

## **THE RIGHT OF VAT DEDUCTION**

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Under the common VAT system, the right of deduction is prescribed by Articles 167 et seq. of EU Directive 2006/112/EC (previously Articles 17 et seq. of the 6th Directive). This right is the "heart" of the common system of VAT. According to the well established relevant case-law of the CJEU, the deduction of VAT constitutes the necessary and critical mechanism for achieving the main objectives set by the common VAT system, namely fiscal neutrality and free competition. This distinguishes VAT from all other indirect taxes constituting turnover taxes (See Case 111/2014 CJEU). Also, through the right of deduction the implementation of various tax rates and the combat against tax evasion is achieved.

Specifically, the Sixth directive has not adopted the method of calculating the added value at each stage of production, but the indirect method of calculating the tax by applying the tax rate to all outputs, and then deduct the tax paid on inputs (i.e. purchases of goods and services used for the production and delivery of the goods or providing the service).

In view of the crucial role of the right of deduction, as emphasized in the preamble of the Directive, the latter exhaustively stipulates for all the required conditions of its implementation, its scope and any applicable restrictions. This was pointed out by the CJEU, which stressed that "these

articles do not leave the Member States any margin of discretion regarding their implementation.”

### **Origin and scope of the right of deduction**

In accordance with Article 168 of the EU Directive 2006/112/EC (and formerly Article 17 par. 2 of the 6th Directive) the taxable person is entitled to deduct from the VAT he is liable to pay the VAT (paid or due) in respect of all inputs (purchases, intra-Community acquisitions or imports of raw and auxiliary materials, marketable and durable goods as well as services supplied etc.), certainly in so far as the goods and services are used for the purposes of the taxed transactions.

In this respect, the Court (CJEU) has held that the right of deduction, as an integral part of the VAT mechanism, should be applied uniformly in all Member States without any further restrictions other than those prescribed by the law.

The extent of the right to deduct input VAT was examined by CJEU in **Cases C-108 and 109/2014** in particular with respect to VAT paid by a parent (holding) company for the acquisition of capital invested in its subsidiaries. The Court correctly based its judgment on the distinction between those cases whereby the holding company is involved in the management of all of its subsidiaries (constituting an economic activity) and those whereby it involves itself only in the management of some of those subsidiaries, allowing in the first case the full deduction of the

VAT paid, whereas in the latter case only the partial deduction.

Moreover, as already mentioned, the right of deduction is recognised only for taxable persons and not simply those liable for the payment of VAT to tax authorities. Therefore, being recognised as a taxable person is crucial. In relation to the issue of when exactly a person acquires the status of taxable person for VAT purposes the Court held in **case 286/83 (Rompelman)** that even preparatory acts to an economic activity (such as the acquisition of a right to the future transfer of property rights in part of a building yet to be constructed with a view to letting such premises in due course) may confer the status of taxable person for VAT purposes. This judgment is in our view correct, since the requirement for being qualified as taxable person is the exercise of economic activity which undoubtedly includes preparatory acts inextricably linked with it. Certainly, there must be a close link of those acts with a subsequent economic activity and the intention to carry out such an activity. Besides, preparatory acts do not belong to the private activity of individuals. In case **C-152/2002 (of 29.4.2004, Terra Baubedarf-Handel GmbH)** the Court ruled on the time that the right of deduction may be exercised. It held that the right to deduct must be exercised in respect of the tax period in which two conditions required are satisfied, namely that the goods have been delivered or the services performed and that the taxable person holds the invoice or the document which, under the criteria determined by the Member State in question, may be

considered to serve as an invoice. This interpretation is also consistent with the principle of neutrality of VAT which, according to existing case-law, enables the intermediate links in the distribution chain to deduct from their own taxable amount the sums paid by each of them to his own supplier in respect of VAT on the corresponding transaction and thus pass on to the tax authorities the part of the VAT representing the difference between the price paid by each to his supplier and the price at which he supplied the goods to his purchaser. As regards the principle of proportionality, it is not infringed when requiring the taxable person to effect the deduction of input VAT in respect of the tax period in which the condition of possession of the invoice or of a document considered to serve as an invoice and that of the origin of the right to deduct are satisfied. First, that requirement is consistent with one of the aims of the Sixth Directive, that of ensuring VAT is levied and collected, under the supervision of the tax authorities, and secondly payment for delivery of goods or performance of services, and therefore payment of input VAT, is not normally made until the invoice has been received.

In another judgment CJEU decided on the criteria determining whether an individual has acquired the goods as a taxable person, in case they are not used immediately for his economic activity. It was stressed that this depends on the different circumstances of each case, including the nature of the goods, the period between their acquisition and their use by a taxable person for the purpose of his economic activities. Besides, under Article 167 par. 1 of Directive 2006/112 the

right of deduction arises at the time the deductible tax becomes chargeable.

The end of the economic activity marks the end of the status of taxable person for VAT purposes hence, at least in principle, the end of the right of deduction. This is not the case when the taxable person is declared bankrupt or is at the stage of liquidation, provided this does not result in tax evasion or a circumvention of the applicable provisions. In those circumstances the right of VAT deduction shall be exercised by the bankruptcy trustee or the liquidator respectively. In this context it was held by CJEU in judgment **C-32/03 (of 3.3.2005, Fini H)** that a person who has ceased an economic activity because the lease contains a non-termination clause, but who continues to pay the rent and charges on the premises used for that activity is to be regarded as a taxable person within the meaning of that article and is entitled to deduct the VAT on the amounts thus paid, provided that there is a direct and immediate link between the payments made and the commercial activity and that the absence of any fraudulent or abusive intent has been established.

The conditions for exercising the right of VAT deduction are prescribed in Article 178 of the 2006/112 Directive. According to the aforementioned provision of the Directive, the main prerequisites for the exercise of the right of deduction, other than that of the status of a taxable person, is that the goods purchased or imported and the services received, were used by the taxable person for transactions subject to VAT and also the possession of a relevant invoice

or of any other document serving as an invoice, when for instance the original invoice was lost (see relevant case **85/95 of 5.12.1996, Reisdorf** and the abovementioned Case C-152/2002, Terra Baubedarf-Handel GmbH, as well as Greek State Council Decisions 1030/2014, 3558/2011 and 2212/2013). The CJEU has emphasised that both of the abovementioned conditions laid down by those provisions have to be met.

In joined cases **C-95 and 96/2007 (of 8.5.2008, Ecotrade SpA)** the CJEU held that VAT Directives do not preclude national legislation which lays down a limitation period for the exercise of the right to deduct, provided that the principles of equivalence and effectiveness are respected. The principle of effectiveness is not infringed merely because the tax authority has a longer period in which to recover unpaid value added tax (in the said case 4 years) than the period granted to taxable persons for the exercise of their right to deduct (in the said case 2 years). More specifically, the CJEU held that a limitation period the expiry of which has the effect of penalising a taxable person who has not been sufficiently diligent and has failed to claim deduction of input tax by making him forfeit his right to deduct cannot be regarded as incompatible with the regime established by the Sixth Directive, in so far as, first, that limitation period applies in the same way to analogous rights in tax matters founded on domestic law and to those founded on Community law (principle of equivalence) and, second, that it does not render virtually impossible or excessively difficult the exercise of the

right to deduct (principle of effectiveness). However, we consider that national legislation of this content is incompatible with the principle of equivalence. On the contrary, in the said judgment, it was correctly held that the right of deduction should not be affected by a failure to comply with obligations arising from formalities.

In a more recent case **C-183/2014 (of 9.7.2015, Radu Florin Salomie)** it was held that Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax precludes, in circumstances such as those of the dispute in the main proceedings, national rules under which the right to deduct input value added tax, due or paid on goods and services used in the context of taxed transactions, is refused to the taxable person, who must nevertheless pay the tax that he ought to have recovered, for the sole reason that he was not identified for value-added-tax purposes when he carried out those transactions, so long as he has not been duly identified for value added tax purposes and the tax return for the tax due has not been filed.

The failure to comply with formalities and its effect on the right of deduction was examined by the Greek Council of State in its judgment 2112/2013, whereby it was held that the vague description in the invoice of the services rendered should not result in the preclusion of the right of deduction (similar case Council of State 5372/2012). Moreover, in the above cases it was clarified that by contrast to income taxation the relevant expenditure does not have to be productive (also relevant case Council of State 3558/2011). The above were

reiterated by the more recent Council of State decision 1030/2014, according to which minor omissions regarding the invoice issued or the accounting obligations of the taxable person may not result in the denial of the right of deduction, as long as tax authorities have the required information in order to ascertain that the relevant conditions for the said right are fulfilled.

Another important requirement for the exercise of the right of VAT deduction according to the existing case law of the CJEU is that the transaction concerned is not connected with fraud. In case **C-439/04 (of 6.7.2006, Axel Kittel)** the limited company Ang Computime Belgium ('Computime') bought and resold computer components and following a report drawn up by the tax authorities, those authorities decided that Computime had knowingly participated in a VAT 'carousel' fraud intended to recover one or more times amounts of VAT invoiced by suppliers for the same goods and that the supplies effected to Computime were fictitious. For those reasons, the tax authorities refused to allow Computime the right to deduct the VAT paid on those supplies. In joined case **C-440/04 (Recolta Recycling)** Recolta bought from a certain Mr Ailliaud 16 luxury vehicles, which the latter had himself purchased from the company Auto-Mail. The purchases by Mr Ailliaud did not give rise to any VAT payable to the Treasury and Mr Ailliaud did not pass on to the Belgian State the VAT paid by Recolta, which resold the vehicles free of VAT to Auto-Mail under an authorisation for export sale. The documents in the file showed that, according to an

investigation by the Special Inspectorate of Taxes, Mr Ailliaud and Auto-Mail had set up a scheme for ‘carousel’ tax fraud, of which the transactions with Recolta formed part. In both of these cases it was pointed out that traders who take every precaution which could reasonably be required of them to ensure that their transactions are not connected with fraud, be it the fraudulent evasion of VAT or other fraud, must be able to rely on the legality of those transactions without the risk of losing their right to deduct the input VAT (see, to that effect, Case C-384/04 *Federation of Technological Industries and Others* [2006] ECR I-0000, paragraph 33). As the Court had already observed, preventing tax evasion, avoidance and abuse is an objective recognised and encouraged by the Sixth Directive (see Joined Cases C-487/01 and C-7/02 *Gemeente Leusden and Holin Groep* [2004] ECR I-5337, paragraph 76). Community law cannot be relied on for abusive or fraudulent ends (see, inter alia, Case C-367/96 *Kefalas and Others* [1998] ECR I-2843, paragraph 20; Case C-373/97 *Diamantis* [2000] ECR I-1705, paragraph 33; and Case C-32/03 *Fini H* [2005] ECR I-1599, paragraph 32). In our view the Court correctly judged that where a recipient of a supply of goods is a taxable person who did not and could not know that the transaction concerned was connected with a fraud committed by the seller, a rule of national law under which the fact that the contract of sale is void – by reason of a civil law provision which renders that contract incurably void as contrary to public policy for unlawful basis of the contract attributable to the seller – causes that taxable person to lose the right to deduct the value added tax he has paid infringes Article 17 of the Sixth

Directive. It is irrelevant in this respect whether the fact that the contract is void is due to fraudulent evasion of value added tax or to other fraud. By contrast, where it is ascertained, having regard to objective factors, that the supply is to a taxable person who knew or should have known that, by his purchase, he was participating in a transaction connected with fraudulent evasion of value added tax, it is for the national court to refuse that taxable person entitlement to the right to deduct.

Another interesting case is **C-18/2013 (of 13.2.2004, Maks Pen EOOD)** on the conditions under which a taxable person is precluded by the right of deduction. More specifically, the Court examined whether Directive 2006/112 must be interpreted as precluding a taxable person from deducting VAT on the invoices issued by a supplier where, although the supply was made, it is apparent that it was not actually made by that supplier or by its sub-contractor, inter alia because they did not have the personnel, equipment or assets required, there was no record of the costs of supplying the service in their accounts and the identification of persons signing certain documents as suppliers was shown to be inaccurate. The Court reiterated that Article 242 of Directive 2006/112 provides, inter alia, that every taxable person is to keep accounts in sufficient detail to permit VAT to be applied and its application checked by the tax authority. On the contested matter it finally ruled that the VAT Directive must be interpreted as precluding a taxable person from deducting the value added tax included in the invoices issued by a

supplier where, although the supply was made, it is apparent that it was not actually made by that supplier or by its sub-contractor, inter alia because they did not have the personnel, equipment or assets required, there was no record of the costs of making the supply in their accounts and the identification of persons signing certain documents as the suppliers was shown to be inaccurate, subject to the twofold condition that such facts constitute fraudulent conduct and that it is established, in the light of the objective evidence provided by the tax authorities, that the taxable person knew or should have known that the transaction relied on to give entitlement to the right to deduct was connected with that fraud, which it is for the referring court to determine.

The issue of tax fraud and its consequences was treated by the CJEU in **joined cases C-131, 163 and 164/2013 (of 18.12.2014, Schoenimport ‘Italmoda’ Mariano Previti vof, Turbu.com BV and Turbu.com Mobile Phone’s BV)**. It was held, correctly in our view, that it is for the national authorities and courts to refuse a taxable person, in the context of an intra-Community supply, the benefit of the rights to deduction of, exemption from or refund of value added tax, even in the absence of provisions of national law providing for such refusal, if it is established, in the light of objective factors, that that taxable person knew, or should have known, that, by the transaction relied on as a basis for the right concerned, it was participating in evasion of value added tax committed in the context of a chain of supplies. Additionally, according to the said judgment, a taxable person who knew, or

should have known, that, by the transaction relied on as a basis for rights to deduction of, exemption from or refund of value added tax, that person was participating in evasion of value added tax committed in the context of a chain of supplies, may be refused the benefit of those rights, notwithstanding the fact that the evasion was carried out in a Member State other than that in which the benefit of those rights has been sought and that taxable person has, in the latter Member State, complied with the formal requirements laid down by national legislation for the purpose of benefiting from those rights.

Finally, in case **C-662/2013 (of 12.2.2015, Surgicare — Unidades de Saúde SA)** the CJEU considered the admissibility of the deduction of input VAT in respect of acts which constitute an abusive practice in conjunction with specific procedural arrangements in such cases. In this judgment, the Court held that in the absence of any EU rules in the area, the means of preventing VAT fraud falls within the internal legal order of the Member States under the principle of procedural autonomy of the latter. In that regard, it is apparent from the Court's settled case-law that it is for the domestic legal system of each Member State, in particular, to designate the authorities responsible for combatting VAT fraud and to lay down detailed procedural rules for safeguarding rights which individuals derive from EU law, provided that such rules are not less favourable than those governing similar domestic actions (principle of equivalence) and that they do not render impossible in practice or

excessively difficult the exercise of rights conferred by the EU legal order (principle of effectiveness).

As it has already been noted, the right of deduction is recognized only for goods and services used for taxable transactions, hence it is not available for goods or services that are not used for taxable transactions. The same applies (i.e. there is no right of deduction) under the same reasoning for goods purchased or services rendered in the context of VAT exempt transactions, or transactions falling out of the scope of VAT, unless it is explicitly prescribed that they are exempt transactions with the right to deduct input VAT (such as exports).

It should be noted that the EU Court rightly requires a direct link between input and output transactions. More specifically in **case C-104/12 (of 21.2.2013, Becker)** the CJEU examined whether a company was entitled to deduct VAT paid for the supply of lawyer services rendered for the defense of the company's administrator in criminal proceedings against him regarding the offense of corruption, taking into consideration that the said criminal offense was connected to the exercise of their functions. The Court, rightly in our view, required the existence of a causal link between the costs relating to those services and the company's economic activity as a whole. In view of the above, the Court ruled that the supplies of lawyers' services, whose purpose is to avoid criminal penalties against natural persons, managing directors of a taxable undertaking, do not give that undertaking the right to deduct as input tax the VAT due on the services supplied.

The Greek courts have already ruled on whether certain supplies of goods and services are linked to taxable transactions therefore providing the right to deduct VAT. In particular it was disputed whether the VAT paid for the cost of feeding the crews of ships carrying out domestic voyages is deductible. Specifically, the Administrative Court of First Instance in Heraklion in its Decision 500/99 pointed out that in principle a taxable person may deduct input VAT from his output VAT only to the extent that the goods or services supplied have been used for taxable transactions. More specifically, the requirement for deducting input VAT is that the relevant expenditure is necessary for the operation of the undertaking by contrast to expenses relating to individual (luxury) needs of the undertaking's members. In view of the above it was held that expenses related to the supplies for ship crews carrying out domestic voyages are obligatory hence constitute operating expenses for ship-owners' companies and therefore there is a right to deduct the respective input VAT.

In relation to this issue the CJEU issued judgment **C-124/12 (of 18.7.2013, AES-3C Maritza East 1 EOOD)** pertaining to a Bulgarian legal provision precluding the deduction of input VAT for costs incurred by a company for transport services, work clothing, protective gear and business trips for staff working for that taxable person on the ground that that staff is provided to it by another entity and accordingly cannot be regarded, for the purposes of that legislation, as members of the taxable person's staff, despite the fact that those costs can be regarded as creating a direct

and immediate link with the general costs connected with all the economic activities of that taxable person. According to the said judgment the Court correctly ruled that this Bulgarian provision is not compatible with EU law, since the relevant personnel costs, regardless of who is the employer, have a direct and immediate link with the general costs connected with all the economic activities of that taxable person.

Moreover, CJEU in case **C-33/2003 of 10.3.2005** was asked to consider the compatibility of a UK provision granting to taxable persons (namely companies) the right to deduct VAT in respect of certain supplies of road fuel to non-taxable persons (namely employees) following an action against the UK under Article 226 EC Treaty for failure to fulfill its obligations deriving from the 6<sup>th</sup> Directive. The Court declared that the disputed provision as long as it did not ensure that the VAT deducted attaches solely to fuel used for the purposes of the taxable person's taxable transactions, is incompatible with Article 17(2)(a) of the Sixth Directive. Additionally, the fact that no invoice was required to be submitted violated Article 18 of the said Directive.

Another particularly interesting decision of the CJEU is **C-25/2003 (of 21.4.2005, Mr & Mrs HE)** concerning the deductibility of input VAT on the expenses for building a house which was the residence of two spouses, in so far as one of them was using one room in that building as an office for business purposes as a writer. The question referred for a preliminary ruling was whether that spouse should be treated as a taxable person having the right of deduction. The Court

reiterated having consistently held that where a capital item is used both for business and for private purposes the taxpayer has the choice, for the purposes of VAT, of (i) allocating that item wholly to the assets of his business, (ii) retaining it wholly within his private assets, thereby excluding it entirely from the system of VAT, or (iii) – as in the present case - integrating it into his business only to the extent to which it is actually used for business purposes. In the latter case, it was held that the spouse, to the extent to which the item was used for business purposes, acted as a taxable person in the purchasing or construction of the building, therefore he is entitled to deduct in respect of all the input value added tax attributable to the share of the item which he uses for the purposes of his business, in so far as the amount deducted does not exceed the limits of the taxable person's interest in the co-ownership of the item. Finally, in relation to the need for an invoice, the Court held that in view of the specific nature of the contested case an invoice issued to the co-owning spouses without distinguishing between them and without reference to such apportionment is sufficient.

In conclusion it could be pointed out that undoubtedly the mechanism of VAT deduction (and refund), contributes to the accomplishment of both of the main goals of VAT, i.e on the one hand ensuring and maintaining competition on equal terms for undertakings subject to VAT and also avoiding multiple taxation of the same good or service, and on the other hand reducing the risk of tax evasion. However, the right of VAT deduction may become the “back door” for the

appropriation of public revenue through the issuance of false or fictitious invoices, and the credit or rebate of VAT that was never actually paid by the issuer of the invoice.