighth Directive was once again brought into discussion in *Monte Dei Paschi Di Siena*.[587] The case concerned Monte Dei Paschi Di Siena, a banking and financial institution established in Italy, which had incurred French VAT in connection with the setting up of an office in that country. Monte Dei Paschi Di Siena submitted an application to the French authorities requesting the refund of the VAT incurred under the Eighth Directive. The French authorities refused to grant the refund.

Following proceedings in the French Courts, the Court of Justice was asked to decide on whether Articles 2 and 5 Eighth Directive should be interpreted as granting taxable persons who are partially exempt in the Member State where they are established, the right to refund of VAT incurred in another Member State, and if so, how the relevant amount of VAT to be refunded should be calculated. The Court ruled in favour of Monte Dei Paschi Di Siena, considering that:

"Articles 2 and 5 of the Eighth Directive must be interpreted as meaning that:

- they grant taxable persons established in a Member State where only part of their transactions are taxed a right to partial refund of the VAT which has been

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[586] The Court's decision is questionable in light of the wording of Article 3(b) and Article 5 Eighth Directive. Taxable person for the purposes of Article 3(b) Eighth Directive can only be interpreted as taxable person within the meaning of Article 4 Sixth Directive: not only is no other definition provided in the Eighth Directive, but equally Article 1 of this Directive specifically refers to Article 4 Sixth Directive when defining "taxable person not established in the territory of the country". In this context, Etienne Debouche is a taxable person for the purposes of Article 3(b) Eighth Directive, and as such is entitled to request from the tax authorities of the Member State where he is established a certificate of this taxable status. The Court argues that "a Member State is correct in not issuing a certificate for the purposes of Article 3(b) Eighth Directive to a lawyer who within that country supplies services exempted pursuant to Article 28(3)(b) Sixth Directive and Annex F thereto in the Member State in which he is established. As provided by the last sentence of Article 3(b) Eighth Directive, a taxable person who benefits from exemption and is consequently not entitled to deduct input tax is not, in accordance with the objective pursued by the Directives, entitled to a refund of VAT paid in another Member State either" (paragraphs 14 and 15 of the Court's judgment). This, however, is not the exact wording of Article 3(b). The last sentence of this Article provides for an exemption to Member State's obligation to issue certificates to taxable persons, as follows: "Member States shall not issue certificates to any taxable persons who benefit from tax exemption pursuant to Article 24(2) of Directive 77/388/EEC". An *a contrario* interpretation of this sentence seems to clearly indicate that in all other situations [other then that of taxable persons who benefit from exemption under Article 24(2)], Member States are obliged to issue these certificates. Thus, from the wording of Article 3(b) Eighth Directive it would appear that where the taxable person is exempt under any provision, other than Article 24(2) Sixth Directive, Member States are under the obligation to issue certificates of their taxable status. The Court's decision contradicts this interpretation. The reason is clear: if Member States where to issue these certificates to taxable persons who are exempt, this would open the way for these persons to deduct their input tax, where it has incurred in other Member States – this is totally contrary to the basic principles of the VAT system under the Sixth Directive, which denies the right to deduct VAT, where the tax was incurred for the purposes of exempt activities. This would have been exactly the case for Etienne Debouche. If the Belgian authorities had issued the certificate of taxable status to Mr. Debouche, he would have been able to obtain refunds for the VAT which he had incurred in the Netherlands for the purposes of his exempt activity. The Court's decision is thus in synchrony with the principles of the EU VAT system. It is, however, in contradiction with the wording of Articles 3(b) and 5 Eighth Directive. In light of the above, the obvious conclusion seems to be that the application of Articles 3 and 5 Eighth Directive can give rise in certain circumstances to solutions which contradict the basic principles of the EU VAT system.

[587] Case C-136/99, [2000] ECR I-6109.

charged in a Member State where they are not established on goods or services used for the purposes of their transactions in the Member State of establishment;

- the amount of VAT refundable is calculated, first, by determining which transactions give rise to a right to deduction in the Member State of establishment and, second, by taking into account solely of the transactions which would also give rise to a right of deduction in the Member State of refund if they were carried out there and of the expenses giving rise to a right to deduction in the latter State."[588]

The Court's ruling in this case had the effect of confirming the existence and the scope of the right to refund of VAT in cases of partially exempt taxable persons.

Less than a year later the Court issued its judgment in *Commission v France*.[589] The case concerned a circular from the French tax authorities on waste disposal, which effectively denied the right to VAT refund to taxable persons established outside France, in cases where those taxable persons had subcontracted part of their work to a taxable person established in France. The Commission brought an enforcement action against France claiming that by refusing the right to refund in these cases, France had failed to fulfil its obligations under the Eighth Directive, and in particular of Article 2 thereof. The Advocate-General agreed, as did the Court, concluding that:

> "[B]y refusing to refund to taxable persons established in a Member State other than the French Republic, who are holders of a main contract for a composite supply of services relating to waste disposal, the VAT which they have been required to pay to the French State in cases where they have subcontracted part of the work covered by such a contract to a taxable person established in France, the French Republic has failed to fulfil its obligations under the Eighth Directive, in particular Article 2 thereof".[590]

In summary, in light of the case law of the Court of Justice, partially exempt taxable persons (within the circumstances described in *Monte Dei Paschi Di Siena*) and taxable persons which subcontract part of their services (within the circumstances described in *Commission v France*) are regarded as within the scope of the right to refund under the Eighth Directive. On the other hand, taxable persons whose activities are regarded as exempt in the Member State of establishment, but taxable in the Member State of refund are considered as outside the scope of that same right.

Formal requirements of the refund procedure

The Court of Justice has ruled on several occasions on the formal requirements of the refund procedure, and namely on two aspects of this procedure, as follows:

— the documentation which should be submitted by the taxpayer along with the refund application – Article 3 Eighth Directive; and,

[588] Paragraph 32 of the judgment.
[589] Case C-429/97, [2001] ECR I-637.
[590] Paragraph 54 of the judgment.

— the time-limit for the refund application to be processed by the tax authorities of the Member State of refund – Article 7(4) Eighth Directive.

The first time the Court of Justice was called to decide on the documentation requirements was in *Etienne Debouche*, the circumstances of which have already been analysed *supra*. The Court ruled then that Article 3(b) Eighth Directive should be interpreted as meaning that a taxable person, who exclusively engages in exempt activities, is not entitled to request the tax authorities of the Member State of establishment to issue the certificate of taxable status mentioned in that Article.

Some years later the Court issued its ruling on *Société Générale des Grandes Sources d'Eaux Minérales Françaises.*[591] The case concerned the interpretation of Article 3(a) Eighth Directive and the requirement to submit original invoices therein. Société Générale des Grandes Sources d'Eaux Minérales Françaises (hereafter "Société Générale"), a French company, incurred German VAT in connection with a dealership agreement signed with UDL, a company established in Germany. In order to obtain refund of the VAT incurred, Société Générale submitted an application to the German authorities, to which it attached duplicates of the original invoices made out by UDL. It claimed that the original invoices had been lost in the post when sent to the lawyers instructed by it to process the VAT refund claim procedure.

The German authorities refused to grant the refund based on the lack of required documentation, *i.e.*, the original invoices, even though a taxable person established in Germany is allowed to deduct VAT on production of a duplicate or photocopy of the invoice, where the original invoice is lost for reasons beyond the taxpayer's control. Following proceedings in the German Courts, the Court of Justice was asked to decide on the following questions:

— Whether Article 3(a) Eighth Directive precludes the Member States from providing that a taxable person may prove his entitlement to refund by submitting a duplicate invoice or import document where the original has been lost for reasons beyond his control;

— If not, where a taxpayer established in a Member State may prove his entitlement to a refund of VAT by submitting a duplicate or photocopy of the invoice if the original invoice was lost for reasons beyond his control, whether does it follow from the principles of discrimination and neutrality of VAT that such a possibility should be extended to taxpayers not established in that Member State.

The Court considered that:

> "Article 3(a) of the Eighth Directive cannot be interpreted as precluding Member States from accepting such an application for a refund in exceptional circumstances where there is no doubt that the transaction which led to the application for a refund occurred, where the loss of the invoice or import document is not attributable to the

[591] Case C-361/96, [1998] ECR I-3495.

taxpayer and where it is established that, in view of the circumstances, there is no risk of further applications for a refund."[592]

Moreover it concluded:

"where a taxable person established in a Member State may prove his entitlement to a refund of VAT by submitting a duplicate or photocopy of the invoice if the original which he received has been lost for reasons beyond his control, the principle of non-discrimination set out in Article 6 of the Treaty and referred to in the fifth recital in the preamble of the Eighth Directive requires that the same possibility be extended to taxable persons not established in that Member State if the transaction which led to the application for a refund occurred and there is no risk of further applications for a refund."[593]

Under Article 7(4) Eighth Directive, the Member State of refund has six months in order to process the refund application. The rule appears to be clear and of straightforward interpretation, however, Member States have experienced some difficulties complying with it. This has resulted in two successful enforcement actions and a preliminary ruling in favour of the taxpayer.

The first case regarding the length of the refund procedure was *Commission v Italy*.[594] In light of numerous complaints it had received from traders in other Member States alleging delays in the refund of VAT by the Italian authorities, the Commission decided to bring an enforcement action against Italy requesting from the Court a declaration that, by allowing the Italian Ministry of Finance to systematically disregard the time-limits for refunds of VAT to taxable persons not established in the territory of the country without intervening, Italy had failed to fulfil its obligations under Article 7(4) Eighth Directive.

According to the Commission, despite the fact that the Eighth Directive had been transposed into the Italian law, refunds to taxable persons not established within Italy were in fact taking thirty-six months and that period was lengthening. The Italian Government did not deny the infringement, however, it claimed that the delays were due to organisational problems and were not the result of a deliberate discriminatory intent. Additionally, it pointed out that the national authorities were seeking ways of ensuring compliance with the six-month period.

Reiterating Member States' obligation to ensure the full and exact application of directives, the Court of Justice ruled in favour of the Commission declaring that:

"by allowing the Italian Ministry of Finance systematically to disregard the time-limits for refunds of value added tax to taxable persons not established in the territory of the country, without intervening from the outset to remove the resultant prejudice to

[592] Paragraph 29 of the judgment.
[593] Paragraph 38 of the judgment.
[594] Case C-287/91, [1992] ECR I-3515.

Community law, the Italian Republic has failed to fulfil its obligations under Article 7(4) of the Eighth Council Directive".[595]

Some years later the issue of Member States' compliance with time limits for VAT refunds arose again in *Commission v Spain*.[596] The circumstances of the case were very similar to the ones in *Commission v Italy*: the Commission had received numerous complaints from traders in other Member States reporting delays in refunds by the Spanish authorities of up to twelve months. The Spanish Government, like the Italian Government, did not deny the infringement but rather tried to justify it on the basis of organisational problems. The Court concluded that by disregarding the six-month time-limit for the refund of VAT to taxable persons not established in the territory of the country, Spain had failed to fulfil its obligations under Article 7(4) Eighth Directive.

Member States' lack of compliance with the time limits established in the Eighth Directive has also given rise to questions regarding payment of interest in these situations. In *Lease Plan*[597] the Court was asked whether it was contrary to Articles 6 and 59 of the Treaty for national rules to provide that taxable persons not established in a Member State, who apply for a refund of VAT in accordance with the Eighth Directive, are entitled to interest only from such time as notice to pay was served on that Member State and at a lower rate than that applied to the interest paid to taxable persons established in the territory of that State automatically on the expiry of the statutory time-limit for reimbursement.

According to the plaintiff, Belgian tax legislation gave taxable persons not established in Belgium, upon the expiry of the statutory time-limit for reimbursement, interest at a lower rate than that of the interest paid to taxable persons established in Belgian. Additionally, whilst the latter received interest automatically in the event of a delay in repayment, taxable persons who were not established in Belgian were obliged, in order to obtain interest after the expiry of the statutory time-limit for reimbursing, to serve formal notice to pay on that State and to bear the cost of that extra formality.

The Belgian Government claimed that discrimination could only arise where different rules were applied to comparable situations, and this was not the case as regards the rules on the payment of interests. It argued that taxable persons established in the Member State concerned, who sought a refund of VAT paid on a transaction effected in a second Member State, could not be compared with that of taxpayers established in the second Member State and who either pursue a taxable economic activity on an irregular basis there or seek refund of the VAT on a transaction of a not exclusively business nature. The Court disagreed, considering that:

"it is contrary to Article 59 of the Treaty for national rules to provide that taxable persons not established in a Member State, who apply for a refund of VAT in accordance with the Eighth Directive, are entitled to interest only from such time as

[595] Paragraph 8 of the judgment.
[596] Case C-16/95, [1995] ECR I-4883.
[597] Case C-390/96, [1998] ECR I-2553.

notice to pay was served on that Member State and a lower rate than that applied to the interest paid to taxable persons established in the territory of that State automatically on the expiry of the statutory time-limit for reimbursement."[598]

Assessment of the Court's jurisprudence

The case-law of the Court of Justice has undoubtedly helped clarify the scope of the right to refund of VAT under the Eighth Directive. Equally, as regards the formal aspects of the refund procedure the Court has not only provided some guidelines as to interpretation of these requirements (e.g. requirement to submit original invoices or import documents in *Société Générale des Grandes Sources d'Eaux Minérales Françaises*), but has also enforced the application of others (such as the time limits for refund in *Commission v Italy* and *Commission v Spain*). However, similarly to the Court of Justice case law on Article 9(2)(e) Sixth Directive, a pattern emerges from the case law on the Eighth Directive provisions, which is indicative of the existence within the system of problems which are not interpretative in nature.

All cases on the interpretation, or enforcement, of Eighth Directive provisions share common features, as follows:

— all cases involve either Member States tax authorities or Member States' Governments;

— in all cases Member States' administrations are seeking to limit, delay, or exclude altogether, the refund of VAT; and,

— in all cases, but one, the Court of Justice ruled against the Member States.[599]

These common features, when analysed in conjunction, seem to indicate Member States' willingness to unduly restrict the scope – and number – of refunds of VAT granted under the Eighth Directive procedure. The motivation behind the adoption of such a restrictive position is evident: firstly, Member States naturally seek to maximise their revenues, and the adoption of a narrow and restrictive approach to the right of refund under the Eighth Directive is an easy way of doing so; secondly, as noted in Chapter 3, Member States often complain about the difficulty and the costs of administrating these refunds, and adopting a restrictive approach will effectively discourage traders from using this procedure. The consequences of the Member States' position regarding the Eighth Directive refund procedure, however, are also evident. As discussed in Chapter 3, for traders the procedure is costly, time consuming, and risky and in this context it is not difficult to understand why traders seek to avoid it, namely through abuse of the reverse-charge mechanism.

In light of the above, it is inevitable to conclude that, similarly to the problems arising from the application of Article 9(2)(e) Sixth Directive, the problems which arise from the

[598] Paragraph 41 of the judgment.
[599] The exception is *Etienne Debouche*, case C-302/93, [1996] ECR I-4495. Equally interesting is the fact that all cases are relatively recent – the first case on the interpretation of the Eighth Directive provisions dates from 1991 – even though the Directive itself dates from 1979.

application of the Eighth Directive are not interpretative but legislative, *i.e.*, they do not arise from the interpretation of the provisions of that Directive, but rather from the refund system which these provisions have created. The Court can, and has, helped to clarify the rules which govern this refund system; however, it cannot efficiently deal with the problems which it creates: that is a task for the legislator.

**(b) INTRASTAT**

As discussed in Chapter 3, since its introduction the Intrastat system has been surrounded by controversy, most notably due to the difficulties and extra compliance costs which it creates for traders. However, despite this the Court has only once been called to decide on Council Regulation No. 3330/91,[600] this was in *Kieffer and Thill*.[601] The case did not concern the interpretation of specific provisions of that Regulation, but rather the nature of the Intrastat system itself, and namely its compatibility with the free movement of goods provisions in the EC Treaty.

The defendants in the main proceedings, Rene Kieffer and Romain Thill, were the managers of a limited company operating a garage in Luxembourg, which repaired cars and bought and sold accident-damaged cars, second hand cars, spare parts and all car accessories. In the course of their business they engage in intra-community transactions. Having failed to submit Intrastat returns, Mr. Kieffer and Mr. Thill were charged by the Luxembourg authorities with infringing the obligation under Regulation No. 3330/91 to transmit information on imports and exports by their company. Both defendants acknowledged that the business conducted by the company they managed exceeded the simplification threshold, and that they should therefore have submitted Intrastat monthly returns, in accordance with the Regulation. They argued, however, that to comply with this obligation they would have to either take on staff or have the obligations carried out by third parties, incurring additional expense in either case. These additional expenses, they claimed, would have the effect of curbing, at least indirectly, their efforts to export in excess of the annual threshold and would encourage the sale of goods on the national market.

The Luxembourg Court considered that the detailed declaration required by Regulation No. 3330/91 constituted an additional constraint to which traders doing business in the national market alone are not subject. Moreover, it stated that the requirement to make that declaration, and the consequent increase in the obligations to be complied with by the undertakings concerned, could have a deterrent effect on small and medium-sized undertakings in Luxembourg whose activities extend beyond the national territory. In those circumstances, it considered that it should be ascertained whether such an impediment was justified from the point of view of the objectives of the Regulation and whether those objectives could not be attained by means constituting less of a constraint. Therefore, it essentially asked the Court of Justice the following questions:

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[600] Council Regulation (EEC) No. 3330/91 (OJ L 316, 16/11/1991, p. 1), which introduced the Intrastat system. This regulation has been recently substituted by Regulation (EC) No. 638/2004 of the European Parliament and of the Council of 31 March 2004, OJ L 102, 07/04/2004, p. 1.
[601] Case C-114/96, [1997] ECR I-3629.

— whether the obligations imposed upon traders under Regulation No. 3330/91 should be regarded as measures having equivalent effect to quantitative restrictions within the meaning of Articles 28 and 29 of the EC Treaty; and

— alternatively, whether these same obligations constitute a restraint upon traders that is unjustified and disproportionate having regard to the objective of general interest pursued, and thereby in breach of the principle of proportionality as defined in Article 5 of the EC Treaty.

The Court of Justice acknowledged that:

> "It is common ground that the detailed nature of the declarations required and the fact that it is obligatory to make a declaration in both the Member State of consignment and that of destination of the goods have restrictive effects with regard to the free movement of goods."[602]

However, the Court noted that barriers to the free movement of goods may be accepted if they are essential in order to obtain reasonably complete and accurate information on movements of goods within the Community, and in this context it considered that the obligations imposed by Regulation No. 3330/91 were not "measures having equivalent effect to quantitative restrictions" for the purposes of Articles 28 and 29 of the EC Treaty. Nor were they disproportionate, as the Court considered that:

> "[W]hile the obligation to make declarations under the Regulation does specifically affect cross-frontier trade, and drawing up the declarations takes time and involves expense, particularly for small and medium-sized undertakings, it does not necessarily follow that those restrictive effects are disproportionate to the aim pursued."[603]

In light of the above, the Court concluded that:

> "[E]xamination of Council Regulation (EEC) No. 3330/91 of 7 November 1991 on the statistics relating to the trading of goods between Member States has not disclosed any factor of such a kind as to cast doubt on its validity".

The Court's ruling in this case might have resolved the controversy surrounding the Intrastat system, namely as regards its compatibility with the EC Treaty rules on the free movement of goods and the principle of proportionality. However, it did not help resolve the practical difficulties which it gives rise to, namely from the traders' point of view. This much was acknowledged by the legislator, as the approval of a new Intrastat legislation demonstrates.

#### (c) VIES

Despite being regarded by traders and tax administrations alike as the source of significant practical problems,[604] the VIES system has never been directly the subject of a

[602] Paragraph 28 of the judgment.
[603] *Ibid*, paragraph 34.
[604] See Chapter 3.

Court of Justice case. Indirectly, however, the system, and namely the difficulties which arise from its application, have been the subject of recent cases opposing the United Kingdom's Customs and Excise Commissioners to British traders.[605] All cases concern the practice adopted by Customs and Excise Commissioners as regards unwitting participants in carousel fraud. According to the Commissioners, transactions forming part of carousel fraud do not qualify as economic activities, within the meaning Article 4(2) Sixth Directive, and as such do not entitle the taxpayer to the right to deduct input tax. It follows that traders carrying out transactions, which form part of carousel fraud, were refused the right to deduct input VAT, even where they had no knowledge of the fraud, and therefore could be broadly qualified as "innocent".

Following appeals from three different traders as regards this practice – Optigen, Fulcrum and Bond House – the VAT and Duties Tribunals of London and Manchester concluded, to the surprise of some,[606] that the Commissioners had rightly maintained that the transactions in question could not be regarded as economic activities and were therefore outside the scope of VAT.[607] All three traders lodged appeals before the High Court against these decisions. The High Court then decided to refer these cases to the Court of Justice. Essentially asking whether transactions such as those undertaken by Optigen, Fulcrum and Bond House qualified as economic activities within the meaning of Article 4(2) Sixth Directive and whether, in order to make that assessment, regard should be had to the chain of transactions as a whole or to each transaction individually.

Although the case is still awaiting decision from the Court of Justice, Advocate-General Poiares Maduro has already delivered his Opinion. In it he clearly takes the view that transactions forming part of carousel fraud should be viewed for the purposes of VAT individually, rather than as a whole.

> "Carousel fraud concerns a series of consecutive activities, performed by a number of traders in a supply chain. It is an essential feature of the common system of VAT that VAT becomes chargeable on each transaction in a supply chain. Each transaction must therefore be regarded on its own merits. Consequently, the character of a particular transaction in the chain cannot be altered by earlier or subsequent events."[608]

In this context he concludes that:

> "In order to determine whether a transaction in a supply chain qualifies as an economic activity within the meaning of Article 4(2) of the Sixth Council Directive [...] the transaction must be considered individually and per se. Transactions forming part of a

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[605] Joint cases C-354/03, *Optigen*; C-355/03 *Fulcrum Electronics;* and C-484/03, *Bond House*, [2005] ECR I-000.

[606] R. Pincher criticises the VAT Tribunal's decisions commenting that "Customs are seeking to impose the cost of fraud, visited upon the Treasury, on those innocently involved in that fraud.[...] what are the courts for if not to protect the innocent?, see "The costs of VAT frauds: *Bond House Systems Ltd* and *Optigen*", (2003) *BTR* 5, p. 346.

[607] See *Bond House Systems Limited v Commissioners of Customs & Excise*, (2003) VAT Decision 18100; and *Optigen Ltd v Commissioners of Customs & Excise*, (2003) VAT Decision 18112. Optigen and Fulcrum's appeals were joined by the VAT and Duties Tribunal, London.

[608] Joint cases C-354/03, C-355/03 and C-484/03, [2005] ECR I-000, Opinion of the Advocate-General, paragraph 27.

circular supply chain in which a trader misappropriates the amounts paid to it as VAT instead of accounting for those amounts to the tax authorities do not on that account cease to constitute an economic activity within the meaning of Article 4(2) of the Sixth Directive."[609]

The Advocate-General's Opinion has been welcomed by British tax and law practitioners,[610] and justifiably so considering the nature of the Customs & Excise Commissioners' practice. In fact, what is most interesting about these cases (and the Commissioners' practice) is on one hand the implicit recognition of the financial costs caused by the inefficient functioning of the current tax administrative arrangements, particularly the VIES system; and on the other hand, the willingness to have that cost shifted to the taxpayer, regardless of the consequences in terms of the potential creation of additional obstacles to legitimate intra-Community trade. As Advocate-General Poiares Maduro acknowledges:

"The United Kingdom seems to envisage combating carousel fraud – or at least dispensing with the problems it poses – by limiting the scope of the VAT system. To my mind, the Court should not consent to this approach. It would drastically shift the burden of the problem from the tax authorities to the private sector, at the expense of legitimate trade and the proper functioning of the VAT system. Moreover, it would deter Member States from taking appropriate measures against carousel fraud."[611]

Should the Court uphold the Opinion of the Advocate-General, the creation of additional obstacles to intra-Community trade will be avoided; nevertheless, the already existing obstacles and the practical difficulties created by this aspect of the EU VAT system, that these cases highlight, can only be dealt with efficiently through Community legislative measures.[612]

### ii) CONVERGENCE OF VAT RATES

As discussed in Chapter 3, the VAT rates structure under the Sixth Directive gives rise to numerous difficulties, namely from the perspective of traders. The apparent simplicity of the structure conceals a system that is susceptible to different interpretations and applications. This is especially true in the case of the list of goods / services which may be subject to reduced rates, in relation to which the lack of clear definitions of categories of goods and services has allowed Member States to introduce extremely subtle distinctions. The introduction of these subtle distinctions has significant consequences for traders, and undermines the level of VAT rates harmonisation which has already been

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[609] *Ibid* Paragraph 43.
[610] See R. Cordara comments in "Economic activity for VAT purposes", (2005) *BTR* 2, p. 182.
[611] Paragraph 42 of the Advocate-General's Opinion.
[612] This is implicitly acknowledged by R. Pincher when he states that "the fraud arose from the exploitation of a weakness in the tax legislation and the administration of the tax for both of which the innocent traders could not be held responsible but for which the State does appear to be responsible. The weakness in the tax legislation arises because the VAT system provides for a particular treatment of cross-border transactions [...]. VAT is not supposed to work in this way, the European governments are supposed to have introduced a different way of collecting VAT on international trade. They have failed to do so. So, at this high level, government, and not the individual, is to blame for these frauds", in *op. cit.*, p. 347.

achieved. In this context, the Commission has tried to minimise the existence of these distinctions by bringing enforcement actions against several Member States, in this way allowing the Court to build extensive jurisprudence on the area.

The Court of Justice jurisprudence on VAT rates can be divided in two groups, as follows:

— cases concerning the application of zero rates of VAT and the interpretation of Article 28(2) Sixth Directive; and,

— cases regarding the application of reduced VAT rates *stricto sensu*, *i.e.*, reduced rates higher than zero, which concerned the interpretation of both Article 12(3) and 28(2) Sixth Directive.

It is interesting to note that the Court of Justice's case-law on the VAT rates structure relates exclusively to the application of reduced rates and has emerged solely from enforcement actions, without the involvement of private parties.[613]

**(1) ZERO VAT RATES**

In its original version, Article 28(2) Sixth Directive allowed Member States to maintain zero rates of VAT[614] until the introduction of a definitive VAT system (Article 28l Sixth Directive),[615] insofar as they satisfy the conditions set out in last indent of Article 17 of the Second Directive,[616] which read:

> "[Member States may] provide for reduced rates or even exemptions with refund, if appropriate, of the tax paid at the preceding stage, where the total incident of such measures does not exceed that of the reliefs applied under the present system. Such measures may only be taken for clearly defined social reasons and for the benefit of the final consumer".

Based on these provisions, Ireland and the United Kingdom continued to make extensive use of zero-rates after the entry into force of the Sixth Directive. In 1985, the Commission decided to bring actions against these two Member States claiming that their VAT legislations failed to comply with the conditions set out in Article 17 of the Second Directive.

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[613] At least not directly – indirectly it is possible that, in some cases, the decision by the Commission to initiate enforcement actions against Member States was influenced by complaints made by traders. Additionally, the Court's judgment in *Adam*, case C-267/99, [2001] ECR I-7467, included important guidelines as regards the application of reduced rates, even though it concerned the application of exemptions under Annex F, see *infra*.

[614] The Article does not use the expression "zero rates", referring rather to "exemptions with refund of the tax paid at the preceding stage".

[615] In 1992, Article 28(2) Sixth Directive was amended by the Approximation of Rates Directive. As regards the possibility of maintaining zero rates, the wording of the provision did not differ substantively from the original version; however, the new version did include a specific derogation authorising Ireland to apply under certain conditions, zero rates of VAT to supplies of electricity. Since then this provision has been amended on several occasions, mostly with a view to extending the list of derogations included therein – see Council Directive 94/5/EC of 14 February 1994 on special arrangements applicable to second-hand goods, works of art, collectors' items and antiques, OJ L 60, 03/03/1994, p. 16; Council Directive 95/7/EC of 10 April 1995 introducing simplification measures, OJ L 102, 05/05/1995, p. 18; Council Directive 96/42/EC of 25 June 1996, OJ L 170, 09/07/1996, p. 34; Council Directive 2000/17/EC of 30 March 2000 on the transitional provisions granted to Austria and Portugal, OJ L 84, 05/04/2000, p. 24.

[616] Second Council Directive 67/228/EEC of 11 April 1967, OJ P 71, 14/04/1967, p. 1303.

In *Commission v Ireland*,[617] the Commission considered that by applying zero rates of VAT to certain agricultural inputs and electricity, Ireland had failed to comply with the last condition set out in Article 17 of the Second Directive, according to which zero rates could only apply "for clearly defined social reasons and for the benefit of the final consumer". The Court agreed that by applying a zero rate of VAT to supplies of electricity, Ireland had contravened the provisions of Article 17 Second Directive, and consequently Article 28(2) Sixth Directive, however it dismissed the Commission's application in relation to agricultural inputs.

The circumstances were very similar in *Commission v United Kingdom*.[618] In this case the Commission argued that by applying zero rates to supplies of several products, including food, water, sewerage, news, fuel, power, construction of buildings, clothing and footwear, the United Kingdom had failed to comply with the last conditions set out in Article 17 of the Second Directive. The Court agreed with the Commission as regards the majority of these products, ruling that, by applying zero rates to supplies to industry of water and sewerage services, news services, fuel and power and goods and services in relation to the construction of buildings, insofar as these were not supplied to final customers, the United Kingdom had failed to fulfil its obligations under the Sixth Directive.

These two rulings have helped clarify the conditions under which Member States are allowed to maintain zero-rates and reduced rates lower than the minimum rate laid down in Article 12(3) Sixth Directive.[619] However, in some cases the distinction between engaging in legal interpretation and legislating is not always clear, and the comments submitted by Ireland and the United Kingdom in these cases highlight this concern. In *Commission v Ireland*, Ireland contended that:

> "[T]here is a political motive behind the Commission's application to the Court and that such a motive is not a proper basis for an action pursuant to Article 169 of the EEC Treaty [now Article 226 EC Treaty]. The Commission's action is intended in fact to attain by means of judicial proceedings an objective which can be achieved only by a decision of the Community legislature. It is clear from the Commission's reply that its intention in bringing these proceedings is to bypass the procedural requirements of Article 28 of the Sixth Directive, under which it is for the Council, acting unanimously, to decide to abolish the exemptions permitted by that article. Ireland therefore submits that it is not the task of the Court "to substitute itself for the political procedures envisaged by Article 28 of the Sixth Directive and to substitute an immediate obligation upon a Member State for the progressive compliance envisaged by Article 28."[620]

The Court of Justice rejected the argument, stating that "in the context of the balance of powers between the institutions laid down in the Treaty, it is not for the Court to consider

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[617] Case 415/85, [1988] ECR 3097.
[618] Case 416/85, [1988] ECR 3127.
[619] According to Article 28(2)(a) Sixth Directive, the conditions set out in Article 17 of the Second Directive must be satisfied in both these cases.
[620] Paragraph 8 of the judgment.

what objectives are being pursued in an action brought under Article 169 of the Treaty [now Article 226]."[621]

In *Commission v United Kingdom*, the United Kingdom highlighted the same concerns regarding the jurisdiction of the Court and the Court replied in a similar way.[622]

Despite the Court's prompt dismissal of the argument put forward by Irish and British Governments, the fact that the issue was highlighted by the two Governments is symptomatic of Member States' misgivings towards any potential judicial activism on the part of the Court of Justice in relation to VAT rates.[623] It is also a strong reminder of the Court's limitations in dealing with the problems raised by the current VAT rate structure – the Court can play a significant harmonising role through the provision of guidelines regarding the definitions of goods and services which may be subject to reduced rates, and the conditions under which these may be applied – *i.e.*, the Court can minimise the scope for the above mentioned subtle distinctions introduced by Member States. However, the Court cannot substitute itself to the legislator, and ultimately the problems which the VAT rates structure gives rise to can only be dealt with in an efficient way through positive harmonisation, *i.e.*, legislation.

### (2) REDUCED VAT RATES

Since 1998 the Commission has engaged in a concerted effort to ensure the Sixth Directive rules on reduced VAT rates are correctly applied within the Member States by bringing several cases before the Court of Justice.[624] The first ruling by the Court of Justice on the application of VAT reduced rates and the interpretation of Article 12(3)(a) Sixth Directive was delivered in the beginning of 2001 on *Commission v Spain*.[625] The case concerned the application of reduced VAT rates to motorways tolls.

Spain applied a reduced rate of VAT to the supply of services consisting in making road infrastructure available to users. Following unsuccessful liaisons with the Spanish Government, the Commission decided to bring an action against Spain claiming that by applying a reduced rate of VAT to these services it had failed to fulfil its obligations under Article 12(3)(a) Sixth Directive.

During the proceedings the Spanish Government submitted that the making available of road infrastructure by private operators should be regarded as the activity of the transport of passengers and their luggage, and may therefore enjoy a reduced rate of VAT under category 5 of Annex H Sixth Directive. The Advocate-General disagreed and so did the Court. According to the Court:

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[621] Paragraph 9 of the judgment.
[622] Paragraphs 8 and 9 of the judgment.
[623] The expression "judicial activism" has been widely used in EU law literature by critics of the Court in order to define the Court's tendency to engage in contextual and teleological interpretation and its bias towards European integration. For an analysis on potential accusations of judicial activism within the area of VAT, see *infra*.
[624] As noted by the Commission itself in *op. cit.*, COM(2003) 397 final, 16 July 2003, p. 5.
[625] Case C-83/99, [2001] ECR I-445.

"It follows from Article 12(3)(a) of the Sixth Directive that the application of one or two reduced rates is an option accorded to the Member States as an exception to the principle that the standard rate applies. Moreover, according to that provision, the reduced rates of VAT may be applied only to the supplies of goods and services specified in Annex H.

It is settled case-law that provisions which are in the nature of exceptions to a principle must be interpreted strictly. [...]

Consequently, the expression 'transport of passengers and their accompanying luggage' must be interpreted in accordance with the usual meaning of those words."[626]

The Spanish Government also submitted that the length of the procedures initiated by the Commission against the Member States not charging VAT on the activity of making road infrastructure available gave rise to a legitimate expectation on the part of Spain that the Sixth Directive did not necessarily require the standard rate of VAT to be applied to that activity. In response to that submission the Court stated that the principle of the protection of legitimate expectations, which is the corollary of the principle of legal certainty, is generally relied upon by individuals (economic operators) in a situation where they have legitimate expectations created by the public authorities, and cannot be relied on by a Member State, in a case such as the present, to preclude an objective finding of a failure on its part to fulfil its obligations under the Treaty or secondary legislation.[627]

In light of the above the Court concluded that by charging a reduced rate of VAT to motorways tolls, Spain had failed to fulfil its obligations under Article 12(3)(a) Sixth Directive.

A few months later the Court of Justice delivered its judgment in *Commission v Portugal*.[628] In question was the application by Portugal of a 5% rate of VAT to several goods and services, including wines, machines and equipment designed for research into alternative forms of energy, agricultural tools and utensils and the passage of the toll bridge over the river Tagus in Lisbon. The Commission claimed that the application of a 5% VAT rate to these products by Portugal was contrary to Articles 12 and 28(2) Sixth Directive. The Portuguese Government admitted that the application of 5% rate, instead of 12%, to these products, with the exception of the toll bridge over the Tagus, was in fact contrary to the Sixth Directive provisions. However, it argued that it had already expressly stated its intention to raise the rate to 12% on the referred products, but was facing internal political issues, particularly in relation to the wine sector. The Court, following on the Opinion of Advocate-General Jacob, dismissed the argument, considering that:

"by maintaining in force a reduced VAT rate of 5% applicable to transactions concerning the goods listed in points 1.8, 2.11 and 3.8 of List I annexed to the Code,

[626] Paragraphs 18 to 21 of the judgment.
[627] Paragraphs 24 and 25 of the judgment.
[628] Case C-276/98, [2001] ECR I-1699.

respectively covering wines, machines and equipment designed for research into alternative forms of energy, and agricultural tools and utensils, the Portuguese Republic has failed to fulfil its obligations under Articles 12 and 28(2) of the Sixth Directive."[629]

As regards the application of 5% VAT rate to tolls on passage of the bridge over the Tagus, the Court concluded that as the services were provided by a body governed by public law they were not taxable under Article 4(5) Sixth Directive. It therefore dismissed the Commission's action insofar as it concerned these services.

The Court's decision in *Commission v Portugal* was shortly followed by a ruling on *Commission v France*.[630] In this case the Court was called to decide on whether by introducing and maintaining a VAT rate of 2.1% to be charged on medical products reimbursable under the social security system, whereas other medical products are taxed at 5.5% VAT rate, France had failed to fulfil its obligations under Article 12 Sixth Directive. The Commission took the view that application of two different reduced rates of VAT to medical products, depending on whether they were reimbursable under the social security system or not, was contrary to the provisions of the First and the Sixth Directives, in particular Article 12(3) Sixth Directive. The French Government argued that the action should be dismissed as the conditions set out in Article 28(2)(a) Sixth Directive for the application of a reduced VAT rate lower than the minimum laid down in Article 12(3)(a), were satisfied.

The Court started by noting that according to Article 28(2)(a) Sixth Directive, the maintenance of reduced rates of VAT lower than the minimum set out in Article 12(3)(a) of the same Directive must be consistent with Community legislation, namely with the principle of fiscal neutrality, which is inherent in the common VAT system. According to the Court "that principle in particular precludes treating similar goods, which are therefore in competition with each other, differently for VAT purposes" and thus:

"It follows that those products must be subject to a uniform rate. The principle of fiscal neutrality for that reason also includes the other two principles invoked by the Commission, namely the principles of VAT uniformity and of elimination of distortion in competition".[631]

However, the Court of Justice concluded that in this particular case reimbursable and non-reimbursable medicinal products were not similar products in competition with each other, and thus, "it is clear that, in introducing and maintaining in force a VAT rate of 2.1% solely for reimbursable medicinal products, the French legislation did not, and does not, infringe the principle of fiscal neutrality."[632] In this context, it dismissed the Commission's action.

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[629] Paragraph 21 of the judgment.
[630] Case C-481/98, [2001] ECR I-3369.
[631] Paragraph 22 of the judgment.
[632] Paragraph 25 of the judgment.

The relevance of the principle of fiscal neutrality within the context of the application of reduced rates of VAT was to be soon highlighted again by the Court of Justice in *Adam*.[633] The case did not concern directly the application of reduced VAT rates but rather the interpretation of Annex F(2) Sixth Directive;[634] however, during the proceedings questions were raised regarding the scope of Member States' freedom to establish their own VAT rates under Article 28(2)(e) of that Directive, namely in light of the principle of fiscal neutrality. In this respect the Court stated that:

> "[T]he determination and the definition of the transactions to which a reduced rate may be applied under those provisions of the Sixth Directive are matters for the Member States concerned.
>
> Nonetheless, in exercising that power, the Member States must respect the principle of fiscal neutrality. That principle precludes in particular treating similar goods and supplies of services, which are thus in competition with each other, differently for VAT purposes, so that those goods and supplies must be subject to a uniform rate".[635]

Some years later, the principle of fiscal neutrality was again invoked by the Commission within the context of reduced VAT rates on yet another enforcement action against France.[636] In this case the Court was called to give a ruling on whether by applying a reduced VAT rate solely to the fixed part of the prices of gas and electricity supplied by the public network, whereas the variable part (which corresponds to the actual amount consumed) remained subject to the standard rate, France had failed to fulfil its obligations under the Sixth Directive, and namely under the principal of fiscal neutrality. According to the Commission, the application by France of a reduced rate of VAT on standing charges for energy networks and a standard rate on any other supply of energy infringed the principle of fiscal neutrality, which is inherent in the Sixth Directive. The Court, however, disagreed.

The Court of Justice started by reiterating that the introduction and maintenance of reduced rates of VAT below the minimum set out in Article 12(3)(a) Sixth Directive was only permissible in so far as it was consistent with the principle of fiscal neutrality. However, it considered that "the Commission has adduced no evidence to show that, in the present case, that principle would be infringed by the selective application of the reduced rate of VAT to one part only of the supply of gas and electricity" and "in any event, there is nothing in the text of Article 12(3)(b) Sixth Directive which requires that provision to be interpreted as requiring that the reduced rate can be charged only if it is applied to all supplies of natural gas and electricity."[637] Moreover, the Court added "since

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[633] Case C-267/99, [2001] ECR I-7467.
[634] Under Article 28(3)(b) Sixth Directive Member States may, during the transitional period, continue to exempt the activities set out in Annex F of the same Directive under the conditions existing in the Member State concerned. Category 2 of Annex F reads "services supplied by authors, artists, performers, lawyers and other members of the liberal professions, other than the medical and paramedical professions, in so far as these are not services specified in Annex B to the Second Council Directive of 11 April 1967."
[635] Paragraphs 35 and 36 of the judgment.
[636] Case C-384/01, *Commission v France*, [2003] ECR I-4395.
[637] Paragraphs 26 and 27 of the judgment.

the reduced rate is the exception, the restriction of its application to concrete and specific aspects [...] is consistent with the principle that exemptions or derogations must be interpreted restrictively."[638] It thus concluded that the application by France of a reduced rate of VAT only to the fixed part of the price of gas and electricity was not in contravention of the principle of fiscal neutrality.[639]

The role of the principle of fiscal neutrality within the context of the application of reduced rates of VAT was again the object of debate recently in *Commission v Germany*.[640] In this case the Commission brought a action against Germany claiming that by applying a reduced rate of VAT to services provided directly to the public or to a concert organiser by music ensembles and to services provided directly to the public by soloists, but applying a standard rate to the services of soloists working for an organiser, Germany had failed to fulfil its obligations under Article 12(3)(a) Sixth Directive.

Interestingly all arguments put forward by both parties in this case were based on the application of general principles of EU law and principles inherent to the EU VAT system. The Commission invoked the principles of fiscal neutrality and objectivity to support its claim that the German VAT legislation was in breach of the Sixth Directive. In its view, the principle of fiscal neutrality precluded similar goods or supplies of services, which compete with each other, from being treated differently for VAT purposes. Similarly, it argued that the principle of objectivity required that one and the same rule be applied to taxable transactions of the same nature, which was the case with soloists and music ensembles, both included under the category of "performing artists" referred to in Annex H(8) Sixth Directive.

The German Government, on the other hand, contended that there was no similarity between the services provided by music ensembles and the services provided by soloists and that this difference resulted from the reading of Annex H itself, namely categories seven and eight therein. Thus, it concluded that its legislation was not in breach of the principles of fiscal neutrality and objectivity. Moreover, it considered that the Commission had infringed the principle of *nemini licet venire contra factum proprium* (so-called estoppel argument), in that in its 1997 report on reduced VAT rates[641] it stated that one of the major problems encountered in the application of the reduced VAT rate is the optional nature of Annex H Sixth Directive and the lack of common definitions for the categories therein. The Commission could not therefore allege a failure on the part of the Member States to fulfil obligations where it had considered there to be no coherent and conclusive approach in the legislation on that point.

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[638] Paragraph 28 of the judgment.
[639] The Commission had presented two other arguments to support their claim that by applying a reduced VAT rate solely to the fixed part of the prices of gas and electricity supplied by the public network, whereas the variable part (which corresponds to the actual amount consumed) remained subject to the standard rate, France had failed to fulfil its obligations under the Sixth Directive. However, these two arguments were also rejected by the Court, and thus the Commission's application was dismissed.
[640] Case C-109/02, [2003] ECR I-00.
[641] *Op. cit.*, COM(97) 559 final, 13 November 1997.

The Court, however, rejected Germany's arguments. As regards the similarity between the services provided by music ensembles and by soloists, the Court considered that "there is nothing to suggest that the services of soloists and music ensembles are not similar, at least [...], if not identical".[642] On the use of estoppel argument, the Court stated that "whatever the Commission's assessment of the problems associated with the application of Annex H to the Sixth Directive in the past that cannot affect the merits of an infringement action based on a clear difference in the treatment of two similar services".[643]

In light of the above, the Court of Justice concluded that Germany had failed to fulfil its obligations under Article 12(3)(a) Sixth Directive, thus implicitly accepting the arguments invoked by the Commission, in that the German legislation was in contravention of the principles of fiscal neutrality and objectivity.

*Commission v United Kingdom* is the most recent case concerning the application of reduced rates of VAT.[644] The case relates to the application of an *effective tax rate* of 5% to auctioneer's commissions, where works of art, collectors' items and antiques are temporarily imported into the United Kingdom for auctioning. In fact, unlike the above cases, in the latest *Commission v United Kingdom* the Commission does not argue that a reduced rate of VAT is formally charged on these services by the United Kingdom, but rather than an *effective* reduced rate is charged by an adjustment of the taxable amount. The controversy arises from the interpretation of the special rule contained in Article 11(B)(6), which allows Member States, under certain conditions, to reduce the taxable amount on the case of imports of the works of art, collectors' items and antiques. The United Kingdom considered that this special rule applied to the auction's price, including the auctioneer's commission; whilst the Commission argues that this special rule applies only to the auction's price, minus the auctioneer's commission. In the Commission's view, the latter should be regarded as an independent supply and thus subject to the normal taxable amount rules, which would result in effect on the application of a standard rate of VAT.

Although the case is still awaiting judgment, Advocate-General Kokott has already released his Opinion, concluding that:

> "The United Kingdom by applying a reduced rate of value added tax to the commission paid to auctioneers on the sale by auction in the auctioneer's own name of works of art, antiques and collectors' items which have been imported under temporary importation arrangements, has failed to fulfil its obligations under Articles 2(1), 5(4)(c) and 16(1) of the Sixth Council Directive."[645]

### (3) ASSESSMENT OF THE COURT OF JUSTICE JURISPRUDENCE

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[642] Paragraph 22 of the judgment.
[643] Paragraph 27 of the judgment.
[644] Case C-305/03, [2005] ECR I-000.
[645] Conclusion 1 of Advocate-General Kokott's Opinion.

The Court of Justice's case-law in relation to the application of reduced rates of VAT is a notable example of cooperation between the Court of Justice and the Commission within the field of VAT. The enforcement actions brought by the Commission before the Court have allowed it to construct a significant body of case-law-based rules, thus playing an important harmonising role within the area of VAT rates. This was principally achieved by the Court through principle-based decisions, which have limited the scope for Member States to introduce subtle product distinctions within their VAT rate structure and stretch the application of reduced rates. In fact, from the analysis of the Court's jurisprudence undertaken *supra* two principles emerge as fundamental in relation to the application of reduced VAT rates: the principle of strict interpretation and the principle of fiscal neutrality.

*Principle of strict interpretation*. According to this principle provisions allowing Member States to apply reduced rates of VAT should be interpreted strictly.

The principle was first established in *Commission v Spain*,[646] in which the Court stated that the possibility of applying reduced rates of VAT should be regarded as an exception to the rule that the standard rate applies, and thus, as with all exceptions, it should be interpreted strictly. In this case the Court was referring particularly to Articles 12(3)(a) and Annex H to the Sixth Directive; however, the principle should be extended to other provisions within the Sixth Directive which allow Member States to apply reduced VAT rates, namely Article 28(2) and (6) and Annex K.[647]

This principle has not been invoked directly in any subsequent cases relating to reduced VAT rates – most likely due to the fact that by then attention had shifted to the limits imposed by the principle of fiscal neutrality – however, it was briefly mentioned by the Court in the second *Commission v France* case.[648]

*Principle of fiscal neutrality*. According to the Court the application of reduced rates of VAT by Member States is only permissible insofar as it is consistent with the principle of fiscal neutrality.

The principle of fiscal neutrality was invoked for the first time in relation to the application of reduced VAT rates in the first *Commission v France* case.[649] The Court then established that the application of different rates of VAT by Member States was subject to respect for the principle of fiscal neutrality, which precluded treating similar goods, which are therefore in direct competition with each other, differently for VAT purposes. In the Court's view, this principle included two other "sub-principles": the principle of VAT

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[646] Case C-83/99, [2001] ECR I-445.

[647] Article 28(6) and Annex K allow Member States to apply reduced rates of VAT to labour-intensive services. For a detailed analysis of these provisions and the so-called "labour-intensive services experiment" see Chapter 3.

[648] Case C-384/01, [2003] ECR I-4395, paragraph 28.

[649] Case C-481/98, [2001] ECR I-3369. The principle of fiscal neutrality had already been invoked on several occasions in relation to other areas of the EU VAT system, namely in relation to the scope of VAT and the application of exemptions – see cases 269/86, *Mol*, [1988] ECR 3627; 289/86, *Happy Family*, [1988] ECR 3655; C-111/92, *Lange*, [1993] ECR I-4677; C-45/95, *Commission v Italy*, [1997] ECR I-3605; C-283/95, *Fischer*, [1998] ECR I-3369; and C-216/97, *Gregg*, [1999] ECR I-4947.

uniformity and the principle of elimination of distortions in competition. As discussed *supra*, the Court concluded in this particular case that the Commission had failed to show evidence that France's application of reduced VAT rates was in contravention of the principle of fiscal neutrality. However, the Court's ruling had the effect of opening the door for the application of the principle to future cases on reduced rates.

In fact, since the first *Commission v France* the principle of fiscal neutrality has been consistently invoked by the Commission to support claims of Member States' illegitimate use of reduced rates. The argument has not always proved to be successful in supporting Commission's claims;[650] however, even where the case has been dismissed for lack of evidence, the Court has always reiterated the role of the principle of fiscal neutrality within the application of reduced rates of VAT.

Through the application of the principles of strict interpretation and fiscal neutrality to the field of reduced rates of VAT the Court has introduced a significant limitation to Member States freedom in this area. Moreover, the application of these principles has the potential to represent a real instrument of harmonisation in the field of VAT rates, mostly considering that, as discussed in Chapter 3, discrepancies in the application of reduced rates of VAT by Member States are the main source of difficulties in relation to the VAT rate structure. Nevertheless, the prospective jurisprudential harmonisation of VAT rates gives rise to two main concerns, as follows:

— There are limits to the level of harmonisation which can be achieved through case-law, *i.e.*, the Court is limited by the legislation itself. For example, the Court cannot deny Member States the freedom to use one or two reduced VAT rates, or to choose to which products from the ones listed in Annex H Sixth Directive to apply the reduced rates.

— There is a considerable risk that, if the Court pursues a policy of harmonisation of VAT rates through principle-based decisions, and thus limits Member States current freedoms to establish their own rates structure, it will be accused by Member State Governments of judicial activism. In fact, as discussed *supra*, the argument has already been tentatively used by Ireland and the United Kingdom in the 1985 cases on the application of zero rates. Although the argument was swiftly dismissed by the Court on both occasions, the fact that the argument was put forward is symptomatic of Member States sensitivity to the topic.

### b) EU VAT SYSTEM AS AN OBSTACLE TO THE FUNCTIONING OF THE INTERNAL MARKET

[650] The argument was successfully invoked by the Commission in *Commission v Germany,* case C-109/02, [2003] ECR I-00, but unsuccessfully in *Commission v France*, case C-384/01, [2003] ECR I-4395.

### i) EU VAT SYSTEM AS A DIRECT OBSTACLE TO THE FUNCTIONING OF THE INTERNAL MARKET: DIFFERENT CRITERIA ON NON-DEDUCTIBLE INPUT TAX

As highlighted in Chapter 3, the lack of uniform criteria in relation to non-deductible expenditure gives rise to serious difficulties, which directly impair the functioning of the Internal Market. The Court has attempted to resolve these difficulties and overcome the lack of harmonisation through extensive, and somewhat revolutionary, case-law. In fact, this is an area where the Court has delivered some of its more controversial decisions, and yet, as the analysis undertaken *infra* will demonstrate, the Court's jurisprudence cannot efficiently and absolutely overcome the shortcomings of the current legal framework, or lack thereof.

The Court's jurisprudence in relation to non-deductible input tax is somewhat vast; however, the most important judgments in this area can be divided into the following three main headings: jurisprudence in respect of the operation of the standstill clause [Article 17(6) Sixth Directive], as regards the cyclical economic reasons clause [Article 17(7) Sixth Directive] and, in relation to derogations.[651]

#### (1) STANDSTILL CLAUSE

The Court's decisions as regards the standstill clause have focussed mainly on three aspects, as follows:

— the scope of the clause;

— the validity of the clause; and,

— the clause's temporal requirements.

Scope

In *Commission v France* the Court was called to decide on the scope of the standstill clause, namely to which exclusions to the right to deduct did the clause apply, *i.e.*, which exclusions were Member States allowed to retain under the standstill clause.[652] The case concerned a provision introduced in the French VAT Code in 1967, which excluded from the right to deduct VAT expenditure on means of transport. In 1996, the Commission brought an action before the Court of Justice requesting a declaration that, by maintaining in force legislation which denied taxable persons the right to deduct VAT on means of transport which constituted the very tool of their trade, France had failed to fulfil its obligations under Article 17(2) Sixth Directive.

The Commission accepted that the second paragraph of Article 17(6) Sixth Directive expressly authorised Member States to retain provisions excluding the right to deduct

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[651] Other cases on limitations to the right to deduct, which do not fall under these headings are, as follows: case 50/87, *Commission v France*, [1988] ECR 4797; C-97/90, *Lennartz*, [1991] ECR I-3795; C-345/99, *Commission v France*, [2001] ECR I-4493; C-33/03, *Commission v United Kingdom*, [2005] ECR I-000; C-204/03, *Commission v Spain*, [2005] ECR I-000; and C-243/03, *Commission v France*, [2005] ECR I-000.

[652] Case C-43/96, [1998] ECR I-3903.

which, like the provision within the French VAT Code, predated the entry into force of the Sixth Directive. However, it argued, the exclusion of the right to deduct provided for in Article 17(6) Sixth Directive relates only to expenditure which is not strictly business expenditure. Thus, the expenditure liable to be excluded from the right to deduct is that incurred by a taxable person on goods and services which are not absolutely essential for the operation of his / her business.

The Court rejected this interpretation, considering from the wording of the first subparagraph of Article 17(6) that the rules which the Council is called upon to adopt are not automatically limited to expenditure which is not strictly business expenditure. Thus, the expression "all exclusions" used in the second subparagraph of Article 17(6), clearly comprised expenditure which is strictly business expenditure. Moreover, the Court considered that this interpretation was confirmed by the historical background of the Sixth Directive and namely the explanatory memorandum to the Sixth Directive proposal. In this context, the Court concluded that Article 17(6) authorised Member States to retain national rules which denied taxable persons the right to deduct VAT on means of transport which constitute the very tool of their trade, and thus, France had not failed to fulfil its obligations under Article 17(2) Sixth Directive.

The issue of the scope of the standstill clause arose once again a year later in *Royscot*.[653] The case concerned a provision introduced in 1973 within the United Kingdom VAT legislation, which excluded the deduction of VAT on the purchase of motor vehicles. The British Court of Appeal essentially asked the Court of Justice whether Article 11(4) of the Second Directive authorised Member States to introduce or retain, and whether Article 17(6) Sixth Directive authorised them to retain, general exclusions from the right to deduct VAT on the purchase of motor vehicles used by a taxable person for the purposes of his / her taxable transactions, even though:

— those cars were essential tools for the taxable persons' business, or

— those cars could not, in a specific case, be used for private purposes by the taxable person concerned.

The appellants, Royscot, Harrison and Domecq, submitted that Article 11(4) of the Second Directive only allowed the introduction of exclusions to the right to deduct where the motor vehicles were capable of being used for the private needs of the taxable person or his staff. Article 11(4) did not apply to goods which were essential tools in the business of the taxable person or to those cases in which it was possible to determine the portion of deductible VAT on the basis of Article 11(2) of the same directive.[654] Thus, a provision similar to the one in United Kingdom legislation excluding the right to deduct VAT expenditure in any circumstances was contrary to Article 11(4) of the Second Directive, which was in force in 1973 at the time when the provision was introduced. With regard to Article 17(6) Sixth Directive, the appellants argued that the standstill clause did

[653] Case C-305/97, [1999] ECR I-6671.
[654] Article 11(2) of the Second Directive established the rules regarding apportionment of tax, similarly to the current Article 17(5) Sixth Directive.

not authorise the retention of exclusions which were not justified under Article 11(4) of the Second Directive. Furthermore, they considered that Article 17(6) authorised Member States to retain exclusions solely where it related to expenditure which contained, or may contain, a non-business element which cannot be distinguished from the business element on the basis of Article 17(5) Sixth Directive.

On the contrary, the United Kingdom, Danish, French, Irish, Finnish and Swedish Governments submitted that it followed clearly from the wording of Article 11(4) of the Second Directive that Member States were entitled to exclude from the deduction system, expenditure on the purchase of motor cars, and to retain such exclusions by virtue of Article 17(6) Sixth Directive. The Commission, however, agreed with the approach taken by the appellants, considering that Article 11(4) of the Second Directive and Article 17(6) Sixth Directive did not authorise Member States to exclude from the right to deduct expenditure on the essential tools of the business of the taxable person.

The Court accepted the appellants' argument that Article 17(6) Sixth Directive presupposes that the exclusions which may be retained by Member States under the standstill clause were lawful under the Second Directive. However, it considered that it followed from the wording of Article 11(4) of the Second Directive that Member States were authorised to exclude from the right to deduct expenditure which is strictly business-related were they were "risk" goods and services. Additionally, the Court reiterated the approach taken in *Commission v France*[655] pointing out that the expression "all the exclusions" used in the standstill clause comprises expenditure which is strictly business expenditure.[656]

The view adopted by the Court in *Royscot* as regards the interconnection between Article 17(6) Sixth Directive and Article 11(4) Second Directive has been confirmed recently in *Charles and Charles-Tijmens*.[657] The case concerned a Dutch VAT provision that excluded the possibility for a taxable person to allocate capital goods, which were used in part for business purposes and in part for private purposes, to his business and therefore, excluding totally the right to deduct VAT on the acquisition of those goods. The Dutch Government sought to argue that the provision fell within the scope of the standstill clause, as it had been introduced prior to the entry into force of the Sixth Directive. The Court accepted the argument that the provision did predate the entry into force of that Directive. However, it added, the standstill clause "presupposes that the exclusions which Member States may retain pursuant to it were lawful under the Second Directive, which predated the Sixth Directive",[658] and Article 11(4) Second Directive did not authorise Member States to exclude from the deduction system goods, which are only partly used for the private purposes of the taxable person. In this context the Court concluded that such a provision was excluded from the scope of Article 17(6) Sixth Directive and was therefore contrary to the Sixth Directive's provisions.

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[655] Case C-43/96, [1998] ECR I-3903.
[656] Paragraph 26 of the judgment.
[657] Case C-434/03, [2005] ECR I-000.
[658] Paragraph 31 of the judgment.

Validity

The Court's decision in *Commission v France* had already implicitly acknowledged the validity of the standstill clause. However it was not until *Royscot* that the Court dealt directly with the issue of the validity of this clause.

In addition to their arguments in relation to the scope of the standstill clause, the appellants, Royscot, Harrison and Domecq, also submitted that the standstill clause was linked to the first sentence of the first subparagraph of Article 17(6) and that this link was also temporal. As the rules envisaged had not entered into force, and following expiration of the four-year period referred to in the first subparagraph, the temporary discretion of the Member States to maintain national exclusions no longer existed. The United Kingdom argued, however, that the wording of Article 17(6) made clear that the authorisation granted to Member States to retain their existing legislation in relation to exclusions from the right to deduct remained in force until such time as the Council adopted the envisaged harmonising provisions. The argument was also supported by the submissions of the Danish, French, Irish, Finnish and Swedish Governments.

The Court agreed. It considered that this interpretation was consistent with the Court's decision in *ORO* in relation to Article 32 Sixth Directive, which contained a transitional provision for second-hand goods similar to that of Article 17(6).[659] It thus concluded that:

> "On a proper construction of Article 17(6) of the Sixth Directive, Member States may retain the exclusions from the right to deduct VAT referred to in its second subparagraph, even though the Council did not decide before the expiry of the period laid down in the first subparagraph, which expenditure should not be eligible for deduction of VAT."[660]

Temporal requirements

The first decision of the Court dealing with the temporal requirements of the standstill clause was delivered in June 2001 in *Commission v France*.[661] The case concerned the exclusion under the French VAT legislation of the right to deduct VAT on the acquisition of diesel used as fuel for the operation of vehicles and machines. From January 1979 until June 1982, France excluded from the right to deduct VAT diesel used as fuel for the operation of vehicles and machines on the purchase of which no VAT was deductible. Between 1982 and 1991, that prohibition underwent several changes, and the authorised rate of deduction was increased gradually from 10% in 1982, to 90% in 1991, and reduced back to 50% during the course of 1991. In 1998, the right to deduct VAT on this type of expenditure was again totally abolished.

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[659] Case C-165/88, [1989] ECR 4081. In this case the Court held that until the Community legislature, which had failed to comply with the time limit imposed for that purpose, had taken action, it was necessary to continue applying Article 32 Sixth Directive, which authorised Member States that applied a special system of VAT to second-hand goods to retain that system. Article 32 was repealed by Council Directive 94/5/EC of 14 February 1994 on special arrangements applicable to second-hand goods, works of art, collector's items and antiques, OJ L 60, 03/03/1994, p. 16.

[660] Paragraph 32 of the judgment.

[661] Case C-40/00, [2001] ECR I-4539.

Taking the view that the re-introduction of an exclusion from the right to deduct was not covered by the standstill clause, and thus incompatible with Article 17(2) Sixth Directive, the Commission decided to bring an action against France. It considered that Article 17(6) did not allow a Member State to subsequently revive a system of derogations which had been abandoned and that, contrary to the arguments of the French authorities, the Member States did not have full discretion to adapt and change, according to their own criteria, a national system of exclusions and limitations to the right to deduct, subject only to the premises that they do not go beyond the position obtained at the time of the Sixth Directive's entry into force.

The French Government, on the contrary, argued that Article 17(6) did not preclude a Member State from amending the exclusions which existed at the time of the entry into force of the Sixth Directive, provided that those amendments did not increase the rate of exclusion beyond the proportion initially set or extend existing exclusions to categories of goods or services not affected at that date.[662] The Court rejected France's argument, agreeing with the Commission. It considered that national legislation was not covered by the standstill clause where its effect was to increase, after the entry into force of the Sixth Directive, the extent of existing exclusions. The same was true of any amendment subsequent to the entry into force of that directive, which increased the extent of exclusions applicable immediately before that amendment. It thus concluded that:

> "[B]y reintroducing from 1 January 1998 a total prohibition on the right to deduct value added tax on diesel used as fuel for vehicles on the purchase of which no value added tax is deductible, after having introduced a partial right to deduct, the French Republic has failed to fulfil its obligations under Article 17(2) Sixth Directive."[663]

Soon after delivering the judgment on *Commission v France*, the Court delivered its decision in *Metropol*, which amongst other issues also entailed considerations on the temporal requirements of the standstill clause.[664] The case concerned an administrative practice adopted by the Austrian authorities in 1996, which excluded from the right to deduct expenditure relating to certain motor vehicles.

The Austrian VAT legislation, introduced in 1994, included a provision which excluded from the right to deduct expenditure in connection with the acquisition, leasing or operation of cars, mixed vehicles or motor cycles.[665] In 1996 this provision was amended in order to include an authorisation to the Government to define the terms 'car' and 'mixed vehicles' by regulations. These regulations, which were adopted in June 1996 and entered into force with retroactive effect from 15 February 1996, established that

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[662] Additionally, the French Government pointed out that the legislation at issue was adopted for environmental reasons and that the Commission had failed to take action against France in 1991 when the rate of deduction of VAT was reduced from 90% to 50%. These arguments were equally rejected by the Court.

[663] Paragraph 24 of the judgment.

[664] Case C-409/99, [2002] ECR I-81. The case also dealt with Article 17(7) Sixth Directive requirements, see *infra*.

[665] This exclusion was subject to some exceptions, namely for driving school vehicles, demonstration vehicles and vehicles which are intended exclusively for commercial resale and vehicles which are used to the extent of at least 80% for commercial passenger transport.

"heavy vehicles and small buses do not fall within the terms car or mixed vehicle". In its tax declarations for 1996 and 1997 Metropol applied to deduct input VAT paid for the use of Pontiac TransSport vehicle. The Austrian tax authorities refused the deduction, pointing out that, whilst Pontiac TransSport vehicles had indeed been classified as 'minibuses' and had consequently been eligible for deduction of VAT until the entry into force of the 1996 regulations, it was common ground that those vehicles did not fall within the definition of 'small buses' laid down by that order. Consequently, being regarded since 15 February 1996 as cars, they were now excluded from the right to deduct.

Following proceedings in the Austrian courts, the Austrian Administrative Court essentially asked the Court of Justice whether the standstill clause precluded Member States from excluding, after the entry into force of the Sixth Directive, expenditure relating to certain motor vehicles from the right to deduct VAT where, at the date of the entry into force of that directive, that expenditure gave rise to the right to deduct VAT in accordance with a consistent practice of the public authorities of that State on the basis of ministerial circular.

The Austrian Government argued that the 1996 regulations were adopted in order to deal with the new types of vehicles which emerged subsequent to the approval of the 1987 circular, such as minivans and MPVs or family carriers, and which were not contemplated by that circular. Thus, the 1996 regulations were adopted not to extend the category of vehicles excluded from the deduction scheme, but to avoid the national legislation in force being interpreted in such a way that those new vehicles, such as Pontiac TransSport and the Fiat Ulysse, which as a rule take the place of cars, would be regarded as minibuses.

The Commission, on the other hand, submitted that although the relevant provision of national law in the main proceedings had not been substantially amended in content since 1 January 1995:

> "[T]he 1996 regulations contained a much narrower definition of minibuses than the 1987 circular. It appears from the order for reference that the effect of that change to the criteria of classification was that the vehicles at issue in the main proceedings are no longer regarded as minibuses, as they were previously. As the new definition of minibuses differs clearly from the view previously taken, it entails a substantial change in the legal position. It is irrelevant in this respect that the former law was based only on a ministerial circular, that is, an administrative rule, since the new criteria which determine the scope of the exclusion of the right to deduct are, in any event, contained in a binding rule of law."[666]

The Court agreed with the Commission. It considered that it was for the national courts to interpret the national legislation in order to determine its contents at the date of entry into force of the Sixth Directive and to establish whether the effect of the 1996 regulations was to extend, after the entry into force of the Sixth Directive, the scope of existing

[666] Paragraphs 39 and 40 of the judgment.

exclusions. However, it was for the Court of Justice to provide the national court with guidance on interpreting the concept of 'national laws' within the meaning of the standstill clause. In this context, the Court stated that the "the term 'national laws' within the meaning of the second subparagraph of Article 17(6) Sixth Directive does not refer only to legislative acts in the strict sense, but also to administrative measures and practices of the public authorities of the Member State concerned".[667] Thus, it concluded:

> "[T]he second subparagraph of Article 17(6) of the Sixth Directive precludes a Member State from excluding, after the entry into force of the Sixth Directive, expenditure relating to certain motor vehicles from the right to deduct VAT where, at the date of entry into force of that directive, that expenditure gave rise to the right to deduct VAT in accordance with a consistent practice of the public authorities of that State on the basis of ministerial circular."[668]

Recently, the issue of the temporal requirements of the standstill clause was again raised in *Cookies World*.[669] The case, whose focus was also on the Austrian VAT provisions, is rather complex and lengthy, involving the interpretation of several Sixth Directive provisions, namely Articles 5(7), 6(2), 17(6) and 17(7).[670]

The Austrian Law on turnover taxes, introduced in 1994, excluded from the right to deduct expenditure connected with the lease or use of cars, dual-purposes vehicles or motor-bicycles. This Law was amended in the beginning of 1995 to include a provision which subjected own consumption to Austrian VAT, and established that it was deemed to occur where a trader incurred expenditure relating to supplies abroad which, if they had been effected to the trader within the national territory, would not have entitled the trader to deduction of input tax.

Cookies World was a company established in Austria. In the course of its business it leased a car from a German undertaking, which was used in Austria. In 1999 the Austrian tax authorities assessed the turnover tax for Cookies World in respect of 1997, including the car leasing charge. Cookies World appealed against this decision. Following proceedings in the national courts, the Administrative Court referred the following question to the Court of Justice: is it compatible with the Sixth Directive for a Member State to treat the following event as a taxable transaction: expenditure relating to services abroad that, if they had been supplied within the national territory of the trader, would not entitle the trader to a deduction of input tax?

As regards the standstill clause, the Austrian Government argued that the provisions under discussion in the main proceeding were covered by that clause. In fact, the provision which established the criteria for own consumption was simply applying the rule excluding from the right to deduct expenditure on cars, dual-purposes vehicles and motor-bicycles, and the standstill clause did not impose any limitation on Member States

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[667] Paragraph 49 of the judgment.
[668] Paragraph 51 of the judgment.
[669] Case C-155/01, [2003] ECR I-8785.
[670] However, the analysis undertaken here will solely focus on the implications of the judgment for the interpretation of Article 17(6), and *infra* of Article 17(7).

as regards the means used to exclude certain expenditure from the right to deduct. It acknowledged that the provision on own consumption did not came into force until 6 January 1995, five days after Austria's accession to the European Union, however, it argued that this five days interval was due to merely logistical considerations.

Cookies World and the Commission, on the contrary, submitted that Article 17(6) Sixth Directive concerned only the exclusion of the right to deduct and could not justify cases of double taxation of the same economic transaction. Moreover, the Austrian provision on own consumption was not part of national law at the time of Austria's accession to the European Union on 1 January 1995, and that constituted a pre-requite for the application of the standstill clause.

The Court rejected the Austrian Government's arguments in relation to the applicability of the standstill clause. It accepted that the Austrian provision on own consumption seemed to be designed so that the exclusion of the deduction of VAT in connection with the leasing of certain vehicles was applied after Austria's accession to the European Union, in the same way from an economic point of view, as it was until that date. However, it said:

> "It seems that the Austrian Government has achieved the objective of retaining the existing legislation on the subject only indirectly. A new chargeable event for VAT purposes has been introduced in the taxation scheme by way of a new provision, which is not the situation referred to by Article 17(6) Sixth Directive.
>
> In any case, even supposing that Article 17(6) Sixth Directive was generally applicable to the facts in the main proceedings, it must be observed that the procedural requirements laid down by that provision for the retention of the national scheme for deduction of VAT are not satisfied.
>
> The Sixth Directive entered into force in the Republic of Austria on the date of its accession to the European Union, 1 January 1995. It is therefore that date which is relevant for the purpose of the application of the second subparagraph of Article 17(6) of the Sixth Directive in so far as concerns that Member State.
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> It is apparent from the order for reference that Paragraph 1(1)(2)(d) of the UStG 1994 [provision on own consumption] first entered into force on 6 January 1995."[671]

In this context, the Court concluded that the Austrian provision on own consumption was not covered by the standstill clause.

Assessment of the Court's jurisprudence

The analysis undertaken *supra* highlighted two main trends on the Court's jurisprudence in relation to the standstill clause, as follows:

— wide approach to issues in connection with the validity and the scope of the clause; and,

[671] Paragraphs 63 to 66 of the judgment.

— strict approach to issues connected with the clause's temporal requirements.

As regards the validity of the clause, the Court has settled any potential controversy by affirming in *Royscot* that the clause is valid and in force, until the approval of legislation harmonising the rules on non-deductible input tax. With this statement the Court, more than establishing the validity of the clause, has widened its temporal scope from an initial four-year period to potentially *ad eternum*. This approach is consistent with the Court's case-law on other aspects of the clause's scope, namely the type of exclusions covered by the clause and the meaning of the expression "national laws". On both aspects the Court adopted a wide view, ruling that the clause applied to all types of exclusions, including to fully business expenditure – *Commission v France*[672] and *Royscot* – and to any type of law, including administrative practices and ministerial circulars – *Metropol*. The Court presented good arguments for adopting such a view in relation to both aspects and, in fact, it does seem that the Court's interpretation is more coherent with the wording and the historical background of the provision. However, it hardly resolves the problems which emerge from its application and, to some extent, it emphasises these problems by "spreading" the standstill effects to potentially all types of expenditure and all forms of law, indefinitely.

As regards the temporal requirements of the standstill clause, the Court has taken the opposite view by adopting a strict approach.[673] Under the Court's case law, Member States are not allowed to increase their level of exclusions or limitations to the right to deduct under the standstill clause after the entry force into force in their jurisdictions of the Sixth Directive.[674] This includes the following circumstances:

— where Member States are only re-introducing the level of exclusion in force at the time of the entry into force of the Sixth Directive – *Commission v France*;[675]

— where the increase results not from legislation, but from administrative practice or ministerial circulars – *Metropol*; and,

— where the increase was introduced only a few days after the entry into force of the directive, due to logistical factors – *Cookies World*.

The Court's strict approach to the temporal requirements of the clause somehow limits its damage to the extent that it precludes Member States from justifying any limitation to the right to deduct under the standstill clause introduced post entry into force of the Sixth

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[672] Case C-43/96, [1998] ECR I-3903.

[673] By temporal requirements, it is meant the requirement established in the standstill clause according to which only exclusions in force at the date of the entry into force of the Sixth Directive are covered by that clause. This aspect of the clause is quite distinct from its temporal scope, which refers to the period during which the clause is in force.

[674] It results from the Court's judgment in *Cookies World* that for Member States whose accession to the European Union occurred after the entry into force of the Sixth Directive – Portugal, Spain, Greece, Austria, Finland, Sweden, Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, Slovenia – the relevant date for the purposes of applying the standstill clause is the date of accession of that Member State to the Community.

[675] Case C-40/00, [2001] ECR I-4539.

Directive.[676] However, the questions which should be asked in terms of the overall Court of Justice's case-law on the standstill clause, are whether the Court's approach to the temporal requirements counteracts its approach to the validity and scope of the clause or, whether the Court could have gone further in order to limit the negative effects of the clause? The answers to the these questions have to be that the Court's approach to temporal requirements does not counteract the effects of its approach to validity, and mostly scope, and that the Court could have indeed gone further in order to limit the negative impact of the clause in the EU VAT system.

In fact, the Court's approach to temporal requirements essentially signifies that Member States cannot justify an increase to their level of exclusion from the right to deduct under the standstill clause, they may, however, in most cases, still resort to the cyclical economic reasons clause [Article 17(7) Sixth Directive], or most likely, to derogations [Article 27 Sixth Directive]. On the other hand, the Court's interpretation of the scope of the clause, namely in relation to the type of exclusions covered, has much more dangerous effects, namely it allows Member States to maintain exclusions from the right to deduct in relation to business expenditure, which goes against the essence of the right to deduct, and consequently the EU VAT system, and that would not have been otherwise allowed.[677] In this respect, the Court could have gone further by limiting the scope of the standstill clause to risky situations where it is unclear whether the expenditure is business or non-business and to situations of limitation, rather then exclusion, of right to deduct. Such interpretation could clearly be justifiable on the basis of violation of the principle of the right to deduct, the principle of proportionality[678] and the jurisprudential principle of strict interpretation of derogations.[679] Whether by taking this route the Court would be accused of engaging in judicial activism is another matter. Ultimately, only the adoption of legislation harmonising the rules on non-deductible input tax could put a definitive end to the negative effects which the standstill clause gives rise to.

### (2) CYCLICAL ECONOMIC REASONS CLAUSE

Interestingly, the Court of Justice jurisprudence in relation to the cyclical economic reasons clause has emerged from cases relating to the standstill clause, where the cyclical economic reasons clause has been invoked as an alternative justification for the introduction of limitations to the right to deduct. The first time the Court was called to interpret Article 17(7) Sixth Directive was in *Metropol*, the second in *Cookies World*.

In *Metropol*, additionally to questions relating to the interpretation of Article 17(6) Sixth Directive, the Austrian Administrative Court also asked the Court of Justice essentially

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[676] Of course, this is not to say that Member States cannot increase their level of exclusions from the right to deduct after that date, they just cannot justify it under the standstill clause, see *infra*.
[677] The Court of Justice's jurisprudence in relation to derogations is demonstrative of this, see *infra*.
[678] Similarly to the Court's justification in *Ampafrance and Sanofi*, see *infra*.
[679] In *Metropol* the Court stated that, "the right of deduction provided for in Article 17 *et seq*. Sixth Directive is an integral part of the VAT scheme and in principle may not be limited. Derogations are permitted only in the cases expressly provided for in the Sixth Directive. Provisions laying down derogations from the principle of the right to deduct VAT, which ensures the neutrality of that tax, are to be interpreted strictly", paragraphs 58 and 59.

whether Article 17(7) must be interpreted as authorising a Member State to exclude from the system of VAT deductions without first consulting the VAT Committee and without a time limit in order to consolidate its budget. The Austrian Government sought to argue in relation to the lack of consultation of the VAT Committee, that the merely consultative nature of the procedure entailed that failure to respect it did not constitute a breach of essential procedural requirements. As regards the absence of temporal limitation for the application of this provision, it considered that cyclical economic reasons clause must allow Member States to correct macro-economic imbalances, and in particular reduce the budget deficit and repay State debt. However, such measures only produce results in the long term, and as Article 17(7) did not impose time-limits, the clause must be interpreted as authorising measures which are not limited in time.

The Commission, on the other hand, submitted that Article 17(7) should be interpreted strictly and as such only authorising Member States to introduce measures which limit the right to deduct during periods of substantial divergence from the normal economic cycle. Therefore, the provision did not allow derogations for unlimited periods based on budgetary reasons.

The Court rejected both arguments presented by the Austrian Government, agreeing with the Commission. As regards the consultation of the VAT Committee, it considered that this consultation "enables the Commission and the other Member States to control the use by a Member State of the possibility of derogating from the general system of deducting VAT, by checking in particular whether the national measure in question satisfies the condition of adoption for cyclical economic reasons."[680] In order to reinforce its position the Court invoked, by analogy, its judgment in *Lennartz* in relation to the consultation procedure required under Article 27(5) Sixth Directive.[681] Thus, the Court stated that consultation of the VAT Committee is "clearly a condition precedent to the adoption of any measure on the basis of that provision."[682] In relation to the lack of time limit, the Court stated that the cyclical economic reasons clause authorised Member States "to adopt measures of a temporary nature intended to cope with the temporary situation of its economy at a given moment. Application of the measures referred to in that provision must therefore be limited in time and, by definition, they may not be of structural nature."[683]

In *Cookies World* the Court reiterated its view on the compulsory nature of the consultation of the VAT Committee. In this case the Court considered that it was not "necessary to rule on the question whether the national measures in question in the main proceedings are of temporary nature and designed to deal with a cyclical economic situation; it is nevertheless common ground that the Austrian authorities did not consult the VAT Committee."[684] Thus, the Court concluded that the Austrian Government could

[680] Paragraph 61 of the judgment.
[681] Case C-97/90, [1991] ECR I-3795.
[682] Paragraph 63 of the judgment.
[683] Paragraph 67 of the judgment.
[684] Paragraph 67 of the judgment.

not rely on Article 17(7) Sixth Directive as a justification for a provision limiting the right to deduct.

The interpretation adopted by the Court in relation to Article 17(7) Sixth Directive in *Metropol* and *Cookies World* was the only interpretation possible if the Court was to avoid eliminating any requirements from the provision. In fact, any other interpretation in relation to the VAT Committee consultation or the meaning of "cyclical economic reasons" would undermine the already vague requirements imposed by Article 17(7), and transform the "cyclical economic reasons clause", into a virtually "open clause" for the introduction of measures limiting the right to deduct.

### (3) DEROGATIONS AND THE PRINCIPLE OF PROPORTIONALITY

Until recently, the Court had only once been called to decide on the validity of a Council Decision authorising a Member State to introduce measures derogating from the Sixth Directive.[685] However, in 1999 the Court received two references from the French national courts, which questioned the validity of a Council Decision authorising France to introduce measures derogating from Article 17 Sixth Directive. The result was a landmark judgment, whose implications not solely for the non-deductible tax area, but for the whole EU VAT system, are still unclear.

The *Ampafrance and Sanofi* cases[686]

In May 1999, the Court of Justice received references from two French Administrative Courts concerning the validity of Council Decision 89/487/EEC, which authorised France to introduce a measure excluding from the right to deduct expenditure in respect of accommodation, food, hospitality and entertainment.[687] The Council Decision had emerged from a judgment of the French Conseil d'Etat. Between 1967 and 1979 France had excluded gradually from the right to deduct, expenditure in respect of accommodation, food, hospitality and entertainment. The last legislative measure excluding from the right to deduct these types of expenditure was only adopted in December 1979, *i.e.*, after the Sixth Directive had entered into force. In 1989, in *Compagnie Alitalia* the Conseil d'Etat held that this legislative measure was invalid as it disregarded the objective of not extending existing exclusions defined in Article 17(6) Sixth Directive. Following the Conseil d'Etat judgment, France requested from the Council an authorisation pursuant to Article 27 Sixth Directive to introduce a measure derogating from the standstill clause. Having been granted authorisation by Decision 89/487/EEC, France proceeded to introduce a provision excluding from the right to deduct all expenditure in respect of accommodation, food, hospitality and entertainment.

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[685] Joint cases 138/86 and 139/86, *Direct Cosmetics Ltd and Laughtons Photographs*, [1988] ECR 3937. The case concerned the validity of Council Decision 85/369/EEC of 13 June 1985 (OJ L199, 31/07/1985, p. 60), which authorised the United Kingdom to introduce measures which derogated from Article 11A(1)(a) Sixth Directive. The Court concluded in these cases that there were no grounds for declaring the Decision invalid.

[686] Joint cases C-177/99 and C-181/99, [2000] ECR I-7013.

[687] Council Decision 89/487/EEC of 28 July 1989, OJ L 239, 16/08/1989, p. 21.

Ampafrance and Sanofi incurred expenditure in respect of accommodation, food, entertainment and hospitality. In both cases, the French tax authorities refused the deduction of the input tax, based on the French provision which excluded from the right to deduct these types of expenditure. During the proceedings in the French Administrative Courts, both appellants argued that Council Decision 89/487/EEC, which authorised France to introduce this limitation to the right to deduct, was invalid. Both Administrative Courts decided to refer the question to the Court of Justice.

In order to support their claim on the invalidity of Council Decision 89/487/EEC, Ampafrance and Sanofi presented several arguments, as follows:

— it employed disproportionate means in so far as it introduced a general and systematic exclusion from the right to deduct VAT, based on the presumption of a risk of tax evasion or avoidance assuming the mixed nature (private and business) of the expenditure concerned. It is disproportionate to exclude certain expenditure from the right of deduction on the ground that such exclusion constitutes an anti-evasion or avoidance measure without being required to prove that a risk of tax evasion or avoidance exists or allowing the taxable person to demonstrate the absence of tax evasion or avoidance by establishing that the expenditure was indeed incurred for business purposes;

— in seeking authorisation from the Council to derogate from rules of the Sixth Directive, the French authorities were not seeking to combat risks of tax evasion or avoidance, but to put in place a mechanism which would obviate the requirement to check whether certain expenditure was incurred for business purposes or not;

— finally, it was incompatible with the principle of proportionality because the objective which it pursues could be attained by other means less detrimental to the principles and objectives of the Sixth Directive. In fact, there were measures in French law which would allow the tax authorities to deal effectively with the problem of tax evasion and avoidance and which would be less onerous for taxable persons than a general and systematic exclusion from the right to deduct the VAT charged on the expenditure at issue.

Additionally, Sanofi submitted that it follows from the preamble to Council Decision 89/487/EEC that the authorisation granted to the French Republic to introduce measures derogating from the rules of the Sixth Directive on the right to deduct VAT could be granted only on a temporary basis and until such time as the Community rules determining expenditure not eligible for deduction of VAT enter into force. The fact that the Council had been unable to adopt such rules had caused that temporary situation to endure, in such a way that the derogation had inevitably become disproportionate to the aims which it pursued.

The French Government, the Council and the Commission disputed all these arguments, however, the Court ultimately agreed with Ampafrance and Sanofi, ruling that Council Decision 89/487/EEC was contrary to the principle of proportionality and thus, invalid.

The Court accepted that there was an undoubted risk of tax evasion or avoidance in these cases, nonetheless it considered that:

> "[T]he application of the system of exclusion of the right of deduction authorised by Decision 89/487 may have the effect that undertakings are unable to deduct the VAT charged on business expenditure which they have incurred and that VAT is thus charged on certain forms of intermediate consumption, contrary to the principle of the right to deduct VAT, which ensures the neutrality of that tax."[688]

Moreover:

> "A measure which consists in excluding as a matter of principle all expenditure in respect of accommodation, hospitality, food and entertainment from the right to deduct VAT, which is a fundamental principle of the VAT system established by the Sixth Directive, although appropriate means less detrimental to that principle than the exclusion of the right of deduction in the case of certain expenditure can be contemplated or already exist in the national legal order, does not appear to be necessary in order to combat tax evasion and avoidance.
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> [...] as Community law now stands, national legislation which excludes from the right to deduct VAT expenditure in respect of accommodation, hospitality, food and entertainment without making any provision for the taxable person to demonstrate the absence of tax evasion or avoidance in order to take advantage of the right of deduction is not a means proportionate to the objective of combating tax evasion and avoidance and has a disproportionate effect on the objectives and principles of the Sixth Directive."[689]

The French Government had requested at the hearing that, in the event that the Court should rule that the Decision was contrary to the principle of proportionality, the temporal effects of the judgment would be limited. To support its request the French Government invoked the principle of legitimate expectations. The Court refused, noting that it was the first time that the principle of legitimate expectations had been invoked by a Government in support of a request to limit the temporal effects of a judgment. It also stated that under the circumstances "the French authorities could not fail to be aware that, by its content, Decision 89/487 was not compatible with the principle of proportionality and, consequently, cannot argue that they could reasonably believe that that decision was valid".[690]

Post *Ampafrance / Sanofi*

Following *Ampafrance and Sanofi* the validity of derogations authorising measures limiting the right to deduct appeared more questionable, and just a few months after the Court had delivered its judgment in that case, another case was referred to the Court of

[688] Paragraph 58 of the judgment.
[689] Paragraphs 61 and 62 of the judgment.
[690] Paragraph 69 of the judgment.

Justice which questioned the validity of a Council Decision authorising Germany to introduce measures derogating from Articles 6 and 17 Sixth Directive, *Sudholz*.[691]

The case concerned the validity of Council Decision 2000/186/EC,[692] which authorised Germany to limit to 50% the right to deduct VAT charged on expenditure on vehicles not used exclusively for business purposes and not to treat as supplies of services for consideration the use for private purposes of vehicles belonging to a taxable person's business. The Court of Justice was asked to decide on whether this Decision infringed the substantive requirements under Article 27(1) Sixth Directive, and was thus invalid.[693] In order to do so, the Court considered that following *Ampafrance and Sanofi* it was necessary to determine whether the flat-rate limit on permitted deductions set at 50% of the amount paid by way of input VAT, could be considered necessary and appropriate for the attainment of the objectives which Decision 2000/186/EC pursued and at least likely to effect the objectives and principles of the Sixth Directive.

The Commission argued that the Decision was not necessary and appropriate for the attainment of the prevention of tax evasion and avoidance, and infringes the principle of proportionality in that a taxable person, such as Mr. Sudholz, who used his passenger car 70% for business purposes, and that could prove that he did so, was nevertheless only permitted to deduct 50% of the input VAT paid on the purchase of the car. Thus, according to the Commission, the 50% limit imposed was disproportionate. The German Government, on the other hand, argued that the 50% percentage corresponded to the average use for private purposes of the vehicles concerned. It also pointed out that the same flat-rate limit has been adopted in other Member States, and it was the also the figure put forward by the Commission in their 1998 proposal regarding the right to deduct.[694]

The Court started by noting that the decision at issue in *Ampafrance and Sanofi* involved a complete exclusion of the right to deduct and not a flat-rate limit on that right. In this respect, it considered that the imposition of a flat-rate limit on the right to deduct would appear to be an adequate measure to prevent the risk of tax evasion and avoidance, while at the same time making verification more straightforward and simplifying the system for charging VAT. As to whether the limit of 50% was proportionate to the object pursued, the Court considered that the fact that the same flat-rate limit had been adopted by other Member States and by the Commission in their 1998 proposal suggested that such a limit was reasonable. It thus concluded that:

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[691] Case C-17/01, [2004] ECR I-00. The Court delivered its judgment on *Ampafrance and Sanofi* on 19 September 2000, and *Sudholz* was referred to the Court in November of the same year.
[692] Council Decision 2000/186/EC of 28 February 2000, OJ L 59, 04/03/2000, p. 12.
[693] The Court was equally asked whether the Decision was invalid due to irregularities following the procedure provided for in Article 27 Sixth Directive, and whether Article 3 was invalid, insofar as it established the retroactive effect of the authorisation.
[694] See *op. cit.*, COM(98) 377 final, 17 June 1998.

"the measure authorised by Decision 2000/186 does not conflict with the objectives or the principles of the Sixth Directive and observes the principle of proportionality".[695]

Assessment of the Court's jurisprudence: legal and political implications of *Ampafrance and Sanofi*

The Court's approach to the validity of derogations authorising the limitation of the right to deduct is very distinct from its approach to the standstill clause. This difference stems from the Court's willingness in the case of derogations to engage in principle-based decisions. In fact, as regards derogations, the Court rather than looking solely to the wording and the historical background as a source of interpretation of the provisions – the adopted method as regards the standstill clause – the Court opted for assessing their compatibility with principles of the EU VAT system, such as the principle of the right to deduct, and Community's general principles, such as the principle of proportionality.

The principle of the right to deduct had already been invoked by the Court on several occasions,[696] stating that due to its fundamental nature within the EU VAT system, limitations to the right to deduct should only be allowed in exceptional situations expressly provided for in the Sixth Directive. However, the situation was somehow different in relation to the principle of proportionality. As referred to by the Court in the *Ampafrance and Sanofi* cases, the principle of proportionality has been consistently recognised by the Court as forming part of the general principles of Community law,[697] and as such the validity of Community acts may be reviewed on the basis of that general principal of law.[698] Nonetheless, never before had the Court availed of this prerogative in respect of VAT legislation and the implications are potentially very significant, not solely for the area of non-deductible input tax, but also for the whole EU VAT system.

As regards non-deductible input tax, *Ampafrance and Sanofi* sent a clear signal to Member States that total exclusions of the right to deduct in respect of specific expenditure would no longer be accepted. The Court's view was made clearer in *Sudholz*, where the Court established that it is acceptable, in light of the EU VAT

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[695] Paragraph 64 of the judgment. The Court, however, found Article 3 of the Decision, which established the retroactive application of the authorisation, invalid for violation of the principle of legitimate expectations. Following this judgment, Germany put forward a request to maintain the limitation to the right to deduct authorised by Council Decision 2000/186/EC, ultimately resulting in Council Decision 2004/817/EC of 19 November 2004, OJ L 357, 02/12/2004, p. 33.

[696] E.g. cases regarding the temporal requirements of the standstill clause, see *supra*.

[697] See in particular case 265/87, *Schrader*, [1989] ECR 2237. The Court held in this case that "the principle of proportionality is one of the general principles of Community law. By virtue of that principle, measures imposing financial charges on economic operators are lawful provided that the measures are appropriate and necessary for meeting the objectives legitimately pursued by the legislation in question. Of course, when there is a choice between several appropriate measures, the least onerous measure must be used and the charges imposed must not be disproportionate to the aims pursued", paragraph 21 of the judgment.

[698] See case C-27/95, *Bakers of Nailsea*, [1997] ECR I-1847, in which the Court declared the invalidity of a Directive on the basis of the infringement of the principle of proportionality. The Court concluded in this case that a private individual may plead in proceedings before a national court an infringement of the general principles of proportionality and non-discrimination in order to challenge the validity of an act of the Community institutions and that Council Directive 64/433/EEC of 26 June 1964 on health problems affecting intra-Community trade in fresh meat (OJ L 121, 29/07/1964, p. 2012) was not invalid having regard to the general principle of proportionality, see paragraphs 21 and 41 of the judgment.

principles and the principle of proportionality, to introduce flat-rate limits to the right to deduct in respect of certain expenditure, where there is a risk of tax evasion or avoidance. However, this flat-rate limit has to be reasonable in light of the type of expenditure concerned.

Moreover, the Court's jurisprudence in this area raises the issue of judicial harmonisation. In fact, a joint analysis of the Court's case-law on the temporal requirements of the standstill clause, in conjunction with the Court's principle-based approach to derogations, gives rise to the question of whether the Court is engaging in a concerted policy: any limitations to the right to deduct introduced before the entry into force of the Sixth Directive are authorised by the standstill clause; however, after that date, limitations to the right to deduct will be subject to strict requirements. If this is the case, the objective of this policy could only be to achieve through jurisprudential means, what could not be achieved through legislative measures, *i.e.*, the reduction of Member States' divergences in relation to non-deductible input tax.[699] Therefore, the Court's jurisprudence as regards non-deductible input tax could be interpreted as an attempt to reach a minimum level of harmonisation in this area through case-law. However, if this is the case, a policy of harmonisation of non-deductible input tax rules through case-law faces the same difficulties as the ones highlighted above as regards harmonisation of VAT rates through case-law, as follows: on one hand, the objective could be more efficiently achieved through the adoption of legislative measures, and on the other hand, there is a serious risk of the Court being accused of judicial activism.

Notwithstanding the above, *Ampafrance and Sanofi* may also have a significant impact on the functioning of the whole Community's VAT system. As mentioned in Chapter 3, the widespread recourse to Article 27 Sixth Directive and derogations, has given rise to serious concerns regarding their negative impact on the functioning of the EU VAT system. Until now the compatibility of derogations in light of the principles of the EU VAT system and the general Community principles had never been questioned, and its contents remained unchallenged. In *Ampafrance and Sanofi*, the Court has given a clear indication that this will no longer be the case, and that it is prepared to engage in principle-based decisions in order to question the validity of derogations.

### ii) EU VAT SYSTEM AS AN OBSTACLE TO THE FUNCTIONING OF THE INTERNAL MARKET: VAT TREATMENT OF PUBLIC SECTOR BODIES

As discussed in Chapter 3, the treatment of public sector bodies under the Sixth Directive is rather complex and gives rise to numerous difficulties, namely in relation to the taxable status of public sector bodies under the first paragraph of Article 4(5), and the qualification of their activities as exempt or not under Article 13A. The Court has

[699] In this respect it is interesting to note that in *Sudholz*, one of the arguments put forward by the German Government and accepted by the Court was that the flat-rate limit authorised by Decision 2000/186/EC was the same as the one proposed by the Commission in relation to that type of expenditure in its 1998 proposal.

attempted to resolve these difficulties through extensive case-law however, as the analysis of the Court's rulings undertaken *infra* will demonstrate, the cases emerge within the context of the complexity of the system, and thus, were the system to be simplified the need for such jurisprudential intervention would be eroded.

### (1) CONCEPT OF PUBLIC SECTOR BODIES

The main points of contention as regards the concept of public sector bodies for the purposes of the application of Article 4(5) Sixth Directive are, as follows:

— which bodies should be included within the expression "other bodies governed by public law"; and,

— which criteria should be used in order to establish when a public legal entity is engaging in activities or transactions "as public authorities".

The Court of Justice's attempts to deal with each of these issues are analysed *infra*, however, due to fact that the jurisprudence in this area is vast,[700] only a few cases have been chosen for consideration. The criterion used for this choice was the relevance of the rulings.

The first time the Court was called to decide on the interpretation of Article 4(5) Sixth Directive was in *Commission v Netherlands*.[701] The case concerned the official services performed by notaries and bailiffs, and namely whether these services should be considered as services performed by "other bodies governed by public law" for the purposes of that Article. It arose from an enforcement action brought by the Commission against the Netherlands, in which it sought a declaration by the Court that by treating the services performed by notaries and bailiffs as outside the scope of VAT, the Netherlands had failed to fulfil its obligations under Articles 2 and 4(1), (2) and (4) Sixth Directive.

The Commission argued that notaries and bailiffs should be considered as taxable persons under Article 4, as they carried out an independent economic activity. Moreover, it considered that the principle of tax on consumption, which underlines the EU VAT system, required Article 4(5) to be interpreted strictly. The Court seemed to agree with this approach. It considered that in order for public sector bodies to be considered as outside the scope of VAT under Article 4(5) Sixth Directive, two conditions had to be fulfilled, as follows:

— the activities had to be carried out by a body governed by public law; and,

— they must be carried out by that body acting as a public authority.

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[700] See cases 235/85, *Commission v The Netherlands*, [1986] ECR 1471; 231/87, *Comune di Carpaneto Piacentino (Piacenza)*, [1989] ECR 3233; C-4/89, *Commune di Carpaneto Piacento and Others*, [1990] ECR I-1869; C-202/90, *Ayuntamiento de Sevilla*, [1991] ECR I-4247; C-247/95, *Markgemeinde Welden,* [1997] ECR I-779; and C-446/98, *Câmara Municipal do Porto*, [2000] ECR I-11435. Also, the "tolls cases" case C-276/97, *Commission v France*, [2000] ECR I-6251; case C-358/97, *Commission v Ireland*, [2000] ECR I-6301; case C-359/97, *Commission v United Kingdom*, [2000] ECR I-6355; case C-408/97, *Commission v The Netherlands*, [2000] ECR I-6417; case C-260/98, *Commission v Greece*, [2000] ECR I-6537; and case C-378/02, *Waterschap Zeeusws Vlaanderen v Staatssecretaris van Financien*, [2005] ECR I-000.

[701] Case 235/85, [1986] ECR 1471.

Thus, according to the Court the conditions set out in that provision are cumulative rather than alternative, and in this context, it considered that:

> "[E]ven assuming that in performing their official services notaries and bailiffs exercise the powers of a public authority by virtue of their appointment to public office, it does not follow that they may enjoy the exemption provided for in Article 4(5). The reason is that they pursue those activities, not in the form of a body governed by public law, since they are not part of the public administration, but in the form of an independent economic activity carried out in the exercise of a liberal profession."[702]

Although agreeing with the Commission as to the result of the case, it was yet unclear from the Court's ruling whether it adopted the Commission's approach in relation to the strict interpretation of Article 4(5) Sixth Directive. This was only confirmed in *Carpareto Piacentino and Rivergaro.*[703]

In *Carpareto Piacentino and Rivergaro* the Court was called to decide on the interpretation of Article 4(5) Sixth Directive in the context of the activities performed by local authorities. The Court was referred several questions, however the most relevant concerned the interpretation of the expression "activities or transactions in which they engage as public authorities".[704] In this respect, the Court was essentially asked to decide on whether some of the activities undertaken by several Italian local authorities should be regarded as "activities or transactions in which they engage as public authorities" for the purposes of Article 4(5).

The Court considered that it was for the national courts to determine which activities or transactions fulfil the conditions set out in Article 4(5) Sixth Directive. However, it did provide some guidelines as to the interpretation of those conditions:

> "In so far as that provision makes such treatment of bodies governed by public law conditional upon their acting 'as public authorities', it excludes therefrom activities engaged in by them not as bodies governed by public law but as persons subject to private law . Consequently, the only criterion making it possible to distinguish with certainty between those two categories of activity is the legal regime applicable under national law.
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> It follows that the bodies governed by public law referred to in the first subparagraph of Article 4(5) Sixth Directive engage in activities 'as public authorities' within the meaning of that provision when they do so under the special legal regime applicable to them. On the other hand, when they act under the same legal conditions as those

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[702] Paragraphs 22 and 23 of the judgment.
[703] Joint cases 231/87 and 129/88, [1989] ECR 3233.
[704] The other questions referred to the Court by the Italian courts were basically the following: whether Article 4(5) was directly applicable; how the expression "significant distortion of competition" should be interpreted for the purposes of paragraph two of that provision; and, finally, how the negligible criterion in paragraph three of that provision should be applied.

that apply to private traders, they cannot be regarded as acting 'as public authorities'."[705]

Thus, in light of the Court's ruling, it emerges that in order to benefit from the VAT regime set out in the first paragraph of Article 4(5) Sixth Directive the body must be qualified as public and be acting within the framework of a special legal regime only applicable to public bodies. Although the criteria could at first glance appear to be redundant, this is not the case as public bodies frequently act under the same conditions as those that apply to private traders, as demonstrated by the case-law.

If the ruling in *Commission v Netherlands* left the issue of the interpretative method which should be adopted in relation to Article 4(5) unclear, the ruling in *Carpareto Piacentino and Rivergaro* clearly demonstrated that the Court favoured the adoption of a strict approach to that provision.[706] This was confirmed by the Court's ruling in *Commune di Carpaneto Piacento*, which was issued some months later. The circumstances of this case were identical to the ones in *Carpareto Piacentino and Rivergaro*, as were the findings of the Court.[707]

The Court's approach to the interpretation of Article 4(5) Sixth Directive was further reiterated in *Ayuntamiento de Sevilla*,[708] which arose in the context of the services performed by tax collectors in Spain. The Court was asked in this case whether the activities performed by these tax collectors should be regarded as activities in which they "engage in as public authorities" for the purposes of the first paragraph of Article 4(5), and thus outside the scope of VAT.[709] It replied negatively, as it considered that the first condition set out in that provision was not fulfilled, *i.e.*, tax collectors were not public bodies, but rather independent third parties to which the exercise of public activities had been outsourced. It thus concluded that,

"An activity carried on by a private individual is not excluded from the scope of VAT merely because it consists in the performance of acts falling within the prerogatives of the public authority.

It follows that, if a commune entrusts the activity of collecting taxes to an independent third party, the exclusion from VAT provided for by the abovementioned provision is not applicable."[710]

Once again, the Court adopted a strict approach to the application of the first paragraph of Article 4(5) Sixth Directive, excluding from the scope of that provision outsourcing

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[705] Paragraphs 15 and 16 of the judgment.
[706] The Court's ruling received approving comments in relation to the adoption of a strict interpretation of Article 4(5), but less so as regards the fact that it failed to provide a Community definition of the expression "activities and transactions in which they engage as public authorities", see the comments of S. van Thiel in "EEC – Public Authorities as Taxable Persons for VAT" *International VAT Monitor*, February 1990, pp. 32-33.
[707] Case C-4/89, [1990] ECR I-1869.
[708] Case C-202/90, [1991] ECR I-4247.
[709] The Court was also asked to decide on whether the activities performed by tax collectors should be considered as "independent" for the purposes of Article 4(1) Sixth Directive, which the Court answered affirmatively.
[710] Paragraphs 19 and 20 of the judgment.

situations. However, the Court opted for a less restrictive approach in relation to the fourth paragraph of that Article in *Marktgemeinde Welden*,[711] a German municipality engaging in the letting of immovable property. The Court was asked in this case whether the fourth paragraph of Article 4(5) Sixth Directive[712] allowed Member States to treat exempt activities, in respect of which, however, it is possible to opt to be taxed – as it is the case with letting of immovable property – of bodies governed by public law as activities which they engage in as public authorities, even where they pursue them under the same legal conditions and in the same way as private traders.

In a written submission the Commission reminded the Court that not conferring the status of taxable person to bodies governed by public law or conferring them with that status but exempting them from VAT, had the same result. Thus, it considered that the fourth paragraph of Article 4(5) Sixth Directive, as a provision derogating from the basic system introduced by the Sixth Directive, should be strictly interpreted and applied to the activities exempted under Article 13 Sixth Directive, only insofar as Article 13 expressly associated them with bodies governed by public law. Therefore, the Commission took the view that Member States were not authorised under the fourth paragraph of Article 4(5) to exclude public bodies from treatment as taxable persons in respect of activities, such as the letting of buildings, which did not satisfy that criterion.

The Court, however, disagreed. It considered that the fourth paragraph of Article 4(5) Sixth Directive did not distinguish between the several activities included in Article 13, and thus:

> "Member States are authorised to exclude from treatment as taxable persons bodies governed by public law which carry out activities exempted under Article 13 of the directive, even if they are performed in a similar manner to those of a private trader."[713]

### (2) EXEMPTIONS

The case-law of the Court of Justice in relation to exemptions is extremely vast,[714] but, only a small percentage of these relate to the interpretation of exemptions applicable to public sector bodies,[715] the first of which is *Commission v Germany*.[716]

This case concerned the interpretation of paragraph (a) of Article 13A Sixth Directive, which exempts the supply of services by public postal services. German legislation exempted from VAT the transport services provided to the public postal services by a

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[711] Case C-247/95, [1997] ECR I-779.
[712] The fourth paragraph of Article 4(5) reads as follows: "Member States may consider activities of these bodies which are exempt under Article 13 and 28 as activities which they engage in as public authorities".
[713] Paragraph 20 of the judgment.
[714] In fact, Articles 11 and 13 Sixth Directive, which concern the determination of taxable amount and VAT exemptions respectively, are the provisions within the EU VAT system upon which the Court has been called to interpret on the most occasions.
[715] Cases 107/84, *Commission v Germany*, [1985] ECR 2655; C-453/93, *Bulthuis-Griffioen*, [1995] ECR I-2341; C-287/00, *Commission v Germany*, [2002] ECR I-5811; C-45/01 *Christoph-Dornier-Stiftung Klinische Psychologie*, [2003] ECR I-00; joint cases C-394/04 and C-395/04, *Ygeia*, [2005] ECR I-000; and C-415/04, *Stichting Kinderopvang Enschede*, [2005] ECR I-000.
[716] Case 107/84, [1985] ECR 2655.

third party. Considering that by exempting these services Germany was in contravention of Article 13A(a) Sixth Directive, the Commission decided to bring an enforcement action against this Member State before the Court of Justice.

According to the Commission the list of exemptions in Article 13 Sixth Directive was exhaustive, and that in light of the wording of 13A(1)(a) that exemption related exclusively to the supply of services by the public postal services, and not to the supply of services by others for the public postal services. The German Government, on the other hand, argued that the Commission was adopting too literal an interpretation of the provision, and that the exemption applied to the supply of postal services, not only where they are carried out directly by the postal authority but equally where they are carried out on behalf of that authority by other undertakings.

The Court disagreed with the German Government, ruling in favour of the Commission. It considered that:

> "it is not possible to apply the exemption laid down by it [Article 13A(1)(a)] to activities which, whilst pursuing the same objectives, are undertaken by bodies which cannot be regarded as 'public postal services' in the organic sense, unless there are other conclusive factors demanding an interpretation which goes beyond the actual wording of the provision . No such factor can be found [...]."[717]

It thus concluded that by applying the exemption to transport services provided to the public postal services by a third party, Germany had failed to fulfil its obligations under Article 13(1)(a) Sixth Directive.

The Court's ruling effectively denied the extension of the exemptions in Article 13 Sixth Directive to outsourcing situations, *i.e.*, where the services provided by public sector bodies have been outsourced to third parties these services will not be exempt of VAT. This strict interpretation of the exemptions applicable to public sector bodies under Article 13A Sixth Directive would be confirmed by the Court in the following rulings.

In *Bulthuis-Griffioen* the Court was called to interpret the exemption applicable under Article 13A(1)(g) Sixth Directive to the supply of services and goods linked to welfare and social security work.[718] In this case the Court was basically asked whether Mrs. Bulthuis-Griffioen, who ran a day nursery in the Netherlands, should benefit from the exemption granted by that provision. The Court, based on a strict interpretation of Article 13A, considered that it should not. It stated that:

> "[T]he exemptions provided for by Article 13 of the Sixth Directive are to be interpreted strictly since they constitute exceptions to the general principle that turnover tax is to be levied on all services supplied for consideration by a taxable person.

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[717] Paragraphs 12 and 13 of the judgment.
[718] Case C-453/93, [1995] ECR I-2341.

> Certain of the exemptions mentioned in Article 13A(1) of the Sixth Directive, including the one provided for in paragraph (g) of that provision, expressly refer to the concept of 'body' or 'organization', whereas others do not. The position is, therefore, that in the former case the exemption may be claimed only by legal persons whereas in the latter case it may also be claimed by natural persons including traders."[719]

It thus concluded that "a trader such as Mrs Bulthuis-Griffioen, a natural person, is not a person covered by Article 13A(1)(g) of the Sixth Directive" and "that fact is sufficient to bar that trader from the exemption available under Article 13A(1)(g) of the Sixth Directive".[720]

The Court's preference for a strict interpretation of the Article 13A exemptions as regards the service providers was again confirmed some years later in *Dornier*.[721] The case concerned Dornier, a German charitable foundation governed by private law, whose object was to develop the practice of clinical psychology by qualified psychologists (who were not doctors). The Court was asked in this case whether Dornier should benefit from the exemption applicable to medical care under Article 13A(1)(b) Sixth Directive.[722] The Court, following the Opinion of the Advocate-General, considered that in principle it should not. It stated that:

> "[P]sychotherapeutic treatment given in an out-patient facility of a foundation governed by private law by qualified psychologists who are not doctors is not an activity closely related to hospital or medical care within the meaning of Article 13A(1)(b) of the Sixth Directive, except where such treatment is actually given as a service ancillary to the hospital or medical care received by the patients in question and constituting the principal service."[723]

The Court's preference for a strict interpretation of Article 13A exemptions has manifested itself by adopting a strict approach, not only as regards the services providers, but equally in relation to the type of services which may be exempt under those provisions. In *Commission v Germany*[724] the Court of Justice adopted a strict

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[719] Paragraphs 19 and 20 of the judgment. Article 13A(1)(g) Sixth Directive reads: "the supply of services and of goods closely linked to welfare and social security work, including those supplied by old people's homes, by bodies governed by public law or by other organizations recognized as charitable by the Member State concerned".

[720] Paragraphs 21 and 22 of the judgment.

[721] Case C-45/01, [2003] ECR I-00.

[722] Article 13A(1)(b) reads: "hospital and medical care and closely related activities undertaken by bodies governed by public law or, under social conditions comparable to those applicable to bodies governed by public law, by hospitals, centres for medical treatment or diagnosis and other duly recognised establishments of a similar nature". The Court was also asked to rule on the interpretation of paragraph (c) of the same provision. However, this aspect of the Court's ruling will not be analysed in detail here, as the exemption provided for in paragraph (c) is of limited relevance in the context of public sector bodies.

[723] Paragraph 51 of the judgment. The Court, however, considered that Dornier should benefit from the exemption applicable under Article 13A(1)(c) Sixth Directive. It considered that: "since the exemption envisaged in Article 13A(1)(c) of the Sixth Directive is not dependent on the legal form of the taxable person providing the medical or paramedical services referred to in that provision, psychotherapeutic treatment provided by a foundation governed by private law and given by psychotherapists employed by the foundation may benefit from that exemption.", paragraph 21 of the judgment.

[724] Case C-287/00, [2002] ECR I-5811.

interpretation of Article 13A(1)(i) Sixth Directive by excluding from the scope of that exemption research activities undertaken by public-sector higher education establishments in Germany.[725] In this case, the German Government sought to maintain a VAT exemption applicable under German legislation to that activity by arguing that research was a service closely related to education in State universities and that research and teaching activities in those establishments could not be separated. The Court, however, disagreed.

It started by reiterating that "the terms used to specify the exemptions provided for by Article 13 Sixth Directive are to be interpreted strictly, since they constitute exceptions to the general principle that VAT is to be levied on all services supplied for consideration by a taxable person".[726] It then continued by stating that "the aim of Article 13(A) Sixth Directive is to exempt from VAT certain activities which are in the public interest. That provision does not, however, provide exemption from the application of VAT for every activity performed in the public interest, but only for those which are listed and described in great detail in it".[727] It thus concluded that "the undertaking by State universities of research projects for consideration cannot be regarded as an activity closely related to university education for the purposes of Article 13(A)(1)(i) of the Sixth Directive".[728]

This restrictive approach has been recently reiterated by Advocate-General Leger in the recent *Ygeia*.[729] The question put to the Court in this case was whether the supply of telephone and television services to a patient, and the supply of accommodation and meals to the people accompanying them, by a hospital, should be regarded as "closely related activities" to medical care, within the meaning of Article 13(A)(1)(b) Sixth Directive. The Advocate-General concluded that these services should only be regarded as "closely related activities" within the meaning of that provision, where they have been subject to medical prescription, *i.e.*, the use of telephone and television services, as well as the presence of the person accompanying the patient had been prescribed by the doctor.

Similar stand has been adopted by Advocate-General Jacobs in the equally recent *Stichting Kinderopvang Enschede*.[730] The case concerned an organisation which itself provides care for children outside school time, but which also puts parents in touch with independent day carers who provide the same service, for which it charges an additional fee. The Court was basically asked whether these intermediary services should be regarded as "supply of services closely linked to welfare" within the meaning of Article 13(A)(1)(g) or as "supply of services linked to the protection of children" within the meaning of Article 13(A)(1)(h) Sixth Directive. The Advocate-General accepted the

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[725] Article 13A(1)(i) reads: "children's or young people's education, school or university education, vocational training or retraining, including the supply of services and of goods closely related thereto, provided by bodies governed by public law having such as their aim or by other organizations defined by the Member State concerned as having similar objects".
[726] Paragraph 43 of the judgment.
[727] Paragraph 45 of the judgment.
[728] Paragraph 49 of the judgment.
[729] Case C-394/04, [2005] ECR I-000.
[730] Case C-415/04, [2005] ECR I-000.

possibility that these services might be exempt, but only insofar as certain conditions were present, namely as follows:

— subjection to VAT would hinder access to the childcare services by increasing their cost;

— the childcare services themselves qualify for exemption under the same provision(s);

— the childcare services are of a kind or quality of which those seeking those services could not be assured if they did not use the intermediary services; and

— the basic purpose of the intermediary services is not to obtain additional income by carrying out transactions which are in direct competition with those of commercial enterprises liable for VAT.[731]

### (3) ASSESSMENT OF THE COURT'S JURISPRUDENCE

As the analysis undertaken *supra* demonstrates, the jurisprudence of the Court of Justice in relation to the VAT treatment of public sector bodies is somewhat extensive. As opposed to what happens in other areas, the difficulties which gave rise to the case-law in this area are mainly of an interpretative nature, as follows:

— clarification of the concept of public sector bodies for the purposes of Article 4(5) Sixth Directive; and,

— provision of guidelines as to the interpretative method to be adopted in relation to the exemptions listed in Article 13A Sixth Directive.

The analysis of the Court's rulings seems to reveal that the Court favours a strict approach in relation to both these aspects. However, it has stopped short of adopting a strict approach to the overall special system applicable to public sector bodies. In fact, in *Marktgemeinde Welden*[732] the Court had the opportunity to adopt a strict view of the system through the strict interpretation of the interconnection between the fourth paragraph Article 4(5) and Article 13, however it chose not to do so. The Court's position in this case is somewhat difficult to comprehend in light of the Court's previous and subsequent jurisprudence as regards both Article 4(5) and Article 13A Sixth Directive. Ultimately it would have been more consistent and more legally coherent from the perspective of the exceptional nature of the regime applicable to the public sector bodies, for the Court to adopt an absolute, strict approach to this regime.

Nonetheless, despite the ruling in *Marktgemeinde Welden*, it seems to be now settled jurisprudence that Articles 4(5) and 13A Sixth Directive contain exceptions to the general rules in Articles 4(1) and (2), respectively, and thus should be interpreted strictly. In this context, the Court has clearly been successful in providing guidelines which have clarified the VAT legal sub-system applicable to public sector bodies.

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[731] Paragraph 59 of the Advocate-General's Opinion.
[732] Case C-247/95, [1997] ECR I-779.

However, notwithstanding the above, it is also clear that although the Court can (and has) issued these interpretative guidelines, the difficulties which arise from the system would undoubtedly be more efficiently dealt with through the legislative simplification of this very system. On one hand, the Court's jurisprudence has not been able to resolve some of the problems highlighted in Chapter 3 which arise from the VAT treatment of public sector bodies, namely problems regarding non-recovery of input tax and tax cascading.[733] On the other hand, dealing with the problem *a priori*, avoiding the emergence of difficulties, rather than *a posteriori*, trying to provide solutions for existing difficulties after the event, would present numerous advantages from both an economic and a legal perspective.

## 3) ASSESSMENT OF THE ROLE OF THE COURT OF JUSTICE IN THE CONTEXT OF THE EU VAT SYSTEM

The case-law emerging from the Court of Justice in the last four decades since the adoption of the Community VAT system has had a fundamental role on the development of this system. However, it can equally be said that VAT has played a fundamental role in the activities of the Court during this period. In fact, Charts 4.3 and 4.4, which focus on the judgments delivered by the Court in the last seven years, demonstrate that, taking into account the multiplicity of areas of Community legislation, VAT cases represent a significant part of the Court's activities.[734] Judgments delivered in VAT cases represent 7% of the total of judgments delivered by the Court during that period.[735] Moreover, judgments delivered on all other areas of taxation represent only 2% of that total.

**CHART 4.3 – Court of Justice Judgments 1997 - 2004**

[733] This cannot be achieved through jurisprudential means, as implicitly acknowledged by Advocate-General Jacobs in *Waterschap Zeeuws Vlaanderen*: "it is inherent in the existence of exceptions to the VAT system that they will interfere to some extent with the application of the principles of neutrality and of equality of treatment. Whatever the merits of the decision to treat public sector bodies as final consumers, it forms an integral part of the Directive. In that in comparable situations, the treatment of taxable persons and persons excluded from the VAT system will inevitably be different", case C-378/02, [2005] ECR I-000, Opinion of the Advocate-General, paragraph 38.

[734] These include areas such as competition, agriculture, free movement of persons, free movement of goods, free movement of services, etc. The data regarding the total number of judgments and judgments delivered on taxation was retrieved from *Statistics concerning the activity of the Court of Justice*, *op. cit.*.

[735] Additionally, during this period, the Court of Justice of First Instance has also delivered three judgments in relation to VAT: cases T-197/99, *Gooch*, [2000] ECR-SC IA-271; II-1247; T-36/00, *Elder and Elder*, [2001] ECR II-607; and T-170/00, *Forde Reederei*, [2002] ECR II-515.

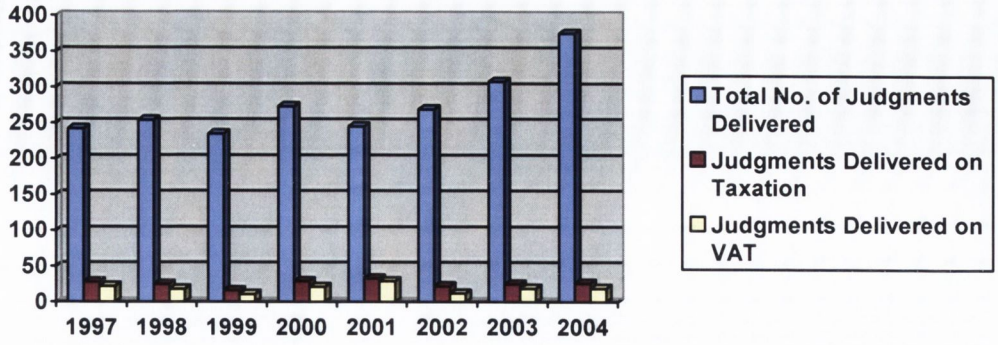
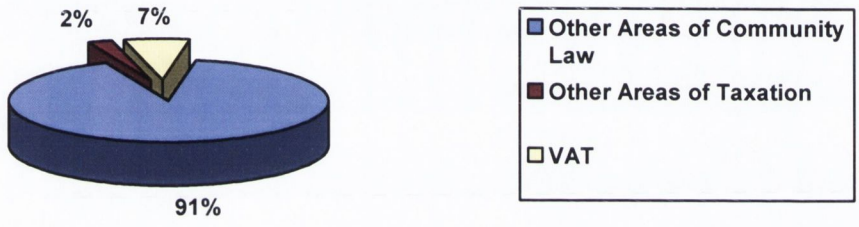



**CHART 4.4 – Court of Justice Judgments 1997 - 2004**




These findings, and, more generally the number of VAT cases, are certainly symptomatic of the importance of the VAT system within the Community legal framework, but, they are also symptomatic of the complexity and the difficulties which arise from the EU VAT system. In fact, it was in face of the complexity of the system and the lack of legislative progress that the Court acquired a vital role in the development of the Community VAT system. This role has been qualified as that of both a Constitutional Court and a Supreme Court: Constitutional Court where it makes a direct application of the Treaty, namely of Article 90; and Supreme Court where it guarantees the uniform interpretation of regulations or national legislation implementing directives.[736]

In practice, the extensive legislation in the field of VAT meant that the Court has tended to act more often as Supreme Court, namely guaranteeing the uniform interpretation of the Directives and the national VAT legislation which have been approved in order to implement them. The positive impact of the Court's jurisprudence in this respect is demonstrated by the fact that in some aspects of the VAT system, such as the definition of fixed establishment, the Commission has considered that it is superfluous to introduce

[736] See F. Vanistendael, "The role of the Court of Justice of Justice as the supreme judge in tax cases", *ECTR*, 1996/3, pp. 114-122. For a reference to the Treaty as the "constitutional charter of the Community" see case 294/83, *Les Verts*, [1986] ECR 1339.

legislation based on the fact that the Court's case-law already provided sufficient guidance.[737]

In other areas, such as VAT rates, the Court seems to have attempted to overcome the lack of legislative developments by adopting a harmonising role, diminishing the existing divergences across Member States' VAT legislations. However, by its nature this is an unsatisfactory solution, which can only be temporary. In its communication on a new VAT strategy the Commission expressed its intention to present legislative proposals which would reflect the Court's decisions in key areas, pointing out that:

> "A number of Court judgments concerning the application of VAT to transactions by holding companies, sales promotion of products in the form of discount vouchers and activities by public bodies have highlighted the fact that some provisions of the Sixth Directive are ambiguous, incomplete or out of date. The Commission may consider making a proposal to the Council to change these provisions".[738]

Whilst the Commission's expressed intention undoubtedly reflects the positive impact of the Court's case-law in these areas, it also highlights the limitations of the Court, as it is clear that the Commission feels that only legislative measures could resolve the difficulties which the EU VAT system has given rise to. In fact, the Court's role in the resolution of the problems raised by the current EU VAT system should be subject to two questions, as follows:

— can the Court efficiently resolve these problems?; and,

— even if it can, should it?

The answer to the first question can be found in the methods of interpretation adopted by the Court on VAT cases and the analysis of the general shortcomings of jurisprudential developments vs. legislative measures. The second question concerns the issue of judicial activism.

### a) COURT OF JUSTICE INTERPRETATIVE METHODS ON VAT CASES

As demonstrated by the case-law analysis undertaken *supra*, in reaching its decisions on VAT cases the Court of Justice employs various interpretative methods,[739] namely strict interpretation, historical interpretation and teleological interpretation.[740] However,

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[737] See *op. cit.*, COM(2003) 822 final, 23 December 2003, p. 9.
[738] See *op. cit.*, COM(2000) 348 final, 7 June 2000, Annex, point 2.3.
[739] F. Vanistendael comments that "the characteristic of the ECJ is that it uses various methods of interpretation at the same time without systematically indicating why one method is preferred over the other", in *op. cit.*, p. 121.
[740] The cases analysed show examples of the application of all these methods of interpretation. The method of strict interpretation has been expressly invoked by the Court in relation to the application of reduced VAT rates, e.g. case C-83/99, *Commission v Spain*, [2001] ECR I-445; as regards the derogations to the principle of right to deduct, e.g. case C-409/99, *Metropol*, [2002] ECR I-81; in relation to the concept of public sector body, joint cases 231/87 and 129/88, *Comune di Carpaneto Piacentino (Piacenza) and Comune di Rivergaro*, [1989] ECR 3233; and in relation to exemptions, e.g. case C-453/93, *Bulthuis-Griffioen*, [1995] ECR I-2341. The method of historical interpretation has been used in relation to the scope of the standstill clause, e.g. case C-43/96, *Commission v France*, [1998] ECR I-3903. Finally, although not expressly invoked by the Court, the teleological method of interpretation have been used by the Court in relation to the application of the fixed establishment criterion, e.g. case C-260/95, *DFDS*, [1997] ECR I-1005; the application of

undoubtedly the most radical decisions, which have had the biggest impact on the development of the Community's VAT system and created the most controversy, have been the ones where the Court employed the method of teleological interpretation, which entails an interpretation in light of the objectives, purposes and aims of the provisions of Community law.[741] These cases were those where the Court departed from the strict wording of the VAT rules, and based its decisions on the purpose of the provisions, the objectives of the Sixth Directive, and, mostly, the principles of the EU VAT system and the general principles of Community law.

### i) TELEOLOGICAL INTEPRETATION AND PRINCIPLE-BASED DECISIONS ON VAT CASES

#### (1) DECISIONS BASED ON VAT PRINCIPLES

Despite the fact that some references to the principles of the EU VAT system can be found in judgments delivered during the 1980s,[742] only towards the 1990s did the Court start consistently basing its decisions on the application of principles such as fiscal neutrality, VAT as a tax on consumption and the right to deduct. All these principles are interlinked and have the same basic idea of neutrality behind them.[743] In *Hong Kong*, one of its earlier judgments on VAT, the Court explains how this idea is expressed in the First Directive.

> "[The Preamble to the First Directive] refers to the need to achieve such harmonisation of legislation concerning turnover taxes as will eliminate factors which may distort conditions of competition and therefore to secure neutrality in competition, in the sense that within each country similar goods should bear the same tax burden, whatever the length of the production and distribution chain.
>
> In order to attain that objective, the First Directive provides in the first paragraph of Article 2 that the principle of the common system of value added tax involves the application of goods and services of a general tax on consumption exactly proportional to the price of goods and services, whatever the number of transactions which take place in the production and distribution process before the stage at which the tax is charged.
>
> The way in which that principle, which is based on the price of the goods and services, is to be applied is indicated in the second paragraph of the same Article, as follows: 'on each transaction, value added tax, calculated on the price of goods or services at the

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reduced VAT rates, e.g. case C-481/98, *Commission v France*, [2001] ECR I-3369; and the validity of derogations, e.g. joint cases C-177/99 and C-181/99, *Ampafrance and Sanofi*, [2000] ECR I-7013.

[741] As T. Tridimas comments "teleological interpretation is particularly suited to Community law", in "The Court of Justice and Judicial Activism", (1996) *ELRev.* 21, p. 205.

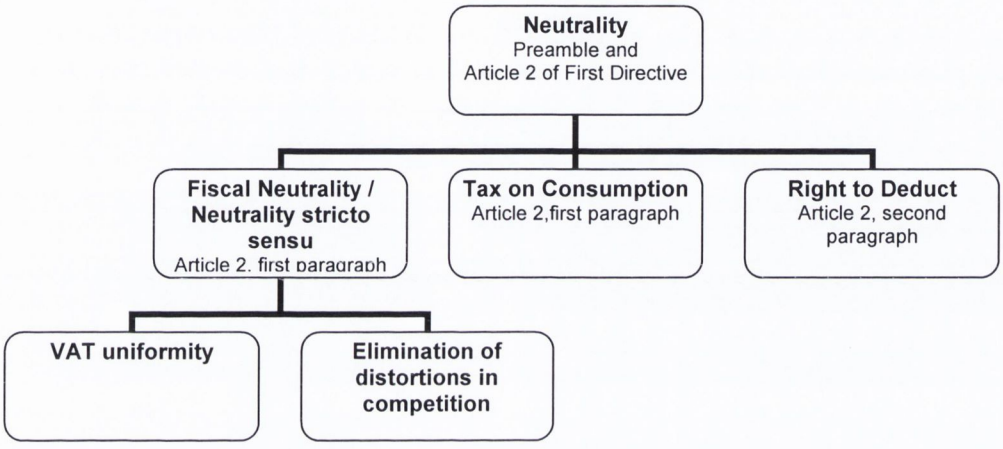
[742] See for example, case 286/86, *Happy Family*, [1988] ECR 3655, which concerned the illegal supply of narcotic drugs. The Court considered in this case that the principle of fiscal neutrality precluded, as far as levying VAT is concerned, a generalised differentiation between lawful and unlawful transactions.

[743] For a summary on the several types of neutrality, see B. Terra and J. Kajus, *A Guide to the European VAT Directives, op. cit.*, Volume 1, pp. 361-365.

rate applicable to such goods or services, shall be chargeable after deduction of the amount of value added tax borne directly by the various components."[744]

It was on the basis of these provisions that the Court constructed a body of case-law founded on the application of the principles of the EU VAT system. The exact interconnection between these provisions and the VAT principles is not totally clear from the Court's jurisprudence; however, the following diagram attempts to summarise the way in which the principles are interlinked and the specific provisions in which they are based.

**Diagram 4.3 – EU VAT Principles**




Fiscal Neutrality

The principle of fiscal neutrality, which could be regarded as neutrality *stricto sensu*, is probably the most important principle of the EU VAT system and the one on which the Court has relied more heavily as a basis for its decisions. Basically it conveys the idea of neutrality where other principles such as VAT as a tax on consumption or the principle of the right to deduct do not apply.

As highlighted *supra*, the principle has been applied by the Court in relation to several areas of the EU VAT system, namely the scope of the tax[745] and, more recently, exemptions and VAT rates. Recently the Court has also advocated the concept that the principle of fiscal neutrality also includes other sub-principles, such as VAT uniformity and elimination of distortions in competition. Although the inclusion of these sub-principles was already somewhat implicit in *Happy Family*, *Lange* and *Fischer*,[746] the explicit statement from the Court only came in *Commission v France*.[747]

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[744] Case 89/81, [1982] ECR 1277, paragraphs 6, 7 and 8. The case concerned the qualification as a taxable person of a person who provided services free of charge.

[745] Cases regarding the inclusion of illegal activities within the scope of VAT.

[746] See cases 286/86, [1988] ECR 3655; C-111/92, [1993] ECR I-4677; and C-283/95, [1998] ECR I-3369, respectively. On all cases, the Court concluded that the principle of fiscal neutrality precluded Member States from treating lawful and unlawful transactions differently for VAT purposes. The same notion was defended by the Court in the case of *Gregg*, where it considered that the principle of fiscal neutrality precluded economic operators carrying on the same activities from being treated differently as far as the levying of VAT is concerned, case C-216/97, [1999] ECR I-4947.

[747] Case C-481/98, [2001] ECR I-3369. See also case C-109/92, *Commission v Germany*, [2003] ECR I-0000.

Tax on Consumption[748]

Although invoked by the Commission in an earlier case,[749] it was not until *Mohr* that the Court based a decision upon the fact that VAT was a tax on consumption.[750] The question in this case was whether a compensation paid by the government for discontinuing milk production was subject to VAT. The Court concluded negatively, arguing that according to Article 2(1) of the First Directive "VAT is a general tax on the consumption of goods and services", and "in a case such as the present one, there is no consumption as envisaged in the Community VAT system".[751]

The Court reiterated this approach in *Landboden-Agradienste*, where it concluded that a national compensation for the extensification of potato production was not within the scope of VAT, as it did not give rise to any consumption.[752]

Right to deduct

The right to deduct has been consistently invoked by the Court as one of the basic principles of the EU VAT system since some of its early judgments on VAT. However, there has been a clear evolution in the Court's application of this principle since its general statement in *Rompleman* that the deduction system ensures that, under the common system of VAT, all economic transactions are taxed in a wholly neutral way.[753] Since then the Court has determined that the principle of the right to deduct, as established in Article 2 of the First Directive and Articles 17 *et seq.* Sixth Directive, entails the following rules:

— limitations and derogations to the right to deduct are only permitted insofar as they are expressly provided for in the Sixth Directive – *Commission v France*;[754]

— the right to deduct must be exercised immediately in respect of all taxes on transactions relating to inputs – *INZO*;[755]

— for the right to deduct to exist there must be a direct and immediate link between a particular input and a particular output transaction or transactions – *Mindland Bank*.[756]

This evolution culminated with the Court's judgment in *Ampafrance and Sanofi* where it established that Council Decision 89/487/EC was invalid based upon a joint reading of

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[748] For a more detailed analysis of the Court of Justice's application of the principle of VAT as a tax on consumption, see D. Butler, "VAT as a Tax on Consumption: Some Thoughts on the Recent Judgment in *Parker Hale Ltd v. Customs and Excise Commissioners*", in (2000) *BTR* 5, pp. 545-553.

[749] Case 235/85, *Commission v The Netherlands*, [1987] ECR 1471, where the Commission argued that the principle of VAT as a tax on consumption dictated a restrictive interpretation of Article 4(5) Sixth Directive. The Court agreed with the Commission as regards the interpretation of that Article, however, it based its decision not on the principle of VAT as a tax on consumption, but on the wording of the Article within the context of the aims of the Sixth Directive.

[750] Case C-215/94, [1996] ECR I-959.

[751] Paragraphs 19 and 20 of the judgment.

[752] Case C-384/95, [1997] ECR I-7387, paragraphs 22 and 23 of the judgment.

[753] Case 268/83, [1985] ECR 655.

[754] Case 50/87, [1988] ECR 4797. See also, cases C-97/90, *Lennartz*, [1991] ECR I-3795; and C-62/93, *BP Soupergaz*, [1995] ECR I-1883.

[755] Case C-110/94, [1996] ECR I-857. See also joint cases C-110/98 to C-147/98, *Gabalfrisa SL and Others*, [2000] ECR I-1577.

[756] Case C-98/98, [2000] ECR I-4177. See also case C-4/94, *BLP Group*, [1995] ECR I-983.

the principle of right to deduct and the principle of proportionality, declaring that limitations to the right to deduct even when authorised by Community law must not have a disproportionate effect on the principle of right to deduct, which is a fundamental principle of the EU VAT system.[757]

Non double-taxation?

The Court's position in relation to double taxation is not totally clear. In one of its earlier judgments on indirect taxation, and prior to the entry into force of the Sixth Directive, it stated that "the EEC Treaty does not contain any rules intended to prohibit the effects of double taxation with regard to products placed on the market in various Member States of the community. The abolition of such effects, which is desirable in the interest of the freedom of movement of goods, can however only result from the harmonisation of national systems under Article 99 [now Article 93] or possibly Article 100 [now Article 94] of the Treaty".[758]

However, a few years later in *Schul*, without ever referring specifically to double-taxation, the Court seemed to argue that Article 95 of the EC Treaty [currently Article 90] precluded Member States from imposing a double VAT burden on the same product. It stated that:

> "Member States are free, by virtue of Article 95, to charge the same amount on the importation of products as the value-added tax which they charge on similar domestic products. Nevertheless, this compensation is justified only in so far as the imported products are not already burdened with value-added tax in the Member State of exportation since otherwise the tax on importation would in fact be an additional charge burdening imported products more heavily than similar domestic products."[759]

The issue of double taxation arose again recently in *Cookies World*, where the Court affirmed that the standstill clause in Article 17(6) Sixth Directive did not apply where the Member State had introduced a new chargeable event into the taxation scheme. In doing so, the Court did not expressly follow the argument of the Commission, which had defended that Article 17(6) could not justify double taxation of the same economic transaction, however, it did seem to accept it implicitly.[760]

### (2) DECISIONS BASED ON GENERAL PRINCIPLES OF COMMUNITY LAW

As opposed to the situation in the field of direct taxation, it is rare for decisions of the Court of Justice in relation to VAT to be based on the application of general principles of Community law, such as non-discrimination, proportionality or legal certainty. Nevertheless, similarly to the tendency highlighted *supra* in relation to the application of VAT principles, there has been a steady rise in the application of such principles in the last few years, confirming the Court's increased willingness to engage in principle-based decisions within the area of VAT.

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[757] Joint cases C-177/99 and C-181/99, [2000] ECR I-7013.
[758] Case 142/77, *Kontrol*, [1978] ECR 1543, paragraph 3.
[759] Case 15/81, [1982] ECR 1409, paragraph 31.
[760] Case C-155/01, [2003] ECR I-8785.

Principle of non-discrimination

The principle of non-discrimination, as established in Article 12 of the EC Treaty, has played a particularly important role in the development of the Court's jurisprudence in relation to direct taxation.[761] However, within the area of VAT the principle has only been applied a few times, most notably in cases regarding the refund procedure under the Eighth Directive, such as *Societe generale des grandes sources d'eaux minerals francaises* and *Lease Plan*.[762] In both cases, the Court held that the principle of non-discrimination precluded Member States from applying different rules for refund of VAT depending on whether the taxable person was established in the territory of that Member State or in the territory of another Member State.

Principle of proportionality

The principle of proportionality had already been expressly invoked by the Court within the area of VAT on other occasions such as *Garage Molenheide* which related to the measures governing the exercise of the right to deduct[763] however it was the Court's application of the principle in *Ampafrance and Sanofi*,[764] which caused the most significant impact. In fact, although the impact of the Court's decision in this case is not yet totally clear,[765] it is undeniable that it projected the principle of proportionality to the centre stage of the Court of Justice's jurisprudence on VAT.

Principle of legal certainty

As the Court has consistently reiterated, "the principle of legal certainty forms part of the Community legal order".[766] The principle requires that "rules imposing charges on the taxpayer must be clear and precise so that he may know without ambiguity what are his rights and obligations and may take steps accordingly."[767] As recently acknowledged by

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[761] The Court has consistently applied the test of discrimination to direct tax cases, within the context of the four freedoms, since its judgment in *Schumacker* where it stated that discrimination arises "through the application of different rules to comparable situations or the application of the same rule to different situations", case C-279/93, [1995] ECR I-225, paragraph 30. This has culminated in the Court's recent ruling in *Marks & Spencer*, case C-446/03, [2005] ECR I-000. For a detailed analysis role of the principle of non-discrimination within Court's jurisprudence on direct taxation, see amongst others: papers delivered at the Association of European Tax Professors 2004 Annual Conference on *Fundamental freedoms and national tax sovereignty in EU*, Paris, June 2004; J.F. Avery Jones, "Carry on Discriminating" in (1995) *BTR*, p. 525; P.J. Wattel, "Home Neutrality in the Internal Market", (1996) *European Taxation*, 36, p. 159; and J.F. Avery Jones "Further Thoughts on Non-Discrimination in Europe Following Asscher", (1997) *BTR*, p. 75.

[762] Cases C-361/96, [1998] ECR I-3495; and C-390/96, [1998] ECR I-2553.

[763] Joint cases C-286/94, C-340/95, C-401/95 and C-47/96, [1997] ECR I-7281. In earlier judgments the Court had already implicitly referred to proportionality by emphasising the need for VAT measures, which derogate from the Sixth Directive provisions, to be maintained within the limits of the strictly necessary in order to achieve their set aim, see for example, case 324/82, *Commission v Belgium*, [1984] ECR 1861, paragraph 29.

[764] Joint cases C-177/99 and C-181/99, [2000] ECR I-7013.

[765] See *supra*.

[766] See for example, case C-381/97, *Belgocodex SA v Belgian State*, [1998] ECR I-8153, paragraph 26; and more recently, joint cases C-487/01, *Gemeente Leusden*; and C-7/02, *Holin Groep*, [2005] ECR I-000, paragraph 57; and joint cases C-354/03, *Optigen Ltd v Commissioners of Customs & Excise*; C-355/03 *Fulcrum Electronics Ltd (in liquidation) v Commissioners of Customs & Excise;* and C-484/03, *Bond House Systems Ltd v Commissioners of Customs & Excise*, [2005] ECR I-000, paragraph 41.

[767] Case 169/80, *Grondrand Freres*, [1981] ECR 1931.

Advocate-General Poiares Maduro, the applicability of the principle within the tax area is a particularly sensitive topic:

> "Tax law is frequently dominated by legitimate concerns about legal certainty, deriving, in particular, from the need to guarantee the predictability of the financial burden imposed on taxpayers and the principle of no taxation without representation."[768]

Although the principle of legal certainty, and its corollary the principle of legitimate expectations, are generally relied upon by individuals where they have legitimate expectations that were created by public authorities,[769] it is not solely in this context that they have been invoked by the parties within VAT cases. In fact, although in *Belgocodex* and *Schlossstrasse* the Court referred to these principles within this more traditional context,[770] in *Ampafrance and Sanofi* and *Commission v Spain* the principle was invoked by Member States seeking to argue that they had legitimate expectations which had been created by Community institutions, *i.e.*, the Commission.[771]

The principle of legitimate expectations gained increased relevance within the VAT context following the Court's application of the principle in *Marks & Spencer*, where it stated that national legislation retroactively curtailing the period for the exercise of a right of a taxpayer provided for in the Sixth Directive was incompatible with the principle of protection of legitimate expectations.[772] This link between retroactive application of VAT provisions and the principle of legitimate expectations was again established by the Court in *Sudholz*, where it held that Article 3 of Council Decision 2000/186/EC of 28 February 2000, which determined the retroactive application of that Decision, was invalid for violation of the principle.[773]

More recently, the principle of legal certainty has been discussed in the context of the applicability of the abuse of rights doctrine to the VAT area and namely whether the applicability of this doctrine would have an unduly impact in terms of legal certainty.[774]

Other principles

Other general principles of Community law, such as the principle of effectiveness[775] and the principle of *nemini licet venire contra factum proprium*[776], have also been either

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[768] Opinion of the Advocate-general in joint cases C-255/02, *Halifax*; C-419/02, *BUPA*; and C-223/03, *University of Huddersfield*, [2005] ECR I-00, paragraph 76.

[769] See for example, case C-107/97, *Criminal proceedings against Rombi and Others*, [2000] ECR I-3367, paragraphs 65 to 67. M. Ridsdale put it better when he pointed out that "the role played by the principle of legal certainty is quite clear: it is the principle guaranteeing taxpayers the tax treatment they expect", in "Abuse of rights, fiscal neutrality and VAT", *ECTR* 2005/2, p. 87.

[770] Cases C-381/97, [1998] ECR I-8153, paragraph 26; and C-296/98, [2000] ECR I-4279, paragraphs 44 *et seq.*, respectively.

[771] As highlighted *supra*. Case C-83/99, [2001] ECR I-445; and joint cases C-177/99 and C-181/99, [2000] ECR I-7013.

[772] Case C-62/00, [2002] ECR I-6325, paragraphs 43 to 47.

[773] Case C-17/01, [2004] ECR I-00, paragraph 41.

[774] For a discussion on the applicability of the abuse of rights doctrine to the VAT area, see *infra*. For a more detailed analysis of the principle of legal certainty in the context of the Court of Justice's battle against aggressive VAT planning, see R. de la Feria, "Legal Uncertainty – The Court of Justice's solution to aggressive VAT planning?", Paper presented at conference on *Topical Developments in VAT Law*, organised by the Irish Centre for European Law, Dublin, 15 July 2005.

invoked by the parties or (and) applied by the Court in VAT cases, albeit less frequently and with less relevance. Significantly, however, the principle of effectiveness was also applied by the Court in *Marks & Spencer*, where it found that the British national legislation in the main proceedings was equally incompatible with that principle.

Abuse of rights or principle of prohibition of abuse of Community law?

The concept of *abus de droit*, or abuse of rights, appears to be of French origin and is regarded in most Member States as a general principle of law.[777] Although the Court had previously referred to abusive practices,[778] the concept of abuse had until recently never been defined by the Court. In *Emsland-Starke* the Court finally laid down the conditions for the existence of abuse, as follows:

> "A finding of abuse requires, first a combination of objective circumstances in which, despite formal observance of the conditions laid down by the Community rules, the purposes of those rules has not been achieved;
>
> It requires, second, a subjective element consisting in the intention to obtain an advantage from the Community rules by creating artificially the conditions laid down for obtaining it."[779]

Following this judgment the issue of whether *abus de droit* is a general principle of Community law, more specifically in matters of the protection of the Community's budgetary resources, and as such can be applied to cases of aggressive VAT planning or VAT avoidance[780] within the Member States, has been the subject of intense controversy.[781] The question has gained particular importance in the United Kingdom,

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[775] Where Member States lay down procedural rules intended to safeguard rights which individuals derive from Community law, such rules should not make the exercise of those rights virtually impossible or excessively difficult, see case C-228/96, *Aprile Srl*, [1998] ECR I-7141.

[776] The so-called "estoppel" argument, which expresses this idea that, public authorities must not rely on their own failings. The argument was used by Germany, against the Commission in case C-109/02, *Commission v Germany*, [2003] ECR I-00, see *supra*.

[777] For a detailed analysis of the concept of *abus de droit* and its applicability in the context of the EU VAT system, see P. Harris, "*Abus de droit* in the Field of Value Added Taxation", (2003) *BTR*, 2, pp. 131-152.

[778] See cases 125/76, *Cremer*, [1977] ECR 1593; and C-8/92, *General Milk Products*, [1993] ECR I-779.

[779] Case C-110/99, [2000] ECR I-1569, paragraphs 52 and 53.

[780] The terminology adopted seems to be dependent on whether you work in the private or the public sector: VAT practitioners and VAT consultants working in the private sector tend to use "aggressive VAT planning"; whilst national tax administrations, EU institutions, or VAT experts working in the public sector tend to use the term "VAT avoidance". This highlights the different perspectives adopted by these sectors: J. Somers expresses the view of most VAT consultants by pointing out "tax consultants would not be doing their job if they did not give their clients the best possible way of minimising VAT costs, within the legal framework", *The Importance of EU VAT – A Practitioner's Perspective*, guest lecture, Trinity College Dublin, School of Law, 21 April 2005; on the other hand, the view that VAT avoidance is an illegitimate and damaging practice, which should be combated, has been expressly stated by the Chairman of HM Customs and Excise, R. Broadbent: "Our view is that contrived tax avoidance schemes impose costs on everyone.[...] it is a damaging activity", in "VAT compliance in the 21st century", (2003) *BTR* 2, p. 127.

[781] As B. Terra and J. Kajus have pointed out "the abuse of rights principle is currently the most debated in terms of VAT principles", in *A Guide to the European VAT Directives, op. cit.*, Volume 1. The controversy is however not limited to the VAT area. In the recent *Chen* case, which concerned potential abuse of free movement of persons rules, Advocate-General Tizzano refused to elevate the doctrine of abuse of rights to Community level stating "for my part, however, I am unable to endorse that view,and would be the case even if I were to disregard the reservations of a general nature prompted by the transposition to Community level of a concept whose existence is a matter

where Customs and Excise initiated a policy of relying on *Emsland-Starke* in cases before the VAT tribunals involving aggressive VAT planning.[782] Ultimately, this approach has lead to several references being made to the Court of Justice, which focused on the possible applicability of the principle of abuse of rights within the area of VAT.

The most famous cases in this respect are the joint cases *Halifax*, *BUPA* and *University of Huddersfield*.[783] These three cases have the following in common:

— they all originated in the United Kingdom courts;[784]

— they all involved taxpayers who were either partially or totally exempt;

— they all involved transactions entered into for the exclusive, or main, purpose of gaining a tax advantage in terms of their right to deduct input VAT; and[785]

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of dispute in national legal systems of law and of which the definition is even less clear", Opinion of Advocate-General in case C-200/02, [2004] ECR I-000, paragraph 111. Although, as J.Y. Carlier points out "in *Chen* the question of abuse of law was maybe more important than that of the purely internal situation", the Court did not examine the issue in detail, limiting itself to follow the opinion expressed by the Advocate-General, see "Case C-200/02, *Kunqian Catherine Zhu, Man Lavette Chen v Secretary of State for the Home Department*", (2005) *CMLRev.* 42, p. 1127.

[782] It might seem somehow strange that this is the case considering that the notion of *abus de droit* does not exist within the British domestic laws, however, that is probably one of the reasons why it has become such an important issue., as P. Harris points out, see *op. cit.*, p. 139. There are however other reasons. Firstly, Customs & Excise Commissioners have been taking a particular strong (and visible) approach to the aggressive VAT planning phenomenon as expressed by R. Broadbent, see *op. cit.*, p. 127. This view is reinforced by the Commissioners' reaction to some of the UK Courts decisions on this matter, as described by D. Ladds and M. Chowdry, see "Debenhams Retail plc v Commissioners of Customs and Excise", (2004) *BTR* 1, pp. 32-33. Secondly, as the Commissioners' Chairman, R. Broadbent, has himself pointed out, the UK has "probably one of the most advanced and creative tax professions in Europe"; moreover, he adds "this activity [aggressive VAT planning] is practitioner driven", *op. cit.*, pp. 125 and 128.

[783] Joint cases C-255/02, C-419/02, and C-223/03, [2005] ECR I-00. In *RAL* the Court of Justice was asked whether there was a principle of abuse of rights in Community law which was applicable in the field of VAT, however both the Court and the Advocate-General opted not to deal with the matter, preferring rather to apply Article 9(2)(c) Sixth Directive to the case, case C-452/03, *RAL*, [2005] ECR I-000. Equally, in *Centralan* the potential application of a principle of abuse of rights was raised by the Commission during the Court's proceedings. However, although implicitly acknowledging the existence of aggressive VAT planning, or VAT avoidance, ultimately Advocate-General Kokott deemed it superfluous to analyse whether the principle of abuse of rights applied, preferring to adopt a purposive interpretation of Article 20(3) Sixth Directive, see Opinion of Advocate-General Kokott in case C-63/04, [2005] ECR I-000, paragraph 61. The case is still awaiting the Court's ruling.

[784] *Halifax* and *BUPA* were referred by the High Court of Justice of England and Wales following extremely controversial decisions from the London VAT and Duties Tribunal, see *Halifax plc v Customs & Excise Commissioners*, (2001) VAT Decision 17124 and *BUPA Hospitals Ltd and Goldsborough Developments Ltd v Customs & Excise Commissioners* (2002) VAT Decision 17588; whilst *University of Huddersfield* was referred by the Manchester VAT and Duties Tribunal.

[785] The facts of the main proceedings can be summarised as follows: Halifax is a banking company and as such the vast majority of its supplies are exempt financial services. Halifax wished to construct "call centres" for the purposes of its business at four different sites located in the United Kingdom on land leased or owned by Halifax. By virtue of the apportionment of tax rule in Article 17(5), Halifax could have recovered only 5% of the VAT paid on their building works. However, following advice from their tax advisers, Halifax set up a scheme whereby it was able to recover effectively the full amount of input VAT incurred on the building works through a series of transactions involving different companies in the Halifax group. BUPA is part of a group of companies in the business of running private hospitals. Until 1998 BUPA supplies were considered zero-rate, and as such BUPA was allowed to recover the totality of its input VAT. However, on that date the United Kingdom Government announced its intention to bring in legislation to exclude such supplies from zero-rating and apply to them the regime normally applicable to medical supplies, *i.e.*, exemption. In the period between the Government's announcement and the entry into force of the new legislation, the BUPA group devised and set up a series of transactions consisting of prepayment arrangements. The idea was to pay in advance for a large quantity of unspecified drugs and prostheses before the entry into force of the new legislation. The prepayment

— finally, in all cases the Court was essentially asked, firstly whether transactions carried out with the sole purpose of enabling input tax to be recovered may constitute an "economic activity" within the meaning of Article 4(2) Sixth Directive; secondly, whether the doctrine of abuse of rights applied in the field of VAT.

Last April Advocate-General Poiares Maduro delivered his long-awaited Opinion in these joint cases.[786] To the relief of most VAT practitioners the Advocate-General rejected the view adopted by the Commissioners for Customs & Excise, also known as the "Halifax doctrine", that transactions carried out with the sole purpose of enabling input tax to be recovered do not constitute an "economic activity" within the meaning of Article 4(2) Sixth Directive.[787] He considered that the term "economic activity" for the purposes of that provision "should be interpreted as meaning that each transaction at issue must be considered objectively and *per se*. In that regard, the fact that a supply is made with the sole intention of obtaining a tax advantage is immaterial".[788] However, Advocate-General Poiares Maduro did adopt the view that a general principle of prohibition of abuse of Community law applied to the field of VAT,[789] sparking intense controversy.[790]

According to the Advocate-General, in order to determine the existence of abuse the following "two-part test" should apply: firstly, the right invoked derives from economic

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arrangements enabled BUPA to recover all input tax on its purchases. The University of Huddersfield is a Higher Education Corporation that makes exempt supplies of education services. The University wished to refurbish two buildings in which it had bought a leasehold estate. By nature of its supplies, the input VAT incurred by the University on the refurbishing costs would be limited to a recovery rate that amount to approx. 14.5% in 1996 and which has since then fallen to approx. 6%. However, following advice from its tax advisers, the University set up a scheme which would enable it to recover the full amount of VAT input on the renovation works through a series of transactions involving separate legal persons.

[786] In fact there was a two-month delay on the delivery of the Advocate-General's Opinion, which was initially due for February 2005 but was in fact only released in April 2005. This delay is perhaps symptomatic of the controversial nature of applying a principle of abuse of rights to the VAT area. Further evidence of the difficulties posed by these cases are the fact that the Court was sitting as a full Court at the joint hearing, and that *Halifax and BUPA*, which were referred by the UK courts in 2002, are still awaiting the Court of Justice's decision, whilst the Court has already issued decisions in all other VAT related cases entering the Court's register during that year.

[787] See the approving comments of P. Brennan in "Why the ECJ Should Not Follow Advocate General Maduro's Opinion in Halifax", (2005) *International VAT Monitor*, July/ August, p. 252.

[788] Paragraph 58 of the Advocate-General's Opinion.

[789] The Advocate-General considered that "it was difficult to conceive the common system of VAT as a sort of abuse-free domain within the Community legal system" and therefore he saw "no reason, in short, why the VAT rules should not be interpreted in accordance with the general principle of the prohibition of abuse of Community law", paragraphs 73 and 76 of the Opinion. However, he preferred the use of the term "prohibition of abuse of Community law", instead of "abuse of rights", arguing that the later term can be misleading, see paragraph 70 of the Opinion.

[790] In fact, rarely, if ever, have practitioners reacted so quickly and so strongly to an Advocate-General's Opinion on a VAT case. For a practitioners' perspective see amongst others: M. Desborough-Hurst, "What the Advocate-General's opinion in Halifax means", (2005) *International Tax Review*, June, International Updates; A. Brown, "VAT avoidance post Halifax", (2005) *International Tax Review*, October, Indirect Taxes Supplement; and in particular P. Brennan, *op. cit.*, pp. 247-254. For a Revenue reaction see F. Daly, "Same Game-Different Goals – Revenue and Tax Practitioners", Paper presented at the *KPMG Tax Conference*, Dublin, 4 November 2005; and J. Feehily's Key note address at the conference on *Topical Developments in VAT Law*, organised by the Irish Centre for European Law, Dublin, 15 July 2005. The Advocate-General's Opinion has also been subject of discussion at various tax conferences held in the last few months, e.g. *Topical Developments in VAT Law*, organised by the Irish Centre for European Law, Dublin, 15 July 2005; *Taxation in a Changing World*, organised by Tax Research Network, Edinburgh, 8-9 September 2005; *VAT and Property 2005*, organised by Lexis-Nexis, London, 13 October 2005; *VAT and the Internal Market: An Update*, organised by the European Law Academy, Trier, 24-25 November 2005. Moreover, the opinion has even been the subject of media attention, see I. Griffiths "EU tax could cost Treasury £1bn", *The Guardian*, 8 April 2005.

activities for which there is objectively no other explanation than the creation of the right claimed (*element of autonomy or subjective element*); secondly, the aims and results pursued by the legal provisions formally giving rise to the tax advantage invoked would be frustrated if that right were conferred (*teleological or objective element*).[791]

In practice, however establishing the existence of either of these elements will be far from easy.

The first element, the *element of autonomy or subjective element*, corresponds loosely to what is generally accepted to be aggressive tax planning or tax avoidance: transactions whose main objective is to obtain a tax advantage.[792] However, demonstrating that there is "objectively no other explanation" for a given transaction other than obtaining a tax advantage might prove difficult: taxpayers will undoubtedly seek to argue that the transactions in question had commercial purposes other than obtaining tax advantages. In fact this argument has already been used by the RAL Group and the University of Huddersfield;[793] therefore, it seems likely that, should the Court uphold the decision of the Advocate-General, the taxpayers' emphasis on this line of argument will increase. Difficulties applying the test will then arise: the test as set out by the Advocate-General requires that obtaining a tax advantage is the sole objective of the transaction, but what if obtaining a tax advantage was the primary objective, but other secondary commercial factors were taken also into consideration? When can a transaction be said to have "objectively no other explanation" other than obtaining a tax advantage?

The second element, the *teleological or objective element*, will not be easy to establish either. If the discussion concerning the first element will be centred on the factual situation, the difficulties regarding the second element will most likely be of a legal nature. Undertaking a teleological interpretation of the EU VAT rules for the purposes of establishing the existence of abuse, might prove to be an arduous task. This is mostly because whenever the Court engages in teleological interpretation of these rules, it tends to do so, on the basis of the general principles of the EU VAT system, such as fiscal neutrality, VAT as a tax on consumption and right to deduct; or more rarely, on the general principles of Community law. However, it could be argued – and is likely taxpayers will seek to do so – that the VAT rules in question are themselves inconsistent with these principles. In fact, taking *Halifax*, *BUPA* and *University of Huddersfield* as an example, the VAT rules allegedly abused in those cases where the rules limiting the right to deduct when exemptions apply. It could be argued that these rules, by treating traders as *de facto* final consumers, creating tax cascading and encouraging self-supplies, are

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[791] Paragraph 86 of the Advocate-General's Opinion.

[792] As R. Broadbent comments "there is a grey area: is the planning aggressive or not? There are schemes that are artificial. Normally when you talk to people they all say you cannot define it, but they all recognise an artificial or an aggressive scheme when they see it", in *op. cit.*, p. 127.

[793] See *RAL (Channel Islands) Ltd, RAL Ltd, RAL Services Ltd, RAL Machines Ltd v Customs & Excise Commissioners* (2002) VAT Decision 17914, paragraphs 18, 19 and 199; and Opinion of the Advocate-General in *Halifax*, *BUPA* and *University of Huddersfield*, paragraphs 34-35. Surprisingly, Halifax accepted that the arrangements had been structured so as to achieve an advantageous fiscal result, see *Halifax plc v Customs & Excise Commissioners*, (2001) VAT Decision 17124, paragraph 24. The decision to concede in this point, prior to the Court's hearing, has been criticised by R. Pincher, see "What is avoidance", (2002) *BTR* 1, p. 10.

themselves in contravention of the basic principles of VAT as a tax on consumption, fiscal neutrality and right to deduct.

Ultimately, the likelihood is that, if the Court's upholds the Advocate-General's Opinion, this will give rise to the emergence in the near future of a whole body of case-law regarding the application of this abuse test.

The root problem lies in the fact that the complexity and ambiguity surrounding the current EU VAT provisions provide ample scope for manipulation. From a trader's perspective the potential savings from implementing aggressive VAT planning schemes or VAT avoidance schemes – especially in the short-term – are sufficient to compensate for the risk of being challenged by the national tax authorities. Moreover, these type of schemes trade on the well-known difficulties of approving new VAT legislation at Community level.[794]

In this context, it seems clear that aggressive VAT planning or VAT avoidance schemes will continue to emerge and the Court will continue to be faced with the almost impossible task of resolving these problems whilst plugging the gaps of the current EU VAT system. If the Court upholds the Opinion of the Advocate-General in *Halifax*, *BUPA* and *University of Huddersfield* and apply the principle of abuse of rights to the area of VAT this will represent further evidence of the lengths to which the Court is willing to go in order to accomplish that task as well as a further progression in its attempts to curtail VAT avoidance schemes.

The difficulty, however, lies in the fact that the Court of Justice's solutions to this type of aggressive VAT planning must contend with the general challenges and shortcomings of finding a jurisprudential solution to what is essentially a legislative problem. In particular there is a serious risk of compromising the principle of legal certainty.[795] At present it is unavoidable to draw the conclusion that if the Court upholds the Opinion of the Advocate-General in *Halifax*, *BUPA* and *University of Huddersfield*, further progress in curtailing VAT avoidance schemes will be achieved at the expense of legal certainty.[796]

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[794] RAL Group's external tax advisers summarised the problems and challenges faced by the EU VAT system (inadvertently) in a letter to the RAL Group dated June 2000, where they stated: "1.1 The restructuring recommended [...] could result in a gross saving of the VAT on the machine takings estimated to be £4,200,000 per annum based on current trading patterns. [...] 1.3. In our view HM Customs & Excise will regard these planning arrangements as 'unacceptable tax avoidance' and will seek to challenge the arrangements. However, a similar concept for telecommunications ran for nearly four years in most Member States of the EU before the UK, French and German Governments secured the unanimous agreement of all 15 Member States to amend the primary legislation and stop the concept. 1.4. Since at the moment we are not aware of any widespread use of these planning arrangements, and the fact that some EU Member States do not charge VAT on gaming machines income, unanimous agreement to amend EC legislation could be difficult to achieve", *RAL (Channel Islands) Ltd, RAL Ltd, RAL Services Ltd, RAL Machines Ltd v Customs & Excise Commissioners* (2002) VAT Decision 17914, paragraph 22.

[795] For a different opinion on this matter, see P. Farmer, who comments "does the principle of legal certainty or legitimate expectations require a more formal approach in the VAT context? It is difficult to see why it should", in "VAT Planning: Assessing the 'Abuse of Rights' Risk", *The Tax Journal*, 27 May 2002, p. 17.

[796] As Lord Hoffmann comments: "The lesson, in my opinion, is that tax avoidance in the sense of transactions successfully structured to avoid a tax which Parliament intended to impose should be a contradiction in terms. The only way in which Parliament can express an intention to impose a tax is by a statute which means that such a tax is to be imposed. If that is what Parliament means, the

### ii) ASSESSMENT OF COURT OF JUSTICE INTERPRETATIVE METHODS ON VAT CASES – LIMITED BY LEGISLATION

The analysis undertaken *supra* highlighted the fact that, despite the steady increase since the nineties on the number of principle-based decisions coming from the Court of Justice in relation to VAT, the overall number is still limited. [797] Notwithstanding this, recent judgments emerging from the Court, such as *Ampafrance and Sanofi* and *Commission v France*, have demonstrated that considerable progress and development of the EU VAT system can be achieved through principle-based jurisprudential decisions.[798] Moreover, these judgments constitute a prime example of what has been designated as the "use of normative supranationalism to overcome the deficiencies of decisional supranationalism".[799] In this context, the question which has to be asked is whether further application by the Court of Justice of VAT principles and general principles of Community law could resolve the difficulties raised by the current EU VAT system, which were highlighted in Chapter 3. For example, arguably the inter-jurisdictional arrangements currently applicable to intra-Community trade are contrary to the principle of fiscal neutrality[800] – could the Court resolve the problems raised by these arrangements through the application of the principle of fiscal neutrality?

In other areas, namely direct taxation, the Court is arguably attempting to resolve the problems which arise in the context of lack of harmonisation by developing a "jurisprudential system" based on the application of general principles of Community law, such as the principle of non-discrimination. What is preventing the Court from adopting a similarly "radical" approach within the area of VAT? Paradoxically it seems the existence of a Community VAT legal system. In fact, within the area of VAT, as opposed to the legal situation within direct taxation, the Court is limited by the existence of a detailed, extensive legislation, which implies that more often than not, a principle-based decision, such as the suggested application of the principle of fiscal neutrality to inter-jurisdictional arrangements, would be contrary to the wording of Community legal provisions.[801] This

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courts should be trusted to give effect to its intention. Any other approach will lead us into dangerous and unpredictable territory", in "Tax avoidance", (2005) *BTR* 2, p. 206.

[797] It has been suggested by I. Roxan that in *Belgocodex* the Court established parameters as to how far it was willing to go in terms of teleological interpretation of VAT provisions and the application of VAT principles, case C-381/97, [1998] ECR I-8153. See "A limit on the purposive interpretation of VAT Directives – Belgocodex v Belgium", in (2000) *BTR* 5, pp. 585-590.

[798] Joint cases C-177/99 and C-181/99, *Ampafrance and Sanofi*, [2000] ECR I-7013; and case C-481/98, *Commission v France*, [2001] ECR I-3369, as regards the right to deduct input tax and in relation to application of reduced VAT rates, respectively. Moreover, recent cases such as *Marks & Spencer* and *Commission v Germany*, have been decided by the Court solely on the basis of the VAT principles and general principles of Community law – cases C-62/00, *Marks & Spencer*, [2002] ECR I-6325; and C-109/02, *Commission v Germany*, [2003] ECR I-00.

[799] P. Craig, *op. cit.*, p. 7. The sentence is used in the context of the Court's jurisprudence regarding the freedom of establishment and Article 43 of the EC Treaty, but undoubtedly the same can be said of the Court's jurisprudence in relation to VAT.

[800] See Chapter 3.

[801] This approach seems to be supported by an analysis of the Court's jurisprudence, which as pointed out by I. Roxan, suggests that "the Court takes a one-sided view of the relationship between the First and Sixth Directives: it will use the First Directive to support the Sixth Directive but not to overrule it", in in *op. cit.*, (2000) *BTR* 5, p. 589.

would no longer be interpretation, but rather revocation of legal provisions,[802] which even if acceptable would give rise to other problems, such as legal vacuum, as the Court cannot introduce a substitute system. This and other issues are analysed *infra* when discussing the shortcomings of jurisprudential developments vs. legislative measures.

### b) JURISPRUDENTIAL DEVELOPMENTS VS. LEGISLATIVE MEASURES

Additionally to the difficulties highlighted *supra* as regards the existence within the area of VAT of a detailed legislative body, a potential resolution by the Court of Justice of the problems raised by the current EU VAT system would have to contend with the general challenges and shortcomings of a jurisprudential solution as opposed to a legislative one. Amongst these challenges are the problems of negative harmonisation or integration, and complexity and factual minutia.

Negative harmonisation

As discussed above, the jurisprudence of the Court of Justice can, and has to some extent, been an instrument of harmonisation and integration within the EU VAT system. However, by its own nature this harmonisation or integration can only be negative, *i.e.*, the Court can remove practices and measures which are contrary to the principles of the EU VAT system or to general principles of Community law, but it cannot introduce new practices or measures which will be compatible with those principles.

In this context, a more radical attempt by the Court to resolve the problems of the EU VAT system could ultimately lead to a legal vacuum. In fact, taking the example given above regarding the current inter-jurisdictional arrangements, if the Court ruled that the current set-up was contrary to the principle of fiscal neutrality, that would remove the obstacle which the current arrangements represent, but it would leave the Community legal system with no arrangements in place, as the Court could not introduce new ones. New inter-jurisdictional arrangements could only be introduced by legislative measures.

These jurisprudential limitations are not exclusive to VAT and the problem of negative integration has already been highlighted in relation to the Court's jurisprudence on direct taxation.[803]

Complexity, factual minutia and legal uncertainty

Additionally to the issue of negative harmonisation, the impact within the EU VAT system of the emerging jurisprudence of the Court of Justice faces another limitation: decisions of the Court of Justice are just that, decisions, and as such are based on a given set of facts. As general as the Court tries to be in its judgments, Court decisions are by their

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[802] In the terminology of T.C. Hartley, "rulings contrary to the text". Analysing the relationship between legal rules and legal rulings of the Court of Justice, the author suggests a distinction between rulings within the text, rulings outside the text and rulings contrary to the text, see "The European Court, Judicial Objectivity and the Constitution of the European Union", (1996) *The Law Quarterly Review* 112, pp.96 *et seq.*

[803] See M. Gammie, "The compatibility of 'national tax principles of the Member States' with a fully integrated market", in paper presented at the European Tax Law Professors Annual Conference *on Fundamental Freedoms and National Tax Sovereignty in EU*, Paris, June 2004; and D.W. Williams, "*Asscher*: the European Court and the Power to Destroy", in *ECTR* 1997/4.

own nature concrete and specific, as opposed to legislation which is naturally general and abstract. Consequently, extrapolating general principles from the Court's decisions and applying those to distinct factual scenarios is a dangerous task. Not solely because given a distinct set of facts the Court might have decided differently, but equally because applying those principles to other circumstances might actually raise serious difficulties.

In this context, problems of complexity and factual minutiae proliferate. The introduction of a general principle in a given judgment will surely demand extra qualifications and explanations by the Court in future judgments. The tendency whenever the Court issues a decision based on a given set of circumstances, namely on controversial areas, such as exemptions and the right to deduct, is to request the Court to determine whether the same conclusion would apply if the circumstances were only slightly different. Whilst this practice has undoubtedly allowed the Court to develop certain areas of the EU VAT system, it also has created a complex set of case-law, where minimal factual details govern.[804]

In this scenario of complexity and factual minutiae the level of legal uncertainty grows and situations of potential abuse, where traders advised by VAT experts artificially "play" with the Court's judgments as a form of tax planning, flourish.

### c) IS THE COURT OF JUSTICE THE APPROPRIATE FORUM TO RESOLVE THE FAILINGS OF THE EU VAT SYSTEM? ACCUSATIONS OF JUDICIAL ACTIVISM

The analysis undertaken *supra* highlights the limitations faced by the Court in attempting to resolve the failings of the EU VAT system. However, assuming that the Court could overcome these limitations and resolve (at least some) of the difficulties of the current EU VAT system, the question is then whether it is appropriate for it to do so.

Since the mid-eighties, the Court of Justice has often been the target of criticisms by academic commentators who accused it of assuming powers which go beyond its judicial function and of adopting a quasi-legislative role.[805] The controversy surrounding the Court's so-called judicial activism[806] has mostly focussed on the Court's interpretation of the Treaties and the Court's approach to constitutional issues, such as the introduction of the principle of direct effect, giving rise to consequent passionate arguments from both the critics of the Court and its defenders.[807] Although the question of judicial activism as

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[804] As J. Swinkels recently commented "the case law of the ECJ, on one hand, provides clarifications on the existing provisions of the Sixth Directive but, on the other hand, also makes application of those provisions more difficult. Every ECJ judgment appears to give rise to new questions", in *op. cit.*, p. 246.

[805] One of the earliest commentators to adopt this perspective seems to have been H. Rasmussen in *On the Law and Policy in the European Court of Justice*, Martinus Nijhoff, 1986.

[806] Although, the use of term "judicial activism" is wide-spread, it has been criticised by T. Tridimas, *op. cit.*

[807] The arguments put forward by both parties will not be analysed here. For a critical view of the Court of Justice see H. Rasmussen, *op. cit.*; H. Rasmussen, "Between Self-Restraint and Activism: A Judicial Policy for the European Court", (1988) *ELRev.* 13, p. 28; P. O'Neill, "The European Court of Justice: A Case Study in Judicial Activism", Lords Selected Committee on the European Communities, Minutes of Evidence (Session 1994-95, 18th Report, H.L. Paper 88); T.C. Hartley, *The Foundations of European Community Law*, Fifth Edition, Oxford University Press 2003, pp. 79-

regards the Court's case-law on VAT has not (as yet) been raised by academic commentators,[808] it has been implicitly invoked by Member States' Governments in several cases, such as *Schul*, *Commission v United Kingdom* and *Commission v Ireland*.[809]

The problem seems to be that this issue has been predominantly approached from a political perspective, euro-sceptics vs. europhiles, rather than from a judicial one. Judicially, the Court is faced with an impossible task – to resolve the problems constantly emerging from an EU VAT system which is incompatible with the establishment and the efficient functioning of the Internal Market, whilst simultaneously trying to avoid accusations of judicial activism. In this context, the Court's role within the development of the EU VAT system has been extremely significant and in overall assessment, balanced, but ultimately its jurisprudential solutions can only be regarded as incomplete and temporary – it is the role of the legislature to efficiently and definitely resolve the endemic problems of the EU VAT system.

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83; and T.C. Hartley, *op. cit.* For a supportive view of the Court of Justice see M. Cappelleti, "Is the European Court of Justice 'Running Wild'?", (1987) *ELRev.* 12, p. 3; J. Weiler, "The Court of Justice on Trial", (1987) *CMLRev.* 24, p. 555; F. Mancini and Keeling, "Democracy and the European Court of Justice", [1994] *MLR* 57, p. 186; T. Tridimas, *op. cit.*; and A. Arnull, "The European Court and Judicial Objectivity: A Reply to Professor Hartley", (1996) *The Law Quarterly Review* 112, pp. 411-423. For an overview of the debate and the arguments put forward by both parties, see S. Douglas-Scott, *op. cit.*, pp. 210-224; and P. Craig and G. de Burca, *op. cit.*, pp. 96-102.

[808] This is not to say that the Court's overall jurisprudence on VAT has not been subject to criticisms, see L. Maublanc-Fernandez and J.P. Maublanc comments in "La Jurisprudence Communautaire relative a la TVA", in *Revue du March Commun et de l'Union Europeenne*, No. 380, juillet-aout 1994, pp. 460-470.

[809] Cases 15/81, *Gaston Schul*, [1982] ECR 1409; 415/85, *Commission v Ireland*, [1988] ECR 3097; and 416/85, *Commission v United Kingdom*, [1988] ECR 3127. In *Schul* the Member States maintained that "the establishment of a system ensuring the complete neutrality of internal taxation with regard to intra-Community trade could take place only by strict application of the principle of taxation in the Member State of destination and that would mean full remission of tax on all products at the time of exportation. It is for the political institutions of the Community to adopt such a solution since it involves a political choice", paragraphs 37. For an analysis of *Commission v United Kingdom* and *Commission v Ireland*, see *supra*.

# CONCLUSION

This thesis set out to prove that the current EU VAT system is incompatible with the concept of Internal Market, as set out in the EC Treaty and interpreted by the Court of Justice. Thirteen years since the entry into force of the transitional VAT system, with no expectations for the adoption of a definitive system, and in light of the new challenges facing the Community, it was considered timely to assess whether the current EU VAT legal system fulfils, or has the potential to fulfil through jurisprudential developments, the conditions of an Internal Market. To that effect legal analysis of the following key issues was undertaken: the concept of Internal Market (Chapter One); the historical development of the EU VAT system (Chapter Two); the practical problems currently generated by the EU VAT system (Chapter Three); and finally, the Court of Justice's jurisprudence in relation to VAT (Chapter Four).

The legal analysis of the concept of internal market was carried out with the principal objective of establishing the legal framework for this thesis. In order to prove that the current EU VAT system is incompatible with the internal market, it was necessary to establish *prima facie*, what actually is the Internal Market, particularly in light of the well-known vagueness of the term. This thesis did not aspire to provide an exhaustive analysis of the concept (which would require a separate doctoral study in itself),[810] instead concentrating on the aspects of the concept which have direct implications for the Community's VAT policy. In this context, the inextricable linkage between the concept of internal market and the White Paper programme was emphasised. It was equally demonstrated that by virtue of the Court of Justice's case law, the concept has been expanded to include not only an area without internal frontiers where the free movement of factors of production is ensured (as set out in the EC Treaty), but also undistorted competition. Moreover, although Article 14 of the EC Treaty does not have direct effect, it does establish an obligation upon the Community to adopt legislation with the aim of establishing and improving the functioning of the internal market. Finally, it was demonstrated that the concept of internal market demands a high level of Community intervention and a low level of flexibility within the VAT area, requirements which can be characterised as following a mitigated centralised model of economic constitution.

The objective of the review of the historical development of the EU VAT system was two-fold: firstly to highlight the fundamental role which harmonisation of turnover taxes has played within the European integration process; and secondly, to demonstrate that the minimum level of VAT harmonisation regarded as indispensable by the Commission in 1985 for the establishment of the internal market has never been achieved. In this context, it was demonstrated that, since its inception, the common VAT system has been depicted as an effective fiscal vehicle for key integrational objectives, namely ensuring fiscal neutrality, eliminating distortions to competition, and, eventually, abolishing the imposition of tax on imports and the remission of tax on exports on intra-Community

[810] See for example A.A.M. Schrauwen, *Marche Interieur – Recherches sur une notion*, Doctorate Thesis, University of Amsterdam, 1997.

trade. It was equally shown that the VAT measures proposed by the Commission as part of the White Paper programme were regarded as too radical, and therefore an alternative system was approved, one which became known as the transitional VAT system. Furthermore, although it remains the ultimate aim, all Commission's attempts to introduce a definitive VAT system have so far failed.

The analysis of the practical difficulties which the current EU VAT system gives rise to is one of the main aspects of this thesis. Despite the importance of the historical argument, it is clear that had the transitional VAT system functioned efficiently, there would have been no grounds to question its compatibility with the Internal Market. Had this been the case, it would have been simply acknowledged that a lower level of harmonisation of VAT, than that initially envisaged by Community institutions, is necessary for the efficient functioning of the Internal Market. However, this was not the case. A brief overview of the current EU VAT legal system highlighted its vastness, complexity and consequent inefficiency. Moreover, in order to better illustrate the difficulties raised by the system, four key problematic areas were chosen for more focused analysis. Their examination demonstrated that current VAT inter-jurisdictional arrangements and the lack of convergence of VAT rates constitute obstacles to the establishment of the Internal Market. Conversely, application of different criteria on non-deductible input tax and the VAT treatment of public sector bodies, constitute, either direct or indirect, obstacles to the functioning of the Internal Market.

Finally, examination of the case-law of the Court of Justice in relation to VAT was undertaken with the main objective of demonstrating that the practical difficulties arising from the EU VAT system cannot be overcome through jurisprudential developments. Rather, they can only be resolved by way of substantive legislative amendment. Similar to the previous analysis of practical implications of the EU VAT legal system, the examination of the VAT case-law of the Court of Justice was a central and fundamental aspect of this thesis. Notwithstanding the difficulties caused by the current system, there would have been no basis to advocate legislative amendment, had it been clear that these difficulties could be effectively resolved through the intervention of the Court of Justice. However, as this thesis demonstrated this did not prove to be the case. In spite of the vast array of VAT issues which the Court has deliberated upon, it has been largely unable to resolve the deep-rooted problems of the EU VAT system. Moreover, analysis of the interpretative methods applied by the Court to VAT cases, namely teleological interpretation and principle-based decisions, provided an insight into the impossible task with which it is faced, that of providing jurisprudential solutions to what are essentially legislative problems. Even where the Court has attempted to do so, this thesis has shown that the solutions provided are crippled with both legal and political shortcomings.

Various conclusions emerge from the research described above. Firstly, Article 14 EC Treaty includes an obligation on the Community to both remove obstacles to the free movement of goods and services, and eliminate distortions of competition. Secondly, the current EU VAT system has failed to reach the minimum level of harmonisation

historically regarded as a pre-requisite for the establishment of the Internal Market. Thirdly, the current system gives rise to serious difficulties which, from a practical perspective, constitute obstacles not merely to the functioning of the Internal Market but to its very establishment. Finally, these obstacles cannot be overcome through incremental developments emerging from the Court of Justice but can only be removed through fundamental and substantive legislative amendment. On the basis of these findings, it is submitted that the current EU VAT legal system does not fulfil, nor does it have the potential to fulfil through jurisprudential development, the conditions of an Internal Market.

By demonstrating the incompatibility of the current EU VAT system with the concept of Internal Market, this thesis aspires to provide an effective theoretical framework for future studies of EU VAT law as well as a research template for the analysis of other aspects of the internal market. Moreover, it is hoped that it will make a positive contribution to the ongoing debate over reform of the EU VAT system. The various difficulties highlighted within this research are already sufficient evidence in support of radical legislative amendment as the only effective remedy to the system's current malaise. However, recent developments, both internal and external to the EU VAT system, have transformed legislative intervention from the rational course of action into an urgent imperative.

Internally, the difficulties faced by the Court of Justice in providing solutions to the problems of the EU VAT system have been brought under the spotlight by recent cases regarding aggressive VAT planning. Recent and imminent rulings in cases such as *RAL*,[811] *Halifax*, *BUPA* and *University of Huddersfield*[812] have sparked intense controversy over the eventual application of a jurisprudential principle of abuse of rights to the VAT area. However, application of such a principle by the Court would run the risk of further undermining an already crippled EU VAT system. Not only would it raise serious concerns over compromising legal certainty, but it would also constitute an implicit admission of failure regarding the possibility of resolving the problems of this system through traditional interpretative means. It can be argued that these cases are therefore a paradigm of the current EU VAT system, highlighting both its inherent shortcomings, as well as the inadequacies of dealing with these shortcomings through jurisprudential means.

Externally, it has been demonstrated that the difficulties arising from the current EU VAT system have been intensified by the new challenges faced by the EU, such as EMU and enlargement. Concurrently, these new challenges, and the Lisbon Strategy in particular, have heightened the sense of urgency in overcoming those difficulties. Reform of the current EU VAT system can play a fundamental role in transforming the EU into "the most competitive and dynamic knowledge-based economy in the World". Therefore, it is up to Member States to break with transition, by taking the political lead. In 1985, when

[811] Case C-452/03, [2005] ECR I-000.
[812] Joint cases C-255/02, C-419/02, and C-223/03, [2005] ECR I-00.

launching the internal market programme, the Commission appealed directly to the political will of the Member States:

> "What this White Paper proposes therefore is that the Community should now take a further step along the road so clearly delineated in the Treaties. To do less would be to fall short of the ambitions of the founders of the Community, incorporated in the Treaties; it would be to betray the trust invested in us; and it would be to offer the peoples of Europe a narrower, less rewarding, less secure, less prosperous future than they could otherwise enjoy. That is the measure of the challenge which faces us. Let it never be said that we were incapable of rising to it."[813]

Insofar as VAT is concerned, these words are truer now than ever before.

[813] White Paper, p. 55.

# ANNEXES

## ANNEX 1

## PLACE OF SUPPLY RULES

| | TYPE OF TRANSACTION | RULES | PLACE OF SUPPLY | LEGAL BASIS SIXTH VAT DIRECTIVE |
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| **PLACE OF SUPPLY OF GOODS** | *INTRA-COMMUNITY SUPPLIES* | **General rule**. In the case of goods not dispatched or transported, the place of supply of goods shall be deemed to be the place where the goods are when the supply takes place. | Member State where the goods are when the supply takes place. | Article 8(1)(b) |
| | | **Goods dispatched or transported** either by the supplier or by a third person: the place of supply shall be deemed to be the place where the goods are at the time when dispatched or transport to the person to whom they are supplied begins. | Member State where the dispatch or transport of goods begins. | Article 8(1)(a) |
| | | **Goods dispatched or transported** by or on behalf of the supplier from a Member State other than that of arrival of the dispatch or transport: the place of supply shall be deemed to be the place where the goods are when dispatch or transport to the purchaser ends, where the following conditions are fulfilled:<br>• the supply of goods is effected for a taxable person eligible for | Member State where the dispatch or transport ends. | Article 28b(B)(1) |

the derogation provided for in the second subparagraph of Article 28(1)(a), for a non-taxable legal person who is eligible for the same derogation or for any other non-taxable person;

- the supply is of goods other than new means of transport and other than goods supplied after assembly or installation, with or without a trial run, by or on behalf of the supplier.

**Goods dispatched and transported**. Where the supply is of goods other than products subject to excise duty, Article 28b(B)(1) shall not apply to supplies of goods dispatched or transported to the same Member State of arrival of the dispatch or transport where:

- the total value of such supplies, less VAT, does not in one calendar year exceed the equivalent in national currency to ECU 100 000 and,
- the total value, less VAT, of the supplies of goods in the previous calendar year did not exceed the equivalent in national currency to ECU 100 000.

The Member State within the territory of which the goods are at the time of departure of the dispatch or transport shall grant those taxable persons who effect supplies of goods eligible under the above the right to choose that the place of such supplies shall be

In principle, Member State where the dispatch or transport of goods begins. However, it shall grant taxable persons eligible under this exception the right to choose that the place of supply will be the Member State where the dispatch or transport ends.

Article 28b(B)(2) and (3)

determined in accordance with paragraph 1.

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| **Goods installed and assembled**, with or without a trial run, by or on behalf of the supplier, the place of supply shall be deemed to be the place where the goods are installed or assembled. | Member State where the installation or assembling of goods is carried out. | Article 8(1)(a) |
| **Goods installed and assembled**. Where the installation or assembling is carried out in a Member State other than that of the supplier, the Member State within the territory of which the installation or assembly is carried out shall take any necessary steps to avoid double taxation in that State. | Both Member State of supplier and Member State within which the installation and assembling of goods is carried out, can tax the transaction. However, the latter State is obliged to take measures to avoid double taxation. | Article 8(1)(a) |
| **Goods supplied on board ships, aircrafts or trains** during the part of a transport of passengers effected in the Community: the place of supply shall be deemed to be at the point of the departure of the transport of passengers. | Member State from where the transport of passengers departed. | Article 8(1)(c) |
| **Natural gas and electricity**. In the case of the supply of gas through the natural distribution system, or of electricity, where such a supply is not to a taxable dealer, the place of supply shall be deemed to be where the consumer has effective use and consumption of the goods. Where all or part of the goods are not in fact consumed by this customer, these non consumed goods are | Member State where the consumer has effective use and consumption of the goods. | Article 8(1)(e) |

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| | deemed to have been used and consumed at the place where he has established his business or has a fixed establishment for which the goods are supplied. In the absence of such a place of business or fixed establishment, he is deemed to have used and consumed the goods at the place where he has his permanent address or usually resides. | | |
| *INTRA-COMMUNITY ACQUISITIONS* | **General rule**. The place of the intra-Community acquisition of goods shall be deemed to be the place where the goods are at the time when dispatch or transport to the person acquiring them ends. | Member State where the dispatch or transport ends. | Article 28b(A)(1) |
| | **Anti-double taxation rule**. The place of the intra-Community acquisition of goods shall be deemed to be within the territory of the Member State which issued the VAT identification number under which the person acquiring the goods unless the person acquiring the goods establishes that that acquisition has been subject to tax in accordance with paragraph 1's general rule.<br><br>If, however, the acquisition is subject to tax in accordance with paragraph 1 in the Member State of arrival of the dispatch or transport of the goods after having been subject to tax in accordance with the first subparagraph, the taxable amount shall be reduced accordingly in the Member State which issued the VAT identification number under which the person acquiring the goods | Member State which issued the VAT identification number of the person acquiring the goods.<br><br>However, this Member State will not tax the acquisition or a tax credit will be given if VAT has been paid under the general rule on the Member State where the dispatch or transport ended. | Article 28b(A)(2) |

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| | made the acquisition.<br><br>For the purposes of applying the first subparagraph, the intra-Community acquisition of goods shall be deemed to have been subject to tax in accordance with paragraph 1 when the following conditions have been met:<br><br>• the acquirer establishes that he has effected this intra-Community acquisition for the needs of a subsequent supply effected in the Member State referred to in paragraph 1 and for which the consignee has been designated as the person liable for the tax due in accordance with Article 28c(E)(3).<br><br>• the obligation for declaration set out in the last subparagraph of Article 22(6)(b) have been satisfied by the acquirer. | | |
| | **Gas and electricity**. In the case of the supply of gas through the natural gas distribution system, or of electricity, to a taxable dealer: the place where that taxable dealer has established his business or has a fixed establishment for which the goods are supplied, or, in the absence of such a place of business or fixed establishment, the place where he has his permanent address or usually resides. | Member State where the taxable dealer has its fixed establishment. | Article 8(1)(d) |
| *IMPORTS* | **Goods dispatched or transported**. Where the place of departure of the consignment or transport of goods is in a third territory, the place of supply by the importer and the place of any subsequent | Member State of import of goods. | Article 8(2) |

supplies shall be deemed to be within the Member State of import of goods.

**Goods dispatched or transported**. Where the following conditions are fulfilled:

- the supply of goods is effected for a taxable person eligible for the derogation provided for in the second subparagraph of Article 28(1)(a), for a non-taxable legal person who is eligible for the same derogation or for any other non-taxable person;
- the supply is of goods other than new means of transport and other than goods supplied after assembly or installation, with or without a trial run, by or on behalf of the supplier,

the goods dispatched or transported from a third country and imported by the supplier into a Member State other than the Member State of arrival of the goods dispatched or transported to the purchaser, they shall be regarded as having been dispatched or transported from the Member State of import.

Member State where the dispatch or transport ends. Article 28b(B)(1)

| | TYPE OF TRANSACTION | RULES | PLACE OF SUPPLY | LEGAL BASIS SIXTH VAT DIRECTIVE |
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| **PLACE OF SUPPLY OF SERVICES** | *ALL TRANSACTIONS (INTRA-COMMUNITY TRANSACTIONS; IMPORTS AND EXPORTS)* | **General rule**. The place of supply shall be deemed to be the place where the supplier has established his business or has a fixed establishment from which the service is supplied or, in the absence of such a place of business or fixed establishment, the place where he has his permanent address or usually resides. | Member State / third country where the supplier has a fixed establishment from which the service is supplied. | Article 9(1) |
| | | **Immovable property**. The place of supply of services connected with immovable property, including the services of estate agents and experts, and of services for preparing and coordinating construction works, such as the services of architects and of firms providing on-site supervision, shall be the place where the property is situated. | Member State / third country where the immovable property is situated. | Article 9(2)(a) |
| | | **Transport**. The place of supply of transport services shall be the place where transport takes place, having regard to distances covered. | Member State / third country where transport takes place. | Article 9(2)(b) |
| | | **Ancillary transport activities**. The place of supply of services relating to ancillary transport activities such as loading, unloading, handling and similar activities shall be deemed to be the place | Member State / third country where services are physically carried out. | Article 9(2)(c) |

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| where those services are physically carried out. | | |
| **Cultural, artistic, sporting, scientific, education, entertainment**. The place of supply of services relating to cultural, artistic, sporting, scientific, education, entertainment or similar activities, including the activities of the organisers of such activities, and where appropriate, the supply of ancillary services, shall be the place where those services are physically carried out. | Member State / third country where services are physically carried out. | Article 9(2)(c) |
| **Movable tangible property**. The place of supply of services relating to valuations and work on movable tangible property shall be the place where those services are physically carried out. | Member State / third country where services are physically carried out. | Article 9(2)(c) |
| **Use and enjoyment**. In order to avoid double taxation, non-taxation or the distortion of competition Member States may, with regard to the supply of services referred to in Article 9(2)(e) – reverse-charge mechanism – except for the services referred to in the last indent when supplied to non-taxable persons, and also with regard to the hiring out of forms of transport consider the place of supply of services, which under this Article would be situated within the territory of the country, as being situated outside the Community where the effective use and enjoyment of the services take place outside the Community. | Third country where effective use and enjoyment of the services takes place. | Article 9(3) |
| **Use and enjoyment**. In order to avoid double taxation, non- | Member State where effective use | Article 9(3) |

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| | taxation or the distortion of competition Member States may, with regard to the supply of services referred to in Article 9(2)(e) – reverse-charge mechanism – except for the services referred to in the last indent when supplied to non-taxable persons, and also with regard to the hiring out of forms of transport consider the place of supply of services, which under this Article would be situated outside the Community, as being within the territory of the country where the effective use and enjoyment of the services take place within the territory of the country. | and enjoyment of the services takes place. | |
| *INTRA-COMMUNITY TRANSACTIONS* | **Movable tangible property**. The place of supply of the hiring out of movable tangible property, with the exception of all forms of transport, when performed for taxable persons established in the Community but not in the same country of the supplier, shall be the place where the customer has established his business or has a fixed establishment to which the service is supplied or, in the absence of such a place, the place where he has his permanent address or usually resides. | Member State where the customer has a fixed establishment (reverse-charge mechanism). | Article 9(2)(e) |
| | **Movable tangible property**. By way of derogation from Article 9(2)(c), the place of supply of services involving valuation of or work on movable property, provided to customers identified for VAT purposes in a Member State other than the one where those services are physically carried out, shall be deemed to be in the | Member State which issued the customer with VAT identification number. | Article 28b(F) |

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| territory of the Member State which issued the customer with the VAT identification number under which the service was carried out for him.<br><br>This derogation shall not apply where the goods are not dispatched or transported out of the Member State where the services were physically carried out. | | |
| **Copyrights, patents, licences and trade marks**. The place of supply of transfers and assignments of copyrights, patents, licences, trade marks and similar rights, when performed for taxable persons established in the Community but not in the same country of the supplier, shall be the place where the customer has established his business or has a fixed establishment to which the service is supplied or, in the absence of such a place, the place where he has his permanent address or usually resides. | Member State where the customer has a fixed establishment (reverse-charge mechanism). | Article 9(2)(e) |
| **Advertising services**. The place of supply advertising services, when performed for taxable persons established in the Community but not in the same country of the supplier, shall be the place where the customer has established his business or has a fixed establishment to which the service is supplied or, in the absence of such a place, the place where he has his permanent address or usually resides. | Member State where the customer has a fixed establishment (reverse-charge mechanism). | Article 9(2)(e) |

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| **Consultancy services**. The place of supply of services of consultants, engineers, consultancy bureaus, lawyers, accountants, and other similar services, as well as data processing and the supplying of information, when performed for taxable persons established in the Community but not in the same country of the supplier, shall be the place where the customer has established his business or has a fixed establishment to which the service is supplied or, in the absence of such a place, the place where he has his permanent address or usually resides. | Member State where the customer has a fixed establishment (reverse-charge mechanism). | Article 9(2)(e) |
| **Obligations to refrain from exercising activity or right**. The place of supply of obligations to refrain from pursuing or exercising, in whole or in part, a business activity or a right referred in Article 9(2)(e), when performed for taxable persons established in the Community but not in the same country of the supplier, shall be the place where the customer has established his business or has a fixed establishment to which the service is supplied or, in the absence of such a place, the place where he has his permanent address or usually resides. | Member State where the customer has a fixed establishment (reverse-charge mechanism). | Article 9(2)(e) |
| **Financial transactions**. The place of supply of banking, financial and insurance transactions including reinsurance, with the exception of the hire of safes, when performed for taxable persons established in the Community but not in the same country of the | Member State where the customer has a fixed establishment (reverse-charge mechanism). | Article 9(2)(e) |

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| supplier, shall be the place where the customer has established his business or has a fixed establishment to which the service is supplied or, in the absence of such a place, the place where he has his permanent address or usually resides. | | |
| **Supply of staff**. The place of supply of staff, when performed for taxable persons established in the Community but not in the same country of the supplier, shall be the place where the customer has established his business or has a fixed establishment to which the service is supplied or, in the absence of such a place, the place where he has his permanent address or usually resides. | Member State where the customer has a fixed establishment (reverse-charge mechanism). | Article 9(2)(e) |
| **Agents**. The place of supply of services of agents who act in the name and for the account of another, when they procure for their principal the services referred in Article 9(2)(e), when performed for taxable persons established in the Community but not in the same country of the supplier, shall be the place where the customer has established his business or has a fixed establishment to which the service is supplied or, in the absence of such a place, the place where he has his permanent address or usually resides. | Member State where the customer has a fixed establishment (reverse-charge mechanism). | Article 9(2)(e) |
| **Telecommunications**. The place of supply of telecommunication services, when performed for taxable persons established in the Community but not in the same country of the supplier, shall be the | Member State where the customer has a fixed establishment (reverse-charge mechanism). | Article 9(2)(e) |

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| place where the customer has established his business or has a fixed establishment to which the service is supplied or, in the absence of such a place, the place where he has his permanent address or usually resides. | | |
| **Radio and television broadcasting**. The place of supply of radio and television broadcasting services, when performed for taxable persons established in the Community but not in the same country of the supplier, shall be the place where the customer has established his business or has a fixed establishment to which the service is supplied or, in the absence of such a place, the place where he has his permanent address or usually resides. | Member State where the customer has a fixed establishment (reverse-charge mechanism). | Article 9(2)(e) |
| **Electronically supplied services**. The place of supply of electronically supplied services, when performed for taxable persons established in the Community but not in the same country of the supplier, shall be the place where the customer has established his business or has a fixed establishment to which the service is supplied or, in the absence of such a place, the place where he has his permanent address or usually resides. | Member State where the customer has a fixed establishment (reverse-charge mechanism). | Article 9(2)(e) |
| **Natural gas and electricity**. The place of supply of the provision of access to, and of transport or transmission through, natural gas and electricity distribution systems and the provision of other | Member State where the customer has a fixed establishment (reverse-charge mechanism). | Article 9(2)(e) |

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| directly linked services, when performed for taxable persons established in the Community but not in the same country of the supplier, shall be the place where the customer has established his business or has a fixed establishment to which the service is supplied or, in the absence of such a place, the place where he has his permanent address or usually resides. | | |
| **Services in intra-Community transport of goods**. By way of derogation from Article 9(2)(b), the place of supply of services in the intra-Community transport of goods shall be the place of departure. | Member State from where transport departs. | Article 28b(C)(1) and (2) |
| **Services intra-Community transport of goods**. The place of supply of services in the intra-Community transport of goods rendered to customers identified for purposes of VAT in a Member State other than that of the departure of the transport shall be deemed to be within the territory of the Member State which issued the customer with the VAT identification number under which the service was rendered to him. | Member State which issued customer with VAT identification number. | Article 28b(c)(3) |
| **Intermediaries – Services intra-Community transport of goods**. By way of derogation from Article 9(1), the place of supply of services rendered by intermediaries, acting in the name and for the account of other persons, where they form part of the supply of | Member State from where transport departs. | Article 28b(E)(1) |

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| services in the intra-Community transport of goods, shall be the place of departure. | | |
| **Intermediaries – Services intra-Community transport of goods**. However, where the customer for whom the services rendered by the intermediary are performed is identified for purposes of VAT in a Member State other than that of the departure of the transport, the place of the supply of services rendered by an intermediary shall be deemed to be within the territory of the Member State which issued the customer with the VAT number under which the service was rendered to him. | Member State which issued customer with VAT identification number. | Article 28b(E)(1) |
| **Services ancillary to intra-Community transport of goods**. By way of derogation from Article 9(2)(c), the place of supply of services involving activities ancillary to the intra-Community transport of goods, rendered to customers identified for purposes of VAT in a Member State other than that within the territory of which the services are physically performed, shall be deemed to be within the territory of the Member State which issued the customer with the VAT identification number under which the service was rendered to him. | Member State which issued customer with VAT identification number. | Article 28b(D) |
| **Intermediaries - Services ancillary to intra-Community transport of goods**. By way of derogation from Article 9(1), the | Member State where the ancillary services are physically carried out. | Article 28b(E)(2) |

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| place of the supply of services rendered by intermediaries acting in the name and for the account of other persons, where they form part of the supply of services the purpose of which is activities ancillary to the intra-Community transport of goods, shall be the place where the ancillary services are physically performed. | | |
| **Intermediaries - Services ancillary to intra-Community transport of goods**. However, where the customer of the services rendered by the intermediary is identified for purposes of VAT in a Member State other than that within the territory of which the ancillary service is physically performed, the place of supply of the services rendered by the intermediary shall be deemed to be within the territory of the Member State which issued the customer with the VAT identification number under which the service was rendered to him by the intermediary. | Member State which issued customer with VAT identification number. | Article 28b(E)(2) |
| **Intermediaries**. By way of derogation from Article 9(1), the place of the supply of services rendered by intermediaries acting in the name and for the account of other persons, when such services form part of transactions other than those referred to in paragraph 1 or 2 or in Article 9(2)(e) – reverse-charge mechanism – shall be the place where those transactions are carried out. | Member State where main transactions are carried out. | Article 28b(E)(3) |
| **Intermediaries**. However, where the customer is identified for | Member State which issued the | Article 28b(E)(3) |

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| | purposes of VAT in a Member State other than that within the territory of which those transactions are carried out, the place of supply of the services rendered by the intermediary shall be deemed to be within the territory of the Member State which issued the customer with the VAT identification number under which the service was rendered to him by the intermediary. | customer with VAT identification number. | |
| *IMPORTS* | **Electronically supplied services**. The place of supply of electronically supplied services, when performed for non-taxable persons who are established, have their permanent address or usually reside in a Member State, by a taxable person who has established his business or has a fixed establishment from which the service is supplied outside the Community or, in the absence of such a place of business or fixed establishment, has his permanent address or usually resides outside the Community, shall be the place where the non-taxable person is established, has his permanent address or usually resides. | Member State where consumer is established. | Article 9(2)(f) |
| | **Telecommunications**. In the case of telecommunication services supplied by a taxable person established outside the Community to non-taxable persons established inside the Community, the place of supply shall be deemed to be the Member State within which territory the effective use and enjoyment of those services take | Member State where the use and enjoyment of the services take place. | Article 9(4) |

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| | place. | | |
| | **Radio and television broadcasting**. In the case of radio and television broadcasting services supplied by a taxable person established outside the Community to non-taxable persons established insider the Community, the place of supply shall be deemed to be the Member State within which territory the effective use and enjoyment of those services take place. | Member State where the use and enjoyment of the services take place. | Article 9(4) |
| *EXPORTS* | **Movable tangible property**. The place of supply of the hiring out of movable tangible property, with the exception of all forms of transport, when performed for customers established outside the Community, shall be the place where the customer has established his business or has a fixed establishment to which the service is supplied or, in the absence of such a place, the place where he has his permanent address or usually resides. | Third country where the customer has a fixed establishment (reverse-charge mechanism). | Article 9(2)(e) |
| | **Copyrights, patents, licences and trade marks**. The place of supply of transfers and assignments of copyrights, patents, licences, trade marks and similar rights, when performed for customers established outside the Community, shall be the place where the customer has established his business or has a fixed establishment to which the service is supplied or, in the absence of such a place, the place where he has his permanent address or | Third country where the customer has a fixed establishment (reverse-charge mechanism). | Article 9(2)(e) |

usually resides.

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| **Advertising services**. The place of supply advertising services, when performed for customers established outside the Community, shall be the place where the customer has established his business or has a fixed establishment to which the service is supplied or, in the absence of such a place, the place where he has his permanent address or usually resides. | Third country where the customer has a fixed establishment (reverse-charge mechanism). | Article 9(2)(e) |
| **Consultancy services**. The place of supply of services of consultants, engineers, consultancy bureaux, lawyers, accountants, and other similar services, as well as data processing and the supplying of information, when performed for customers established outside the Community, shall be the place where the customer has established his business or has a fixed establishment to which the service is supplied or, in the absence of such a place, the place where he has his permanent address or usually resides. | Third country where the customer has a fixed establishment (reverse-charge mechanism). | Article 9(2)(e) |
| **Obligations to refrain from exercising activity or right**. The place of supply of obligations to refrain from pursuing or exercising, in whole or in part, a business activity or a right referred in Article 9(2)(e), when performed for customers established outside the Community, shall be the place where the customer has established | Third country where the customer has a fixed establishment (reverse-charge mechanism). | Article 9(2)(e) |

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| his business or has a fixed establishment to which the service is supplied or, in the absence of such a place, the place where he has his permanent address or usually resides. | | |
| **Financial transactions**. The place of supply of banking, financial and insurance transactions including reinsurance, with the exception of the hire of safes, when performed for customers established outside the Community, shall be the place where the customer has established his business or has a fixed establishment to which the service is supplied or, in the absence of such a place, the place where he has his permanent address or usually resides. | Third country where the customer has a fixed establishment (reverse-charge mechanism). | Article 9(2)(e) |
| **Supply of staff**. The place of supply of staff, when performed for customers established outside the Community, shall be the place where the customer has established his business or has a fixed establishment to which the service is supplied or, in the absence of such a place, the place where he has his permanent address or usually resides. | Third country where the customer has a fixed establishment (reverse-charge mechanism). | Article 9(2)(e) |
| **Agents**. The place of supply of services of agents who act in the name and for the account of another, when they procure for their principal the services referred in Article 9(2)(e), when performed for customers established outside the Community, shall be the place | Third country where the customer has a fixed establishment (reverse-charge mechanism). | Article 9(2)(e) |

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| where the customer has established his business or has a fixed establishment to which the service is supplied or, in the absence of such a place, the place where he has his permanent address or usually resides. | | |
| **Telecommunications**. The place of supply of telecommunication services, when performed for customers established outside the Community, shall be the place where the customer has established his business or has a fixed establishment to which the service is supplied or, in the absence of such a place, the place where he has his permanent address or usually resides. | Third country where the customer has a fixed establishment (reverse-charge mechanism). | Article 9(2)(e) |
| **Radio and television broadcasting**. The place of supply of radio and television broadcasting services, when performed for customers established outside the Community, shall be the place where the customer has established his business or has a fixed establishment to which the service is supplied or, in the absence of such a place, the place where he has his permanent address or usually resides. | Third country where the customer has a fixed establishment (reverse-charge mechanism). | Article 9(2)(e) |
| **Electronically supplied services**. The place of supply of electronically supplied services, when performed for customers established outside the Community, shall be the place where the customer has established his business or has a fixed | Third country where the customer has a fixed establishment (reverse-charge mechanism). | Article 9(2)(e) |

establishment to which the service is supplied or, in the absence of such a place, the place where he has his permanent address or usually resides.

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| **Natural gas and electricity**. The place of supply of the provision of access to, and of transport or transmission through, natural gas and electricity distribution systems and the provision of other directly linked services, when performed for customers established outside the Community, shall be the place where the customer has established his business or has a fixed establishment to which the service is supplied or, in the absence of such a place, the place where he has his permanent address or usually resides. | Third country where the customer has a fixed establishment (reverse-charge mechanism). | Article 9(2)(e) |

## ANNEX 2

## GOODS / SERVICES WHICH MAY BE SUBJECT TO REDUCED VAT RATES

**IN ALL MEMBER STATES**

| SUPPLIES / IMPORTS OF GOODS / SERVICES | CONDITIONS | LEGAL BASIS SIXTH VAT DIRECTIVE |
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| **Foodstuffs** (including beverages but excluding alcoholic beverages) for human and animal consumption; live animals, seeds, plants and ingredients normally intended for use in preparation of foodstuffs; products normally intended to be used to supplement or substitute foodstuffs | ➢ Minimum 5% rate;<br>➢ Until the VAT definitive system is in force, Member States may continue to apply a reduced rate lower than 5% or a zero-rate, where these were the rates in force on 1 January 1991;<br>➢ Until the VAT definitive system is in force, Member States which were obliged to increase their standard rate, as applied at 1 January 1991, by more than 2%, may apply a reduced rate lower than 5%, but not zero-rate. | Article 12(3)(a)<br>Annex H<br>Article 28(2)(a)<br>Article 28(2)(c) |
| **Water** | ➢ Minimum 5% rate;<br>➢ Until the VAT definitive system is in force, Member States may continue to apply a reduced rate lower than 5% or a zero-rate, where these were the rates in force on 1 January 1991;<br>➢ Until the VAT definitive system is in force, Member States which were obliged to increase their standard rate, as applied at 1 January 1991, by more than 2%, may apply a reduced rate lower than 5%, but not zero-rate. | Article 12(3)(a)<br>Annex H<br>Article 28(2)(a)<br>Article 28(2)(c) |

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| **Pharmaceutical products** of a kind normally used for health care, prevention of diseases and treatment for medical and veterinary purposes, including products used for contraception and sanitary protection | ➢ Minimum 5% rate;<br>➢ Until the VAT definitive system is in force, Member States may continue to apply a reduced rate lower than 5% or a zero-rate, where these were the rates in force on 1 January 1991;<br>➢ Until the VAT definitive system is in force, Member States which were obliged to increase their standard rate, as applied at 1 January 1991, by more than 2%, may apply a reduced rate lower than 5%, but not zero-rate. | Article 12(3)(a)<br>Annex H<br>Article 28(2)(a)<br>Article 28(2)(c) |
| **Medical equipment**, aids and other appliances normally intended to alleviate or treat disability, for the exclusive personal use of the disabled, including the repair of such goods, and children's car seats | ➢ Minimum 5% rate;<br>➢ Until the VAT definitive system is in force, Member States may continue to apply a reduced rate lower than 5% or a zero-rate, where these were the rates in force on 1 January 1991;<br>➢ Until the VAT definitive system is in force, Member States which were obliged to increase their standard rate, as applied at 1 January 1991, by more than 2%, may apply a reduced rate lower than 5%, but not zero-rate. | Article 12(3)(a)<br>Annex H<br>Article 28(2)(a)<br>Article 28(2)(c) |
| **Transport of passengers** and their accompanying luggage | ➢ Minimum 5% rate;<br>➢ Until the VAT definitive system is in force, Member States may continue to apply a reduced rate lower than 5% or a zero-rate, where these were the rates in force on 1 January 1991. | Article 12(3)(a)<br>Annex H<br>Article 28(2)(a)<br>Article 28(2)(c) |

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| | ➢ Until the VAT definitive system is in force, Member States which were obliged to increase their standard rate, as applied at 1 January 1991, by more than 2%, may apply a reduced rate lower than 5%, but not zero-rate. | |
| **Books.** Supply, including on loan by libraries, of books (including brochures, leaflets and similar printed matter, children's picture, drawing and colouring books, music printed or in manuscript, maps and hydrographic or similar charts), newspapers and periodicals, other than material wholly or substantially devoted to advertising matter | ➢ Minimum 5% rate;<br>➢ Until the VAT definitive system is in force, Member States may continue to apply a reduced rate lower than 5% or a zero-rate, where these were the rates in force on 1 January 1991;<br>➢ Until the VAT definitive system is in force, Member States which were obliged to increase their standard rate, as applied at 1 January 1991, by more than 2%, may apply a reduced rate lower than 5%, but not zero-rate;<br>➢ Not supplied electronically. | Article 12(3)(a)<br>Annex H<br>Article 28(2)(a)<br>Article 28(2)(c) |
| **Cultural events.** Admission to shows, theatres, circuses, fairs, amusement parks, concerts, museums, zoos, cinemas, exhibitions and similar cultural events and facilities | ➢ Minimum 5% rate;<br>➢ Until the VAT definitive system is in force, Member States may continue to apply a reduced rate lower than 5% or a zero-rate, where these were the rates in force on 1 January 1991;<br>➢ Until the VAT definitive system is in force, Member States which were obliged to increase their standard rate, as applied at 1 January 1991, by more than 2%, may apply a reduced rate lower than 5%, but not zero-rate; | Article 12(3)(a)<br>Annex H<br>Article 28(2)(a)<br>Article 28(2)(c) |

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| | ➢ Not supplied electronically. | |
| **Broadcasting.** Reception of broadcasting services | ➢ Minimum 5% rate;<br>➢ Until the VAT definitive system is in force, Member States may continue to apply a reduced rate lower than 5% or a zero-rate, where these were the rates in force on 1 January 1991;<br>➢ Until the VAT definitive system is in force, Member States which were obliged to increase their standard rate, as applied at 1 January 1991, by more than 2%, may apply a reduced rate lower than 5%, but not zero-rate;<br>➢ Not supplied electronically. | Article 12(3)(a)<br>Annex H<br>Article 28(2)(a)<br>Article 28(2)(c) |
| **Artists.** Services supplied by or royalties due to writers, composers and performing artists | ➢ Minimum 5% rate;<br>➢ Until the VAT definitive system is in force, Member States may continue to apply a reduced rate lower than 5% or a zero-rate, where these were the rates in force on 1 January 1991;<br>➢ Until the VAT definitive system is in force, Member States which were obliged to increase their standard rate, as applied at 1 January 1991, by more than 2%, may apply a reduced rate lower than 5%, but not zero-rate;<br>➢ Not supplied electronically. | Article 12(3)(a)<br>Annex H<br>Article 28(2)(a)<br>Article 28(2)(c) |
| **Social housing.** Supply, construction, renovation and | ➢ Minimum 5% rate; | Article 12(3)(a) |

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| alteration of housing provided as part of a social policy | ➢ Until the VAT definitive system is in force, Member States may continue to apply a reduced rate lower than 5% or a zero-rate, where these were the rates in force on 1 January 1991;<br>➢ Until the VAT definitive system is in force, Member States which were obliged to increase their standard rate, as applied at 1 January 1991, by more than 2%, may apply a reduced rate lower than 5%, but not zero-rate. | Annex H<br>Article 28(2)(a)<br>Article 28(2)(c) |
| **Agricultural production**. Supplies of goods and services of a kind normally intended for use in agricultural production but excluding capital goods such as machinery or buildings | ➢ Minimum 5% rate;<br>➢ Until the VAT definitive system is in force, Member States may continue to apply a reduced rate lower than 5% or a zero-rate, where these were the rates in force on 1 January 1991;<br>➢ Until the VAT definitive system is in force, Member States which were obliged to increase their standard rate, as applied at 1 January 1991, by more than 2%, may apply a reduced rate lower than 5%, but not zero-rate. | Article 12(3)(a)<br>Annex H<br>Article 28(2)(a)<br>Article 28(2)(c) |
| **Accommodation** provided by hotels and similar establishments including the provision of holiday accommodation and the letting of camping sites and caravan parks | ➢ Minimum 5% rate;<br>➢ Until the VAT definitive system is in force, Member States may continue to apply a reduced rate lower than 5% or a zero-rate, where these were the rates in force on 1 January 1991;<br>➢ Until the VAT definitive system is in force, Member States which were obliged to increase their standard rate, as applied at 1 January | Article 12(3)(a)<br>Annex H<br>Article 28(2)(a)<br>Article 28(2)(c) |

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| | 1991, by more than 2%, may apply a reduced rate lower than 5%, but not zero-rate. | |
| **Sporting.** Admission to sporting events and use of sporting facilities | ➢ Minimum 5% rate;<br>➢ Until the definitive VAT system is in force, Member States may continue to apply a reduced rate lower than 5% or a zero-rate, where these were the rates in force on 1 January 1991;<br>➢ Until the definitive VAT system is in force, Member States which were obliged to increase their standard rate, as applied at 1 January 1991, by more than 2%, may apply a reduced rate lower than 5%, but not zero-rate;<br>➢ Not supplied electronically. | Article 12(3)(a)<br>Annex H<br>Article 28(2)(a)<br>Article 28(2)(c) |
| **Charity organisations.** Supply of goods and services by organisations recognised as charities by Member States and engaged in welfare or social security work, insofar as these supplies are not exempt under Article 13 | ➢ Minimum 5%rate;<br>➢ Until the VAT definitive system is in force, Member States may continue to apply a reduced rate lower than 5% or a zero-rate, where these were the rates in force on 1 January 1991.<br>➢ Until the VAT definitive system is in force, Member States which were obliged to increase their standard rate, as applied at 1 January 1991, by more than 2%, may apply a reduced rate lower than 5%, but not zero-rate. | Article 12(3)(a)<br>Annex H<br>Article 28(2)(a)<br>Article 28(2)(c) |
| **Undertakers.** Services supplied by undertakers and | ➢ Minimum 5% rate; | Article 12(3)(a) |

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| cremation services, together with the supply of goods related thereto | ➢ Until the VAT definitive system is in force, Member States may continue to apply a reduced rate lower than 5% or a zero-rate, where these were the rates in force on 1 January 1991;<br>➢ Until the VAT definitive system is in force, Member States which were obliged to increase their standard rate, as applied at 1 January 1991, by more than 2%, may apply a reduced rate lower than 5%, but not zero-rate. | Annex H<br>Article 28(2)(a)<br>Article 28(2)(c) |
| **Medical and dental care.** Provision of medical and dental care as well as thermal treatment in so far as these services are not exempt under Article 13 | ➢ Minimum 5% rate;<br>➢ Until the VAT definitive system is in force, Member States may continue to apply a reduced rate lower than 5% or a zero-rate, where these were the rates in force on 1 January 1991;<br>➢ Until the VAT definitive system is in force, Member States which were obliged to increase their standard rate, as applied at 1 January 1991, by more than 2%, may apply a reduced rate lower than 5%, but not zero-rate. | Article 12(3)(a)<br>Annex H<br>Article 28(2)(a)<br>Article 28(2)(c) |
| **Waste.** Services supplied in connection with street cleaning, refuse collection and waste treatment, other than the supply of such services by bodies referred to in Article 4 (5) | ➢ Minimum 5% rate;<br>➢ Until the VAT definitive system is in force, Member States may continue to apply a reduced rate lower than 5% or a zero-rate, where these were the rates in force on 1 January 1991;<br>➢ Until the VAT definitive system is in force, Member States which were obliged to increase their standard rate, as applied at 1 January | Article 12(3)(a)<br>Annex H<br>Article 28(2)(a)<br>Article 28(2)(c) |

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| | 1991, by more than 2%, may apply a reduced rate lower than 5%, but not zero-rate. | |
| **Natural gas and electricity** | ➢ Minimum 5% rate;<br>➢ Member States must notify the Commission;<br>➢ There is no risk of distortion of competition. | Article 12(3)(b) |
| **Imports of works of art, collector's items and antiques** | ➢ Minimum 5% rate. | Article 12(3)(c) |
| **Supplies of works of art** | ➢ Minimum 5% rate;<br>➢ Effected by their creator or his successors in title; OR,<br>➢ Effected on an occasional basis by a taxable person other than a taxable dealer, where these works of art have been imported by the taxable person himself or where they have been supplied to him by their creator or his successors in title or where they have entitled him to full deduction of VAT. | Article 12(3)(c) |
| **Restaurant services** | ➢ Until the VAT definitive system is in force, Member States which were obliged to increase their standard rate, as applied at 1 January 1991, by more than 2%, may apply a reduced rate lower than 5%, but not zero-rate;<br>➢ Until the VAT definitive system is in force, Member States may continue to apply a reduced rate lower than 5% or a zero-rate, | Article 28(2)(c)<br>Article 28(2)(d) |

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| | where these were the rates in force on 1 January 1991. | |
| **Children's clothing and footwear** | ➢ Until the VAT definitive system is in force, Member States which were obliged to increase their standard rate, as applied at 1 January 1991, by more than 2%, may apply a reduced rate lower than 5%, but not zero-rate;<br>➢ Until the VAT definitive system is in force, Member States may continue to apply a reduced rate lower than 5% or a zero-rate, where these were the rates in force on 1 January 1991. | Article 28(2)(c)<br>Article 28(2)(d) |
| **Housing** | ➢ Until the VAT definitive system is in force, Member States which were obliged to increase their standard rate, as applied at 1 January 1991, by more than 2%, may apply a reduced rate lower than 5%, but not zero-rate;<br>➢ Until the VAT definitive system is in force, Member States may continue to apply a reduced rate lower than 5% or a zero-rate, where these were the rates in force on 1 January 1991. | Article 28(2)(c)<br>Article 28(2)(d) |
| **Live plants and wood.** Supplies of live plants (including bulbs, roots and the like, cut flowers and ornamental foliage) and wood for use as firewood | ➢ Until definitive VAT system is in force;<br>➢ Minimum 5% rate. | Article 28(2)(i) |
| **Labour-intensive services**, listed as small services of repairing bicycles, small services of repairing shoes and | ➢ Minimum 5% rate; | Article 28(6) |

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| leather goods, small services of repairing clothing and household linen (including mending and alteration); renovation and repairing of private dwellings, excluding materials which form a significant part of the value of the supply; window cleaning in private households; domestic care services (e.g. home help and care of the young, elderly, sick and disabled); and hairdressing | ➢ The services must be labour intensive, largely provided direct to final customers, mainly local and not likely to create distortions, and there must be close link between the lower prices resulting from the rate reduction and the forevideable increase in demand and employment;<br>➢ Maximum of three of the labour-intensive services listed in Annex K;<br>➢ Member States must notify the Commission;<br>➢ Must not prejudice the smooth functioning of the Internal Market. | Annex K |
| **Other goods / services** | ➢ Until the entry into force of the definitive VAT system, Member States which, at 1 January 1991, applied zero-rates or reduced rates lower than 5%, to supplies of goods and services, other than those specified in Annex H, may continue to apply to those supplies reduced rates lower or higher than 5%;<br>➢ Until the entry into force of the definitive VAT system, Member States which, at 1 January 1991, applied a reduced rate to supplies of goods and services other than those specified in Annex H, may continue to apply a reduced rate not lower than 12%. However this rule does not apply to supplies of second-hand goods, works of art, collectors' items or antiques. | Article 28(2)(b)<br>Article 28(2)(e) |

**IN SPECIFIED MEMBER STATES**

| SUPPLIES / IMPORTS OF GOODS / SERVICES | CONDITIONS | LEGAL BASIS SIXTH VAT DIRECTIVE |
|---|---|---|
| **AUSTRIA** | | |
| **Letting of immovable property** for residential use | ➢ Until definitive VAT system is in force;<br>➢ Minimum 10% rate | Article 28(2)(j) |
| **GREECE** | | |
| **Lesbos, Chios, Samos, the Dodecanese and the Cyclades, and on the following islands in the Aegean: Thasos, Northern Sporades, Samothrace and Skiros** | ➢ Until definitive VAT system is in force;<br>➢ Reduced rates in comparison to those applying on the mainland. | Article 28(2)(f) |
| **IRELAND** | | |
| **Energy products for heating and lighting** | ➢ Until definitive VAT system is in force;<br>➢ Minimum 5% rate;<br>➢ Member States must notify the Commission;<br>➢ If there are distortions of competition. | Article 28(2)(a) |
| **PORTUGAL** | | |
| **Azores and Madeira.** Imports and supplies carried out in these regions. | ➢ Reduced rates in comparison to those applying on the mainland. | Article 12(6) |
| **Restaurant services** | ➢ Until definitive VAT system is in force;<br>➢ Minimum 12% rate. | Article 28(2)(k) |

## ANNEX 3

## NON-DEDUCTIBLE INPUT TAX

| | GOODS AND SERVICES IN RESPECT OF WHICH RIGHT TO DEDUCT IS EXCLUDED | GOODS AND SERVICES IN RESPECT OF WHICH THERE IS A PARTIAL RIGHT TO DEDUCT / DEDUCTIBILITY PERCENTAGE |
|---|---|---|
| **AUSTRIA**[814] | ➢ Vehicles (excluding driving school vehicles, taxis and hire car vehicles). | ➢ Entertainment costs – 50%. |
| **BELGIUM**[815] | ➢ Manufactured tobaccos;<br>➢ Spirits other than those intended for resale or to be supplied for the purposes of services;<br>➢ Accommodation, meals and beverages under an accommodation or catering contract. There are two exceptions to this rule: where these costs are incurred by a company's staff effecting outside supplies of goods or services; and where these costs are incurred by taxable person who in turn supply the same services for consideration;<br>➢ Entertainment costs – these include costs incurred by companies for public relation purposes providing hospitality for outside visitors, in particular suppliers and customers. | ➢ Motor vehicles use for passenger transport including those which can be used for both the transport of passengers and goods, and goods and services relating to vehicles – 50%. Exceptions to this rule: vehicles intended to be sold or leased by a taxable person whose particular economic activity involves the sale or leasing of motor vehicles; vehicles used solely for passenger transport for hire or reward; and, new vehicles within the meaning of Article 28a(2) of the Sixth VAT Directive forming the subject of supplied exempted under Article 28c(A)(b) of the same Directive. |
| **CYPRUS**[816] | ➢ Business entertainment expenses, unless supplied to employees of the taxable person or, if the taxable person is a corporate body, to its directors or to persons otherwise engaged in its management; | N/A |

[814] Information as *per* January 2004 document.
[815] Information as *per* February 2004 document.
[816] Information as *per* January 2004 document.

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| | ➢ Supply, importation or hire of a motor car (saloon car), except when: hired with the services of a driver, for the purpose of carrying passengers; for self-hire purposes; used as an instruction vehicle; or purchased for the purpose of being resold. A motor car is any vehicle of a kind normally used on public roads, which has three or more wheels and is constructed or adapted solely or mainly for carrying up to 9 passengers; | |
| **CZECH REPUBLIC**[817] | ➢ Acquisition of passenger cars, including acquisition in the form of leasing and its technical reconstruction, alteration, and modernisation (unless acquired for further sale, leasing or export);<br>➢ Technical reconstruction, alteration and modernisation of rented assets, and repairs of rented assets effected by a lessee with the approval of the lessor, if the repairs are carried out within 5 years prior to the end of the lease;<br>➢ Acquisition of returnable bottles (unless acquired for export purposes); and,<br>➢ Business representation expenditure. | N/A |
| **DENMARK**[818] | ➢ Purchase of a goods transport vehicle of a maximum authorised weight of 3 tonnes where it is not used exclusively for the traders' supplies of goods and services;<br>➢ Food for the trader's owners and employees;<br>➢ Acquisition and running of accommodation for owners and employees;<br>➢ Payments in kind to owners and employees;<br>➢ Acquisition and running of nurseries, kindergartens, recreation centres, summer cottages and the like for employees; | ➢ Hotel and catering services provided they are of a strictly commercial nature – 25%;<br>➢ Purchases relating to board and lodging for participants in training courses organised by the trader, where such purchases are in proportion to the courses held – 25%; and,<br>➢ Hire of passenger vehicles by traders for more than six consecutive months where at least 10% of the annual mileage travelled by the hired vehicle related to the trader's deductible |

[817] Information as *per* October 2003 document.
[818] Information as *per* January 2004 document.

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| | ➢ Entertainment, representation and gifts; and,<br>➢ Acquisition and running of passenger vehicles designed for the transport of not more than 9 people – however, this rule does not apply to the cost of using the fixed link across the Sound or to traders dealing in or hiring out motor vehicles or operating driving schools. | supplies of goods and services – 25%. |
| **ESTONIA**[819] | ➢ Goods and services relating to the reception of guests, or the provision of meals or accommodation for employees of the taxable person. This rule does not apply to accommodation services received during a business trip. | N/A |
| **FINLAND**[820] | ➢ Immovable property which the taxable person or his staff use as a residence, a kindergarten or a recreational or leisure facility as well as goods and services connected with the immovable property or its usage;<br>➢ Transportation of the taxable person or his staff between residence and place of work;<br>➢ Entertainment and hospitality;<br>➢ Passenger cars, motorcycles, caravans, vessels intended for pleasure and sports and aircraft whose maximum weight is not more than 1550 kg, and all the goods and services relating to them. This restriction does not apply to vehicles and ships for sale, hire or use in professional passenger transport or driving schools and a passenger car that is used exclusively for the use with deduction rights; | N/A |
| **FRANCE**[821] | ➢ Accommodation for managers and employees;<br>➢ Vehicles and any other motorised equipment designed to transport people | ➢ Diesel fuel used to operate vehicles for which no input tax can be deducted – 80%; |

[819] Information as *per* February 2004 document.
[820] Information as *per* February 2004 document.
[821] Information as *per* October 2003 document.

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| | or for mixed use;<br>➢ Transport of persons and ancillary operations;<br>➢ Goods provided free of charge (or against payment far lower than their normal price);<br>➢ Prohibited publicity;<br>➢ Certain petroleum products. | ➢ Petroleum gas and other hydrocarbons present in a gaseous state and kerosene where these products are used for vehicles or other equipment for which no input tax can be deducted – 50%. |
| **GERMANY**[822] | ➢ Entertainment costs which cannot be deducted for income tax purposes or which related to private household costs; and,<br>➢ Removal costs resulting from change of residence. | Information not available. |
| **GREECE**[823] | ➢ Purchases, imports or intra-Community transactions of manufactured tobacco products;<br>➢ Purchases, imports or intra-Community transactions of alcoholic beverages, provided they are intended for non-taxable transactions only;<br>➢ Functions, entertainment and hospitality expenditure;<br>➢ Accommodation, meals, beverages, transport and recreation for the company's staff or agents;<br>➢ Purchases, imports or intra-Community transactions of private passenger cars designed for the transport of up to nine people, motorbikes and mopeds, private vessels and aircraft intended for recreation or sport, as well as expenditure incurred for fuel, repair work, maintenance, hire and use of the above. This rule does not apply where the means of transport are intended for sale or hire, or for transporting persons in return for | N/A |

[822] Information *as per* January 2004 document.
[823] Information *as per* October 2003 document.

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| | payment;<br>➢ Purchases, imports or intra-Community transactions of building materials, where the supply of these materials is covered by a duly submitted guarantee and no tax applies to their further use. | |
| **HUNGARY**[824] | ➢ Leaded or unleaded motor vehicles;<br>➢ Passenger cars, motorcycles above 125 cc, yachts, sporting and leisure boats;<br>➢ Foodstuffs and beverages;<br>➢ Services of restaurants, confectionery shops, and other public catering services;<br>➢ Entertainment services;<br>➢ Purchases and services received in connection with the operation and maintenance of passenger cars;<br>➢ Usage of long-distance and local taxi services;<br>➢ Parking services and highway tolls;<br>➢ Purchases related to the construction or remodelling of residential properties; and,<br>➢ Purchase of residential property which is not eligible provided such purchase is not for the purpose of resale. | ➢ Local and long-distance telephone services, mobile phone services, and on Internet-protocol-based voice transmission services – 70%. This deduction restriction will not apply to taxable persons who re-invoice at least 30% of the services in question for the purpose of resale.<br>➢ Products given for the purpose of telework – the proportion of deduction allowed is related to the proportion of the employees' work costs undertaken by the employers. |
| **IRELAND**[825] | ➢ Provision of food or drink, or accommodation or other personal services, for the taxable person, his or her agents or employees, except to the extent | N/A |

[824] Information as *per* January 2004 document.
[825] Information as *per* October 2003 document.

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| | that he or she is accountable for VAT;<br>➢ Expenditure incurred by a taxable person on food or drink, or accommodation or other entertainment services, where such expenditure forms all or part of the costs of providing an advertising service in respect of which tax is due and payable by the taxable person;<br>➢ Entertainment expenses incurred by a taxable person, his or her agents or employees;<br>➢ Acquisition (including hiring) of passenger motor vehicles otherwise than as stock-in-trade (that is, for resale) or for use in a vehicle hire or driving school business;<br>➢ Purchase of petrol otherwise than as stock-in-trade;<br>➢ Contract work involving the handing over of goods when such goods are themselves not deductible. | |
| **ITALY** | No information available. | No information available. |
| **LATVIA**[826] | N/A | ➢ Goods purchased for representative purposes – 60%;<br>➢ Services received with respect to the preparation of public conferences, receptions and meals, as well as for the manufacture of representative items – 60%. |
| **LITHUANIA**[827] | ➢ Entertainment and representation expenditure; | ➢ Representation expenses – 75%. |

[826] Information *as per* October 2003 document.
[827] Information *as per* October 2003 document.

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| | ➢ Acquisition and lease of passenger cars designed for the transportation of no more than 8 people (excluding driver), and motor vehicles of the class attributed to the category of off-road vehicles, provided that the car is not supplied or leased, used as a taxi or for driving instruction services. This rule does not apply to motor vehicles of the specified categories where they are attributed to special purpose motor vehicles under legal acts regulating the classification and coding of vehicles;<br>➢ Passenger transport by motor vehicles designed for the transportation of no more than 8 people (excluding driver), or a motor vehicle of the class attributed to the category of off-road vehicles. | |
| **LUXEMBOURG**[828] | ➢ Entertainment expenditure. | N/A |
| **MALTA**[829] | ➢ Tobacco or tobacco products;<br>➢ Alcoholic beverages;<br>➢ Motor vehicles, vessels or aircraft including the supply thereof for hire or leasing arrangements. This rule does not include the supply, intra-community acquisition or importation of motor vehicles, vessels or aircraft where these are used for the purpose of: the carriage of goods or passengers for consideration, being provided under a charter or hire agreement, being used for driving instruction. Excluded from this rule are also motor vehicles designed and manufactured for the carriage of goods, or with seating accommodation for 9 persons or more;<br>➢ Goods and services used for the purpose of repairing, maintaining, fuelling and keeping any motor vehicle, vessel or aircraft; and,<br>➢ Electricity; | N/A |

[828] Information as *per* October 2003 document.
[829] Information as *per* October 2003 document.

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|---|---|---|
| | ➢ Receptions, entertainment or hospitality, except where the provision is made for consideration in the normal course of the taxable person's economic activity;<br>➢ Provision by the taxable person to his employees or, in the case of a body of persons, to its officers or employees, of transport or entertainment. This provision, however, does not apply to transport provided by a taxable person to his employees on vehicles with a seating capacity of not less than 7.<br>The above rules do not apply where the goods are supplied, acquired or imported for the purpose of resale, whether in the state in which they were acquired or imported or after treatment or processing or inclusion in other goods supplied by that person, in the normal course of the taxable person's economic activity. | |
| **NETHERLANDS** | No information available. | No information available. |
| **POLAND**[830] | ➢ Accommodation and gastronomic services;<br>➢ Motor fuels, diesel oils and gas used for driving passenger cars and other cars with maximum load capacity of up to 500 kg. | No information available. |
| **PORTUGAL**[831] | ➢ Coaches, recreational craft, helicopters, aircraft or motorcycles except where the sale or operation of such means of transport is part of that taxable person's activity;<br>➢ Fuels normally used in motor vehicles (petrol), excluding acquisitions of diesel, liquefied petroleum gas and natural gas covered by partial deduction | ➢ Diesel, liquefied petroleum gas and natural gas – 50%. Except where they are used for the following vehicles, in which case the total VAT may be deducted: heavy passenger vehicles; vehicles licensed for public transport, excluding rental cars; vehicles using diesel, LPG or natural gas which are not registered; tractors used |

[830] Information as *per* January 2004 document.
[831] Information as *per* October 2003 document.

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| | rule (see cell on the right);<br>➢ Business transport and travel by the taxable person and his staff, including tolls and user fees;<br>➢ Accommodation, meals, beverages, tobacco and entertainment expenses;<br>➢ Leisure and luxury goods which are not considered, by virtue of their nature or amount, to be normal operating costs. | exclusively or predominantly for agricultural purposes; and road haulage vehicles of over 350 kg. |
| **SLOVAKIA**[832] | ➢ Personal car;<br>➢ Equipment for a personal car, including its installation;<br>➢ Catering expenditure;<br>➢ Catering and accommodation services, being the travel costs of the payer;<br>➢ Purchase of returnable bottles, excluding intra-community supplies and exports. | N/A |
| **SLOVENIA**[833] | ➢ Yachts and boats intended for sport and recreation, private aircrafts, personal automobile and motorcycles, fuels, oils, spare parts and services closely connected to them, other than the following: vessels or vehicles used for the business of rental, lease and subsequent sale, vehicles for use in auto-schools, and vehicles for performing or operating routs for transport of pupils or workers; and,<br>➢ Business entertainment, food and accommodation. | N/A |
| **SPAIN** | No information available. | No information available. |

[832] Information as *per* January 2004 document.
[833] Information as *per* January 2004 document.

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| **SWEDEN**[834] | ➢ Ships, aircraft etc except where certain conditions are met;<br>➢ Lifeboats except where certain conditions are met;<br>➢ Aviation petrol and kerosene;<br>➢ Costs of own use of goods for representation purposes subject to entitlement to deduct for such purposes against income tax;<br>➢ Mail delivery services, transport services and connected services performed by mail delivery businesses for a foreign mail delivery businesses in delivering mail or parcels to recipients in Sweden. | ➢ Lease (hire) of cars – 50%. |
| **UNITED KINGDOM**[835] | ➢ Cars, including fitted accessories and delivery charges which are available for private use;<br>➢ Business entertainment expenses;<br>➢ If taxable person is a developer, certain articles that are installed in buildings that taxable person sells or leases at the zero rate. | ➢ Lease of cars for business purposes – 50%. |

[834] Information as *per* February 2004 document.
[835] Information as *per* January 2004 document.

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