The EC Tax Journal

SOME COMMENTS ON THE DEDUCTIBILITY OF VAT

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In this article I intend to discuss the conditions to which deduction of VAT is made subject with particular reference to selected cases decided by the European Court of Justice. At the outset it is necessary to distinguish the right of deduction from the exercise of this right and the adjustment of VAT deductions.

Part I: The Right of Deduction

1. Conditions attaching to the right of deduction - General

The conditions attaching to the right of deduction are set out in Article 17 of the Sixth VAT Directive. As is well-known this provides as follows:

> "2. In so far as the goods and services are used for the purposes of his taxable transactions the taxable person shall be entitled to deduct from the tax which he is liable to pay:
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> (a) value added tax due or paid within the territory of the country in respect of goods or services supplied or to be supplied to him by another taxable person;
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> (b) value added tax due or paid in respect of imported goods within the territory of the country;
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> (c) value added tax due under Articles 5(7)(a), and 6(3) and 28a(6);

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(d) value added tax due pursuant to Article 28a(1)(a).

3. Member States shall also grant every taxable person the right to the deduction or refund of the value added tax referred to in paragraph 2 in so far as the goods and services are used for the purposes of:

(a) transactions relating to the economic activities as referred to in Article 4(2) carried out in another country, which would be deductible if they had been performed in the territory of the country;

(b) transactions which are exempt pursuant to Article 14(1)(i), 15, 16(1) (B), (C) and (D) or (E) or (2) or 28c(A) and (C);

(c) any of the transactions exempt pursuant to Article 13B(a) and (d) (1) to (5), when the customer is established outside the Community or when those transactions are directly linked with goods to be exported to a country outside the Community".

Summarising this article, I would say that the taxable person is basically entitled to deduct VAT if he has used the goods or services supplied to him for:

- carrying out taxable transactions or transactions which are assimilated thereto;
- carrying out transactions which are exempted in respect of export or import or transactions which are assimilated thereto;
- carrying out transactions abroad, which would have given a right to deduction if they had been carried out within the Member State.

These are the general principles governing the right to deduct VAT. The first of the three requirements mentioned above I describe as "taxed transactions". This clarification is necessary since there are also transactions which are "taxable" but not effectively taxed, since they are exempt (see Article 13 A and B of the Sixth Directive). If one were to use the term "taxable transactions" then that would give a right of deduction for exempt transactions.

It appears from Article 17 that the following two conditions must be met before there can be a right to deduct VAT:

(1) there must be a taxable person; and

(2) he must use the "supply" in respect of which he wants to deduct the input VAT for the purposes of specific transactions.

The starting point is that VAT is a consumption tax which must be charged entirely to the final consumer. Anyone who is not a final consumer must have a right to deduct input tax so that the goods reach the final consumer "free" of VAT and that the same amount of VAT is charged at the final consumption stage, irrespective of the length of the commercial chain and the number of transactions. In this respect the final consumer is not only the "end user" or the private consumer. The professional user of goods and/or services may also be the final consumer if the goods or services cease to be the subject of a transaction in respect of which VAT is payable (see for example the decision of the ECJ in the *Hong Kong Trade* case in which the Hong Kong Trade Development Council, which made free supplies to traders was held not to be a taxable person and so had no right to deduction of VAT it had paid).[2]

I propose to examine the two conditions outlined above in more detail. The first, that there must be a taxable person indicates that in other words there must be "subjective liability to tax". The second, regarding the use of the supplied goods or services, indicates that the expenses must have a well-defined destination; in other words there must also be an "objective liability to tax".[3] I deal with subjective liability to tax at 3 below and objective liability to tax at 4 below. First of all, though, I examine what VAT qualifies for deduction.

2. What VAT Qualifies for Deduction?

2.1 *Only VAT due or paid by the taxable person qualifies for deduction.*

As we saw earlier Article 17 of the Sixth Directive mentions, in point 2(a), the VAT "due or paid [by the taxable person] ... in respect of goods or services supplied or to be supplied to him by another taxable person."

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2 *Staatssecretaris van Financiën v Hong Kong Trade Development Council*, Case 89/81, [1992] ECR I-1277.

3 The distinction between objective and subjective tax liability is not acknowledged as such in Belgium. It presumably originates from the period during which VAT was devised. The Advocate General refers to the distinction in his opinion in the Hong Kong Trade decision. (See p 1291).

This requirement contains two elements:

(1) Only the VAT which is due or paid by the taxable person can be deducted by him;

(2) the goods or services must be supplied to him.

At first sight this wording may seem superfluous but it is not. Two points may be made:

(1) The taxable person cannot deduct VAT on goods which he acquires, but on which VAT is charged which could not have been deducted at a previous stage (e.g. the purchase of a car from a private individual).

(2) The goods need not necessarily have been physically delivered to the taxable person; it is sufficient that they have been invoiced and sold to him. For example, when goods have been delivered directly to his employees, the employer retains the right of deduction, if it is he who has really purchased the goods (see the *Intiem* case).[4] The European Court of Justice stated in that case that the deduction system must be applied in such a way that its scope corresponds as far as possible to the sphere of the taxable person's business activity. The purpose of Article 17(2) of the Directive cannot be to exclude from the right of deduction the value added tax paid on goods which, although sold to the taxable person in order to be used exclusively in his business, were not physically delivered to him. This interpretation, the Court continues, is supported by the objective of the deduction system, which we find in the second paragraph of Article 2 of the First Council Directive, i.e, on each transaction, VAT is to be chargeable after deduction of the amount of VAT borne directly by the various cost components.

2.2 *Only the VAT which has been correctly invoiced qualifies for deduction.*

When VAT has been improperly charged by a supplier of goods or services, under Belgian administrative case law, the taxable person has no right to deduct this

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4 *Leesportefeuille "Intiem" CV v Staatssecretaris van Financiën,* Case 165/86, [1988] ECR 1471.

VAT. The European Court of Justice confirmed this in the *Genius Holding* case,[5] even though the European Commission, pleaded before the Court in favour of a right of deduction.

The Court pointed to the text of Article 17 of the Sixth Directive, which states that there is a right of deduction of the VAT "due or paid" in respect of goods or services supplied. This text differs from Article 11 of the Second Directive (which does not apply any more since the Sixth Directive has come into force) and the Commission's proposal for the text of Article 17 of the Sixth Directive, under which the taxable person was entitled to deduct any tax "invoiced" to him in respect of goods or of services supplied to him. The Sixth Directive itself refers to VAT *due*.

The Court also pointed out that its interpretation of Article 17 was confirmed by the other provisions of the Sixth Directive, including Article 18, which requires that the taxable person must hold an invoice drawn up in accordance with Article 22(3), stating clearly the tax corresponding to each supply of goods or services, for the right of deduction to be exercised. It follows, according to the Court, that the right cannot be exercised in respect of tax which does not correspond to a given transaction. The Court also referred to Article 20 of the Directive, which provides that the initial deduction shall be adjusted where that deduction was higher or lower than that to which the taxable person was entitled. The Court said that it followed from this that such adjustment should be made if the initial deduction did not correspond to the amount of the tax legally due, even if it corresponded to the amount of the tax mentioned on the invoice. The Court concluded that this interpretation of Article 17 of the Sixth Directive was better adapted to prevent tax evasion than if any tax invoiced could be deducted.

It appears to the writer that this does not solve all the problems. Does the party which has contracted for the goods or services in good faith have no protection at all? Do the principles of equity not become relevant at any stage?

The European Court of Justice stated in the *Genius Holding* case that it is up to the Member States to provide in their internal legal systems for the possibility of correcting any tax improperly invoiced where the person who issued the invoice shows that he acted in good faith.[6] But what if this person was acting in bad faith, when the recipient of the supply was acting in good faith? The European Court of Justice concedes that there must be a system which can correct the

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5 *Genius Holding BV v Staatssecretaris van Financiën,* Case 342/87, [1989] ECR 4227.

6 Supra at p 4247, para 18.

mistake, but it requires good faith. The Court's decision in the *Genius Holding* case does not, therefore, provide a complete solution.

It must be emphasised that under Article 11 of the Second Directive the Court would, presumably, have come to a different conclusion. As we saw above, Article 17 of the Sixth Directive which refers to VAT "due" lays down a more restrictive approach than that which applied under Article 11 of the earlier Second EEC Directive which granted a right of deduction of VAT *invoiced*. It is precisely on the difference in wording between Article 11 of the Second Directive and Article 17 of the Sixth Directive that the Court of Justice relied in stating that it is not the VAT invoiced, but the VAT properly due, which can be deducted.[7]

Turning to the domestic Belgian legislation, it is significant that Article 45 of the Belgian VAT Code refers not to VAT "due" but to taxes "levied". In this respect one cannot help but note that the title of Article 45 remained unchanged when it was adapted to the Sixth Directive and after the 1993 statutory amendment. Since a Directive can only prevail over national legislation to give a citizen rights not obligations, the solution adopted in Belgium could be the one which the Commission advocated in *Genius* and which the Court found in the Second Directive.

3. The Subjective Liability to Tax

3.1 *Expenses incurred before the existence of and after the cessation of the enterprise.*

As the business must exist in order to have a right of deduction, there cannot be, in principle, a right of deduction for VAT incurred before the existence of the enterprise, or after its cessation. Nevertheless, it can happen that certain expenses are incurred before one becomes a taxable person and that the goods or services supplied are used in a taxable activity at a later stage. For example, an individual purchases a computer. Two years later he becomes a taxable person and uses the computer for his activity. Can the individual still exercise a right to deduct the VAT paid on the purchase of his computer? Article 20.2 of the Sixth Directive provides that, in the case of capital goods, an adjustment shall be made "on the basis of the variations in the deduction entitlement in subsequent years in relation to that for the year in which the goods were acquired or manufactured."

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7 Supra at p 4246 paras 12 and 13.

In view of this text, one could try to argue that when a right of deduction, which did not exist initially, arises at a later stage, an adjustment of the deduction can be made. A deduction entitlement must be granted to so-called "mixed" taxable persons when a capital asset passes from a non-taxable to a taxable activity. Why then would the taxable person not have a right of deduction when a capital asset passes from his private sphere to a taxable activity? In both cases the goods are transferred from the realm of end consumption back to a use in a business activity. There is no reason to distinguish between the situations, however, the Court of Justice in *Lennartz* did not accept this reasoning.[8]

In the opinion of the Court, Article 20.2 of the Sixth Directive did not contain any provision concerning the origin of any right to deduct which is contained in Article 17 of the Sixth Directive. Since Article 17 implies that goods must be acquired for the purpose of taxable (or assimilated) transactions at the time when the deductible tax becomes chargeable, an individual who holds an asset in his private possession, does not have a right of deduction. The adjustment system only applies if there was a right of deduction at the beginning. Whether goods are acquired for the purpose of taxable activity is a question of fact. Article 20 however, only relates to the adjustment of an existing right of deduction, and does not itself create a right of deduction.

In the author's opinion, in this case, the Court has not sufficiently taken account of the basic principles of VAT and has let itself be tempted by an overly rigid interpretation of the Sixth Directive. The system of adjustments in respect of capital goods aims to ensure that VAT is charged on them when they pass from the business activity to the private sphere. VAT is charged in accordance with the number of years they are assumed to have been used privately. On the other hand the goods must remain free of VAT in so far as they are used for a taxable-activity. Furthermore, the Sixth Directive contains various provisions for the situation where goods from the private sphere are used again for business purposes. (There is no general principle, but there are various practical measures.) From this perspective, it is only logical that investments in the private sphere which, at some stage in future will be used for a taxable activity, are rendered free of VAT in so far as and for the period that they will be used for this activity. The same rule applies in the reverse situation when VAT has been charged.

In the author's view, the decision in *Lennartz* has far reaching consequences and it would be advisable to submit this issue to the Court of Justice again.

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8 *Lennartz v Finanzamt München III*, Case C 97/90 [1991] ECR I-3795.

4. The Objective Liability to Tax

In order for a right of deduction to be available the taxable person must carry out, or be likely to carry out transactions which fall within the scope of the VAT. The supplies of goods and services referred to in the Sixth Directive are transactions effected for consideration. Transactions which are carried out free of charge are, therefore, not taxable transactions. If the entrepreneur does not carry out any taxable transactions, he is not a taxable person. Although this position has been criticised, the Court of Justice has stated that the person who only carries out transactions free of charge is not a taxable person.[9]

There is no obligation for the taxable person to carry out taxable transactions exclusively. It is possible that, apart from his taxable activities, he carries out, regularly or occasionally, other transactions, or even that he has a second activity which falls outside the scope of the VAT. In this last case, we shall call him a *mixed taxable person* and his situation in respect of the deduction is dealt with in Article 17(5) of the Sixth Directive. The issue which arises now is, how and to what extent the taxable person's right of deduction is affected by the fact that he carries out activities which do not fall within the scope of VAT, and in what way his deduction entitlement is restricted. This is discussed in the three sections following.

4.1 *The Destination Principle*

From the text of Article 17 of the Sixth Directive we can conclude that there is only a deduction entitlement if the goods or services are used for specific purposes. However, at the time that the expense is incurred, this purpose is not always clearly defined. The expense can be incurred long before the taxable transaction, for which the supply is intended to be used, takes place. The real "destination" (the real use) can be presumed at that time, but it will not be established. The purpose of the expense can change afterwards. For example, the shoes which are purchased by a shoe dealer, may be destined to be sold, but it is also possible that he may put them on himself, thereby giving them a private purpose.

The strict application of the criterion of Article 17 of the Sixth Directive might be taken to imply that the deduction entitlement would only originate at the moment that the real destination of the supply is established. It is, however, more appropriate to interpret Article 17 as meaning that there is a right of deduction for all goods which are destined to be used in a taxable activity.

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9 See the decision of the Court of Justice in *Re Hong Kong Trade*, referred to in footnote 3.

This is also what the Court of Justice has stated in *Rompelman*:[10]

> "...the economic activities referred to in Article 4(1) may consist of several consecutive transactions, as is indeed suggested by the wording of Article 4(2) which refers to 'all activities of producers, traders and persons supplying services'. The preparatory acts, such as the acquisition of assets and therefore the purchase of immovable property, which form part of those transactions must themselves be treated as constituting economic activity.[11]
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> "...furthermore, the principle that VAT should be neutral as regards the tax burden on a business requires that the first investment expenditure incurred for the purposes of and with a view to commencing a business must be regarded as an economic activity. It would be contrary to that principle if such an activity did not commence until the property was actually exploited, that is to say until it began to yield taxable income. Any other interpretation of Article 4 of the Sixth Directive would burden the trader with the cost of VAT in the course of his economic activity without allowing him to deduct it in accordance with Article 17 and would create an arbitrary distinction between investment expenditure incurred before actual exploitation of immovable property and expenditure incurred during exploitation. Even in cases in which the input tax paid on preparatory transactions is refunded after the commencement of actual exploitation of immovable property, a financial charge will encumber the property during the period, which may sometimes be considerable, between the first investment expenditure and the commencement of exploitation. Anyone who carries out such investment transactions which are closely connected with and necessary for the future exportation (sic) of immovable property must therefore be regarded as a taxable person within the meaning of Article 4.[12]
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> "...Therefore Article 4 does not preclude the revenue authorities from requiring the declared intention to be supported by objective

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10 *Rompelman v Minister van Financiën*, Case 268/83, [1985] ECR 655.

11 Supra at p 665, para 22.

12 Supra at p 665, para 23.

> evidence such as proof that the premises which it is proposed to construct are specifically suited to commercial exploitation."[13]

Continuing with this approach, the Court stated in a subsequent case in 1988[14] that, in the absence of a provision authorising the Member States to restrict the deduction entitlement of a taxable person, the latter must have the right to exercise this entitlement immediately for any tax which has burdened transactions carried out in the previous stage.

Restrictions of the deduction entitlement have an influence on the level of the tax burden and must apply in the same way in all Member States. Consequently, derogations are only admissible in those situations which are expressly provided for in the Directive.

We must therefore conclude that there is a right of deduction as of the moment that the business is started, if there is a real and honest intention to develop taxable activities.[15] It is, therefore, not relevant whether the intention is actually realised. Should one, for one reason or another, not manage to realise the intention, e.g. because one is declared bankrupt before the activities are really developed, then this does not affect the deduction entitlement in so far as one's original intentions were genuine.

This last issue is a matter of fact and, depending on the circumstances, it can lead to problems of proof. The description of the company's object in its articles of incorporation will not be conclusive. The circumstances will have to show that there really was an intention to realise the object. Moreover, the description of the object of the enterprise can be ambiguous, and may include taxable activities as well as other activities. Furthermore, the company does not always carry out each of the activities described.

In the *Intercommunale voor Zeewaterontzilting* case in 1996,[16] the European Court of Justice considered this type of situation in response to a reference for a preliminary ruling from the Court of First Instance of Bruges. The case related to a Belgian company, established by certain Belgian provinces and municipalities,

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13 Supra p 665, para 24.

14 *Commission v France*, Case 50/87, [1988] ECR 4797.

15 See in this context: *Lennartz v München III* Case 97/90 [1991] ECR 1-3795.

16 *Intercommunale voor Zeewaterontzilting (Inzo), in liquidation v Belgian State*, Case C-110/94 [1996] ECR I-857.

for the purpose of developing and exploiting processes for the treatment of sea water and brackish water in order to turn it into drinking water which then could be marketed. To this end, the company acquired certain capital assets and commissioned a study on the profitability of a project for the construction of a desalination plant. The study of the project identified numerous profitability problems and some investors withdrew, whereupon the project was abandoned in 1988 and the company was put into liquidation.

The Belgian VAT authorities essentially argued that the commissioning of the study could not be described as an act unequivocally indicating the company's intention subsequently to move to a commercial phase, because its articles of association allowed it to confine itself merely to performing that study and its members had reserved the right to decide not to proceed after the study had been carried out. Accordingly, the Belgian VAT authorities maintained that the company had not unequivocally shown its intention to carry out taxable transactions.

The European Court of Justice observed that the Belgian VAT Authorities had accepted, in the first instance, that the company had the status of a taxable person, and reversed its decision afterwards. (There had, in fact, been repayments of input tax on the basis of the VAT returns). The Court stated that if the VAT authorities acknowledged that a company is a taxable person, the carrying out of a profitability study may be regarded as an economic activity, even if the purpose of that study is to investigate the degree of profitability of the activity envisaged. The fact that the activity is not carried out afterwards is irrelevant.

The Court continued (and this is the new element) that once it has granted the status of a taxable person, the VAT authorities cannot withdraw this status retroactively on account of the fact that certain events have or have not occurred. This would be contrary to the principle of legal certainty for the rights and obligations of taxable persons. Once the status of a taxable person has been granted, the decision remains valid. It cannot be retrospectively affected by subsequent events. The Court added that the person concerned must have made the declaration of intention to begin the envisaged economic activities in good faith. In cases of fraud or abuse, the tax authority may nevertheless withdraw the status. Nothing precludes the tax authority from requiring objective evidence in support of the declared intention to commence economic activities which will give rise to taxable transactions.

If the initial purpose of the taxable activity is not realised, or if the capital assets are used for a purpose other than the taxable activity, the deduction will be partially adjusted. If, for one reason or another, a building remains entirely unoccupied (e.g. because it was badly finished) the "destination principle" must be respected.

In essence, one can state that all purchases, investments and expenses which are made in the light of the activity of an enterprise and which undergo the risk of the enterprise, give the taxable person a right of deduction in respect of the input VAT at the time that the expenses are incurred, if the business has a taxable activity or if it can be expected that such activity will normally be developed.

In the light of the definition of the taxable person in the Sixth Directive as a person who independently carries out an economic activity, the destination principle can be translated to mean that for all expenses incurred in a business with a taxable activity, there is a right of deduction. As soon as assets or services received have a "business" character, as soon as they become "business assets", there is a right of deduction. As soon as the goods or services received become business assets, one can, as it were, assume that they have a "VAT destination". Whether a taxable person uses an asset for the purposes of his economic activity remains a matter of fact.

When determining this, one will have to examine first, the type of goods, and second, the period between the acquisition and the effective use (see the decision in the *Lennartz* case quoted above). This does not mean that the furniture dealer who purchases a cabinet with the intention of placing it in his private house, will have a right to deduction of the VAT in respect of this cabinet. The cabinet has never become a business asset, it has not become part of the business and as such there is no right of deduction. The destination principle excludes the deduction.

Nevertheless, as companies are restricted in their activities by their corporate objects, they only have business assets and all assets which they acquire automatically become business assets (at least, in the eyes of Belgian law). In so far as they have an object which includes taxable activities, one could state that there is in fact a presumption that all the goods and services which they obtain are destined for this object. Consequently, one could say that all their expenses give them in principle a right of deduction, to the extent that they do not have a mixed object which also includes activities which are not subject to VAT. If, at a later stage, it becomes clear that the presumed destination differs from the real destination, an adjustment of the deductions will have to be made (Article 20 of the Sixth Directive).

4.2. *Transactions Effected for Consideration outside the VAT Sphere.*

The decision of the Court of Justice of 6th April 1995 is a fine example of how the deduction of VAT is effected if the taxable person carries out activities which remain outside the VAT sphere.[17] In this decision, the Court examined the situation of an English company which was a management/holding company and which also provided services to the trading companies in which it held shares. In respect of this economic activity, the company must be considered to be a taxable person.

The questions arose when the English company sold one of its shareholdings to use the proceeds to pay off its debts. In order to effect this share transfer, the company used the services of merchant bankers, solicitors and accountants. The turnover tax which was charged by these advisers in respect of their services, was set off by the company against its output tax. The English VAT Authorities rejected this deduction because the share sale was not subject to the turnover tax.

The taxable person did not accept this qualification on the basis that the sale of the shareholding had allowed the company to continue its main activity i.e. to provide taxable services. There is therefore, at least, an indirect link between incurring the cost of the input tax and the taxable services which the company provides. Therefore the company argued, the deduction of input tax should be granted.

In the first place, the Court refers to a combined reading of Article 17, para 2 and para 5 of the Sixth Directive, from which it concludes that the right of deduction of the input tax can only be reserved for the supply of goods and services which have a *direct and immediate* link with the taxable transactions. The ultimate aim pursued by the taxable person is irrelevant in this respect. The Court also pointed out that the system for calculating the deductible proportion of VAT as provided by Article 19 of the Sixth Directive, presupposes that the goods or services have been used by the taxable person both for transactions in respect of which there is a right to deduct and for transactions where there is no such right. This condition was not met as the services of the legal advisers were only used for a transaction which is exempt from turnover tax (the share transfer). In those circumstances, the deduction of input tax (even partially) is excluded. One must not take account of the ultimate aim pursued by the taxable person.

From the Court's comments, we can conclude that a taxable person who carries out transactions which give a deduction entitlement (in this case the management of the shareholding) and transactions which do not qualify for the deduction (the share transfer) has no right of deduction, not even a partial one.

The decision of the Court of Justice contains two important principles:

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17 *BLP Group Plc v Commissioners of Customs & Excise*, C-4/94, [1995] ECR I-983.

(1) There can only be a mixed tax liability if there are mixed expenses. In this respect, it is not relevant how many types of expenses or activities there are. The expenses are the starting point. There can be income from different activities, but initially this does not make any difference;

(2) The expenses only give a deduction entitlement under the rule of the mixed tax payer (Article 17, Sixth Directive) if they have a mixed use, i.e. if they are used both for the tax exempt activity and for the activity which is subject to VAT.

4.3 *Income which does not relate to any transactions (partial tax liability).*

The destination principle contains a clear link between the goods and services received and the goods or services supplied by the taxable person. The expenses must be incurred for specific activities. The proceeds of these activities are not to be considered (except for mixed taxpayers, but then not in order to determine the deduction entitlement, but for calculating the amount of the deduction). The fact that one has income without having carried out any transactions in order to receive this income (subsidies, grants, donations, membership fees, etc.), does not, in my opinion, affect the deduction entitlement, nor the amount of the deduction.

The following example may help to clarify this:

A Belgian ASBL (Association sans but lucratif/Not-profit organisation) which has as its main object the promotion of tourism, organises press conferences, advertises, organises stands in fairs and carries out other activities without receiving direct consideration. These activities do not make the organisation a taxable person because they are not the sort of transactions envisaged by the VAT code. The grants, membership fees, donations and other subsidies received, are not the consideration for its activities to promote tourism in general. On the other hand, the sale of publications, fliers, brochures, etc is a taxable activity. Although the organisation is a taxable person for part of the activities which it carries out for the realisation of its object, the Belgian VAT Administration nevertheless considers that the organisation does not qualify as a mixed tax payer. In my opinion, the fact that subsidies, grants or membership fees are received cannot affect the deduction entitlement.

Article 17 of the Sixth Directive simply has to be applied; it does not link the deduction entitlement to any destination of the expenses. In my view, the qualities of a taxable person and of a non-taxable person are not mixed, for the sole reason that the subsidies, etc. are received - this can only be the case if there are taxable and non-taxable activities, not if there are taxable and non-taxable proceeds. The decision of the Court of Justice in BLP supports this position.

Part II: Exercise of the Right of Deduction

Article 18 of paragraph 1 of the Sixth Directive provides that, in order to exercise his right of deduction in respect of input VAT on goods and services supplied to him, the taxable person must hold an invoice drafted in accordance with Article 22 paragraph 3. If the input tax relates to VAT due on importation, the taxable person must be able to present a document evidencing the importation specifying him as consignee or importer, and stating or permitting calculation of the amount of tax due. If the deduction relates to transactions assimilated to supplies of goods and services, the taxable person must comply with the formalities established by each Member State. For the deduction of VAT in respect of transactions for which the purchaser or beneficiary is required to pay the VAT, he must again, comply with the formal requirements imposed by the Member State. As for VAT in respect of intra-community acquisitions, all useful information must be recorded in order to be able to establish the amount of the tax due, and the taxable person must have an invoice. In order to exercise the deduction entitlement, the invoice which one must hold, must comply with all relevant statutory requirements and contain all information prescribed by the law.

In two cases, a Court submitted a reference for a preliminary ruling to the European Court of Justice as to whether the Belgian State could impose certain conditions in respect of the contents of the invoice.

We have already mentioned that the Sixth Directive requires, in Article 18 paragraph 1, that in order to exercise his right of deduction in respect of input VAT on goods and services supplied to him, the taxable person must hold an invoice drafted in accordance with Article 22, paragraph 3. Article 22, paragraph 3(b), states that the invoice must give clearly the price exclusive of tax and the corresponding tax at each rate as well as any exemptions. Under paragraph 3(c) the Directive adds that the Member States shall determine the criteria for considering whether a document serves as an invoice.

The question referred to the European Court of Justice was whether these provisions permit the Member States to make the exercise of the right to deduction subject to the holding of a document which must contain specific information. The Court pointed out that[18] these provisions allow Member States to request certain particulars which are necessary in order to ensure the levying of value-added tax and permit supervision by the tax authorities. Such particulars must be limited to what is necessary to ensure the levying of the VAT and to allow control.

18 *Jeunehomme and Others v Belgian State*, Joined Cases 123 and 334/87, [1988] ECR 4517. See also *Reisdorf v Finanzamt Köln-West* Case C-85-95 (5th December 1996).

Moreover, such particulars must not, by reason of their number or technical nature, render the exercise of the right of deduction practically impossible or excessively difficult. It is for the national court to determine whether or not the particulars required by the Belgian legislation are in compliance with the criteria set out above.

Part III: Adjustment of the Deduction of VAT in respect of Capital Goods

The Definition of Capital Goods

In respect of the adjustment of the deduction entitlement, capital goods are all tangible assets which are destined to be used permanently as working instruments or equipment. Article 20, paragraph 4 of the Sixth Directive authorises the Member States to define the notion of "capital goods". The Second Directive did not give the Member States that authority. The question then arose, under that Directive, as to whether the national legislator could in fact give a definition of this concept in order to determine the meaning and scope of "capital goods". The European Court of Justice said[19] that the Second Directive did not refer to national legislation. Consequently, the interpretation of the term in general could not be left to each Member State. The Court stated that according to the expression the term has to be interpreted by reference to its normal meaning and in the context of the provisions of the Directive. These indicate that it covers goods which are used for an economic activity and which are distinguished from other goods by their value and durable nature so that the costs of acquiring them are normally depreciated over several years rather than recorded as one-off expenditure.

Since the Second Directive did not contain sufficient indications to determine in a uniform manner which conditions must be complied with in respect of the value, duration of use and depreciation, the Court concluded that the Member States had a certain margin of discretion as regards those matters provided that they paid due regard to the distinction between capital goods and other goods used in the management and running of undertakings.

As noted above, the decision of the Court related to the application of the Second Directive. The Sixth Directive (Article 20(4) does give the Member States the authority to define "capital goods" under the provisions relating to the adjustment of deductions. Is this decision of the Court then still relevant? It may well be

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19 *Verbond vom Nederlandse Oudememiligeu v Inspecteur der Invoerrechten en Accijuzen* Case 51/76 [1977] 113.

because when we take account of the principles put forward by the European Court of Justice in *Re Gaston Schul*,[20] it seems certain that no definition can be given which might infringe the general principles underlying the Sixth Directive (free movement of goods, neutrality, avoidance of double taxation).

The definition given by the Court raises certain questions which may be rather theoretical. A Dutch commentator maintains that the Court has not made clear whether the conditions of durability and value must be applied simultaneously, or whether they must be applied separately.[21] The implicit conclusion to be drawn from the decision seems to be that the conditions must be applied simultaneously, together with the conditions in respect of depreciation. One must, however, maintain some logic when applying the definition put forward by the Court. It would be hard to argue that a very valuable instrument which deteriorates quickly[22] would not constitute a capital asset, even if it is not to be depreciated.

The issue of the depreciation must, of course, be considered objectively, and not in terms of the depreciation actually applied in a specific enterprise. Capital goods are goods which are normally depreciated, irrelevant of whether an enterprise depreciates them in a specific case. The definition will, however, always leave room for debate.

Part IV: The Mixed Taxpayer

Deduction of a proportion of VAT by the mixed taxpayer

Article 17, paragraph 5 of the Sixth Directive provides for the deduction of a proportion of VAT by a mixed taxpayer.

The proportion deductible shall be made up by a fraction, defined by Article 19 paragraph 1, of the Sixth Directive, as having:

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20 *Gaston Schul Donane Expediteur BV v Inspecteur der Invoerrechteu en Accijuzen (Roosendaal)* Case 15/81 [1982] ECR 1409.

21 BIJL, DB, 'Zijn bedrijfsmiddelen investeringsgoederen?' Weekblad Fiscaal Recht, 1977, nr 5310 p 265.

22 In its observations to the court, the German government gave the example of a diamond saw. (See supra p 122).

- as numerator, the total amount, exclusive of value added tax, of turnover per year attributable to transactions in respect of which value added tax is deductible under Article 17(2) and (3).

- as denominator, the total amount, exclusive of value added tax, of turnover per year attributable to transactions included in the numerator and to transactions in respect of which value added tax is not deductible. The Member States may also include in the denominator the amount of subsidies, other than those specified in Article 11A(1)(a).

The proportion must be determined on an annual basis, fixed as a percentage and rounded up to a figure not exceeding the next unit.

The question arises as to whether all "proceeds" must be included in the numerator and denominator, or whether only the proceeds of transactions carried out must be considered? E.g. do dividends have to be included in the denominator of the fraction. The European Court of Justice was of the opinion that they did not.[23]

The Court based itself on the following arguments:

- In ordinary language, dividends are not part of the turnover. Turnover means the proceeds of the sale of goods. In the layout of the annual accounts dividends are also recorded separately from the turnover (See the Fourth Company Law Directive).

- Including dividends in the denominator of the proportion seems contrary to the purpose of the deduction of VAT, i.e. to exempt the economic activities as much as possible of VAT. Otherwise, an increase in the dividends received by an enterprise would result in a reduction of the right to deduct VAT in respect of its economic activities. In other words, the mere holding of financial participations is so passive that it requires little or no use of the goods on which VAT is due.

This decision has an indirect impact on what is called in Belgium partial taxable persons (see above). Their deduction entitlement is limited by the fact that they receive subsidies and other proceeds. We have already argued that it does not make any sense to include such proceeds in the limitation of the deduction entitlement because there are no expenses involved in obtaining subsidies and

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23 *Sofitam v Milnstre Chargé du Budget* Case C-333/91 ECR [1993] I-35B distinguished in *Régie Dauphinoise v Ministre de Budget* Case C-306-94 [1996] I-3695. See also, *Taxable Persons and the "Private Life" of Companies* P Farmer ECTJ 2/1 [1997] 41.

therefore, there is no input tax on the relevant expenses. We have also mentioned that Article 17 of the Sixth Directive limits the deduction in terms of the destination principle and not in terms of the proceeds. The situation is almost identical here but the proceeds were not obtained by incurring expenses on which input tax has been paid. The decision in *Sofitam* applies to all types of passive income. The notion of passive investment income is, however, unclear. For example, some intra-group lettings of property may entail no expenses or transactions on the part of the lessor. Could the *Sofitam* decision apply in such a situation? The position is, of course, different for professional property companies. In this context their rent will be taken into account for the purposes of Article 19.

Part VI: The Sale Subject to VAT of an Asset which is only used Partially for the Economic Activity.

Goods which are used partially for a VAT activity, in principle, only give a limited right of deduction, i.e. in so far as it is used for the purpose of the business. If such goods are disposed of under conditions which make VAT payable, it is traditionally assumed in Belgium that VAT must be calculated on the price of the entire goods. Output tax must therefore also be charged in respect of the part of the asset for which there was no deduction entitlement.

This means, of course, that the asset is subject to tax twice. This is not acceptable. The Belgian VAT code does, however, provide for a system of adjustment, which will not be detailed here.

The decision of the European Court of Justice in *Armbrecht*[24] casts further light on this issue. A German businessman who had used a property partially for a VAT activity, sold it. As it had only been used partially for VAT purposes, he only charged output VAT on the part used for VAT purposes. No tax was paid in respect of the part of the property which was used privately. The German Tax Authorities did not agree with this approach, and the issue was referred to the European Court of Justice for a preliminary ruling.

The Court stated that for a transaction to be subject to VAT, the taxable person must act 'as such'. A taxable person performing a transaction in a private capacity does not act as a taxable person and the transaction which he performs is not subject to VAT. Furthermore, there is no provision in the Directive which precludes a taxable person who wishes to retain part of an item of property

24 CJEC, 4th October 1995, *Re Finanzamt Uelen v Dieter Armbrecht*, Case C-291/92, [1995] ECR I-2775.

amongst his private assets excluding that part from the VAT system. The taxable person may choose whether or not to integrate into his business, for the purposes of applying VAT, part of an asset which is given over to his private use. This approach concurs with one of the basic principles of the Directive, namely that a taxable person must bear the burden of VAT only when it relates to goods or services which he uses for private consumption and not for his taxable business activities.

The Court said that the availability of this option does not impede the application of another rule stated by the Court in *Lennartz* (see above), to the effect that capital goods used both for business and private purposes may nonetheless be treated as business goods, the VAT on which is, in principle, wholly deductible. Apportionment between the part allocated to the taxable person's business activities and the part retained for private use must be based on the proportions of private and business use in the year of acquisition. Moreover, the taxable person must throughout his entire period of ownership of the property in question, demonstrate an intention to retain part of it amongst his private assets.

Only in so far as an asset is used for taxable transactions, can the taxable person deduct the VAT due or paid from the output tax which he owes. If the taxable person decides not to allocate a part of an asset to his business assets, it is clear that at no time does this part ever become part of his business assets. Therefore, the taxable person cannot be deemed to use business goods for private purposes. The part which is not used to provide taxable supplies of goods or services, for business purposes, will remain outside the scope of the VAT system and when applying the deductions of the VAT, one does not have to take account of this part.

We can draw the following conclusions from this decision:

- An asset which is partially destined for private purposes, will be partially free from VAT on disposal if no deduction of VAT was effected at the time of the acquisition in respect of the private use. In those circumstances there will be no possibility of an adjustment of the deduction.

- The private use of an asset which is part of a taxable person's business assets, is only subject to VAT if he has effectively considered this asset as part of his business assets by taking a full deduction of the input tax. The taxable person has the choice not to apply a VAT destination to an asset and not to deduct the input tax. His private use must, therefore, not be taxed.

- If the taxable person has not made a deduction at the time of the acquisition of the asset, irrespective of whether he uses it wholly or partially for private purposes, its disposal must not be subject to VAT. The taxable person has then opted not to act as a taxable person in respect of this asset. The author notes that the Belgian VAT code only provides, in Article 44 paragraph 2, 13, that no VAT is due in respect of the disposal (supply) of an asset in respect of which the deduction of VAT is excluded by law.

- Another conclusion is that the taxable person probably does not have the choice to use an asset during one year for business purposes and not to do so during another year. Once the asset is allocated to the private sphere, it remains there. If one purchases for private purposes, or at a time when one was not a taxable person, this asset cannot, at a later stage, be placed within the sphere of VAT, e.g. at the time that he becomes a taxable person. In this respect the Court has confirmed its decision in *Lennartz*.

I conclude these observations by noting that the rules concerning deduction of VAT are not always as clear as they seem to be. The Court of Justice will probably have to decide many more cases in this area.