MONCKTON CHAMBERS

Case and Comment

The right to deduct in Luxembourg – (VAT) world domination continues

Andrew Macnab, Barrister, Monckton Chambers

Case C-159/17, ***Întreprinderea Individuală Dobre M. Marius***, ECLI:EU:C:2018:161 (judgment of 7 March 2018)

Case C-533/16, ***Volkswagen AG***, ECLI:EU:C:2018:204 (judgment of 21 March 2018)

Case C-8/17, ***Biosafe v Flexipiso***, ECLI:EU:C:2018:249 (judgment of 12 April 2018)

Case C-81/17 ***Zabrus Siret SRL***, ECLI:EU:C:2018:283 (judgment of 26 April 2018)

The Court of Justice (CJEU) has released four recent judgments concerning compatibility with EU law of national restrictions on the right to deduct input VAT. The judgments confirm the "*dominant position*" of the right to deduct in the common system of VAT.

The right to deduct

Each judgment starts with a recitation of some of the following basic principles or rules of the right to deduct, which will by now be familiar to every VAT practitioner:

- The right of taxpayers to deduct the VAT due or paid on goods and services received as inputs (*i.e.* input tax) from the VAT they are liable to pay on their supplies of goods and services (*i.e.* output tax) is a fundamental principle of the common system of VAT established by (now) Directive 2006/112/EC (*i.e.* the Principal VAT Directive or PVD).

- The right to deduct is an integral part of the VAT scheme and in principle may not be limited.

- The right to deduct is exercisable immediately in respect of all the taxes charged on input transactions.

- The deduction system is intended to relieve the trader entirely of the burden

of the VAT payable or paid in the course of all his economic activities. The common system of VAT consequently ensures the neutrality of taxation of all economic activities, whatever their purpose or results, provided they are themselves subject in principle to VAT.

- The right to deduct is subject to compliance with both substantive and formal requirements or conditions.

- The substantive requirements for the right to arise are, first, that the "interested party" is a "taxable person" (within the meaning of the Directive), and, second, that the goods or services relied on to give entitlement to the right to deduct must be used by the taxable person for the purposes of his own taxed output transactions and (third) that, as inputs, those goods or services must be supplied by another taxable person.

- The formal requirements or conditions for the right to deduct are those that regulate the rules governing its exercise and monitoring thereof and the smooth functioning of the VAT system, such as the obligations relating to accounts, invoicing and filing returns. (For example, the detailed rules governing the exercise of the right to deduct require that the taxable person must hold an invoice drawn up in accordance with Articles 220 to 236 and Articles 238 to 240 PVD.)

- The fundamental principle of VAT neutrality requires deduction of input tax to be allowed even if the taxable person has failed to comply with some of the formal requirements. (For example, identification for VAT purposes and the obligation of a taxable person to state when his activity as a taxable person commences, changes or ceases are only formal requirements for the purposes of control and cannot compromise the right to deduct if the substantive conditions are satisfied.)

- The right to deduct input VAT arises on the date on which the tax becomes chargeable. In principle, however, the right to deduct can be exercised only once the taxable person holds a VAT invoice.

- The right to deduct is generally exercised during the accounting period when the input VAT has arisen, i.e. at the time the tax becomes chargeable. The right to deduct must, in principle, be exercised in respect of the period during which (1) the right has arisen and (2) the taxable recipient is in possession of an invoice which shows the VAT payable by him.

- Nevertheless, a taxable person may be authorised to make a deduction even if he did not exercise his right during that period, subject to compliance with certain conditions and procedures determined by national legislation.

- The possibility of exercising the right to deduct without any temporal limit would be contrary to the principle of legal certainty, which requires the tax position of the taxable person, in the light of his rights and obligations vis-à-vis the tax authority, not to be open to challenge indefinitely.

- 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, is therefore compatible with the EU VAT regime, provided the limitation period complies with the principles of equivalence and effectiveness. As the regards the latter, the limitation period must not in practice render impossible or excessively difficult the exercise of the right to deduct.

- Member States impose other obligations that they deem necessary for the correct collection of VAT and the prevention of evasion. Prevention of evasion, avoidance and abuse is a recognised objective and encouraged by the PVD. The measures Member States may adopt must not go further than is necessary to attain such objectives. Therefore, measures may not be used in such a way that they would have the effect of systematically undermining the right to deduct VAT and, consequently, the neutrality of VAT.

- Penalising the failure of the taxable person to comply with the obligations relating to accounts and tax returns by denial of the right to deduct goes further than is necessary to attain the objective of ensuring correct application of those obligations, since EU law does not prevent the Member States from imposing a fine or financial penalty proportionate to the seriousness of the offence.

- The position could be different if the effect of failure to satisfy formal requirements is to prevent the production of conclusive evidence that the substantive requirements have been satisfied. Refusal of the right to deduct depends more on the lack of information necessary to establish that the substantive requirements have been satisfied than it does on failure to comply with a formal requirement.

- The right to deduct may be refused if it has been established, in the light of objective evidence, that that right is being invoked fraudulently or abusively.

- Even if breaches of formal requirements do not prevent the production of conclusive evidence that the substantive requirements have been satisfied, the circumstances may establish that the taxable person deliberately failed to fulfil the formal requirements with the aim of evading payment of the tax.

- It is for the national court to ascertain whether the tax authorities have the information necessary to establish that the substantive requirements giving rise to the right to deduct input VAT have been satisfied, notwithstanding failure to satisfy formal conditions.

- Refusal of the right to deduct is an exception to the application of the fundamental principle constituted by the right to deduct. It is therefore incumbent on the tax authorities to establish, to the requisite legal standard, that the objective evidence establishing the existence of a fraud or abuse is present. It is for the national courts subsequently to determine whether the tax authorities concerned have established the existence of such objective evidence.

C-159/17 *Dobre*

Mr Dobre was "identified for VAT purposes" in Romania between 13 July 2011 and 31 July 2012. He failed to submit returns, which led to the revocation of his registration from 1 August 2012. Thereafter, he continued to charge VAT and issue invoices including VAT, but did not submit returns accounting for that VAT. On 30 January 2014, he submitted the missing returns for 2011 and the first half of 2012. Following an inspection in 2015, the tax authorities issued a tax demand for the VAT Mr Dobre had charged on supplies following deregistration. In response, he filed a claim to deduct the input VAT he had paid on goods and services used for those taxable supplies. The tax authorities rejected that claim. Mr Dobre appealed.

The national court referred questions to the CJEU, which reformulated those questions as asking whether the PVD precluded national legislation which allowed the tax authorities to refuse a taxable person the right to deduct VAT when his identification for VAT purposes had been revoked for failure to submit VAT returns in time. Having recited a selection of the principles/rules above, the CJEU held as follows-

- failure to file a VAT return, which would allow VAT to be applied and monitored by the tax authorities, is liable to prevent the correct collection of the tax and, therefore, to compromise the proper functioning of the common system of VAT;

- therefore, EU law does not prevent such infringements from being considered to amount to tax fraud and the right to deduct being refused in such a case;

- the PVD does not therefore preclude national legislation which allows tax authorities to refuse a taxable person the right to deduct VAT when it is established that, on account of the alleged infringements committed by

that person, the tax authorities could not have access to the information necessary to establish that the substantive requirements giving rise to the right to deduct input VAT paid by that taxable person have been satisfied, or that that person acted fraudulently in order to enjoy that right, a matter which it is for the referring court to ascertain.

Case C-533/16, *Volkswagen*

In outline, between 2004 and 2010, taxable persons supplied Volkswagen with moulds for the manufacture of lights for motor vehicles. The suppliers did not charge VAT or include VAT on their invoices, as they considered the transactions to be exempt supplies of "financial compensation" rather than standard rated supplies of goods. Why is not clear, but not relevant. In 2010, the suppliers realised their mistake and issued invoices charging the VAT due by Volkswagen (which Volkswagen paid); the suppliers filed supplementary VAT returns for all years from 2004 to 2010; and paid the relevant VAT to the tax authorities. In 2011, Volkswagen claimed a refund of the input VAT from the tax authorities. The claims were accepted for 2007 to 2010, but rejected for 2004 to 2006. The tax authority decided that the right to refund arose on the date of delivery of the goods and that, consequently, the claims for 2004 to 2006 were time barred by the national 5-year limitation period. Volkswagen contended that the right to deduct only arose when goods and services had been supplied and the VAT has been applied by the supplier through the issuing of an invoice; and that the limitation period could not begin to run if those two conditions had not been met.

The Slovakian Supreme Court referred questions to the CJEU, which reformulated them as asking, in essence, whether EU law precluded national rules under which, in circumstances in which VAT was charged to the taxable person and paid by it several years after delivery of the goods in question, the benefit of the right to a refund of VAT is denied on the grounds that the limitation period for the exercise of that right began to run from the date of supply of the goods and expired before the application for a refund was submitted. After the familiar recitation of principles/rules, the CJEU held as follows:

- although the supplies of goods were carried out between 2004 and 2010, the suppliers did not make an adjustment of the VAT until 2010, when they drew up invoices including the VAT, sent supplementary returns to the tax authorities and paid the VAT that was due. The risk of tax evasion or non-payment of VAT had been excluded.

- In those circumstances, it was objectively impossible for Volkswagen to exercise its right to a refund before that adjustment, as, prior to that, it had neither been in possession of the invoices nor aware that the VAT was due.

- It was only following that adjustment that the substantive and formal conditions giving rise to a right to deduct VAT were met and that Volkswagen could therefore request to be relieved of the VAT burden due or paid, in accordance with the PVD and the principle of fiscal neutrality.

- Accordingly, since Volkswagen did not demonstrate a lack of diligence, and in the absence of an abuse or fraudulent collusion with the suppliers, a limitation period which began from the date of supply of the goods and which, for certain periods, expired before that adjustment, could not validly deny Volkswagen the right to a refund of VAT.

Case C-8/17, *Biosafe*

Biosafe was essentially a variant of *Volkswagen*. Between February 2008 and May 2010, Biosafe sold Flexipiso rubber granules manufactured from recycled tyres, on which Biosafe applied VAT at the reduced rate of 5%. In 2011, the Portuguese tax authorities ruled that the standard VAT rate of 21% should have been applied and issued revised VAT assessments against Biosafe. Biosafe paid the assessments and claimed reimbursement from Flexipiso, by sending it debit notes, on 24 October 2012. Flexipiso refused to pay the additional VAT on transactions carried out on or before 24 October 2008, on the ground that it could not itself deduct that VAT because the national 4-year limitation period applicable to claims to deduct ran from the date of issue of the original invoices, not from the date of issue or receipt of the rectifying documents; and, essentially, that this was all Biosafe's fault. Biosafe sued Flexipiso in contract. The lower courts held that Biosafe could not pass on the VAT relating to those invoices to Flexipiso, because Flexipiso no longer had the right to deduct VAT, and because it was clear that the error regarding the applicable tax rate was attributable to Biosafe.

The Portuguese Supreme Court referred questions to the CJEU, which reformulated them as asking, in essence, whether the PVD and the principle of neutrality precluded national rules pursuant to which the right to deduct VAT was to be refused on the ground that the limitation period for the exercise of the right started to run from the date of issue of the initial invoices and had expired, in circumstances where, following a tax adjustment, additional VAT was paid to the State and was the subject of documents rectifying the initial invoices several years after the supply of the goods in question. After the familiar recitation of principles/rules, and relying almost exclusively on Volkswagen, the CJEU decided as follows:

- Although the existence of systematic practices of tax evasion and avoidance could not be excluded in the circumstances of the case, the CJEU had no jurisdiction to question the national court's assessment of the facts and the determination that the "error regarding the choice of

applicable VAT rate [was] clearly attributable to Biosafe".

- In those circumstances, it seemed that it was objectively impossible for Flexipiso to exercise its right to deduct before the VAT adjustment carried out by Biosafe, since before then it did not possess the documents rectifying the initial invoices and did not know that additional VAT was due.

- It was only following that adjustment that the substantive and formal conditions giving rise to a right to deduct VAT were met and that Flexipiso could therefore request to be relieved of the VAT burden due or paid in accordance with the VAT Directive and the principle of fiscal neutrality. Since Flexipiso did not show any lack of diligence before the receipt of the debit notes, and failing any abuse or fraudulent collusion with Biosafe, a limitation period that started to run from the date of issue of the initial invoices and that, for certain transactions, expired before this adjustment, could not validly be used to deny Flexipiso the exercise of the right to deduct VAT.

Case C-81/17 *Zabrus*

In brief, Zabrus was the subject of a VAT inspection by the tax authorities for the period 1 May 2014 to 30 November 2014. The inspection concluded in January 2015. Thereafter, Zabrus sought refunds of two amounts of input tax incurred during the period covered by the inspection, as a result of corrections made after conclusion of the inspection. The first amount resulted from the correction of an accounting note; the second resulted from the correction of transactions in respect of which Zabrus identified the relevant supporting documents only after the conclusion of the inspection. The tax authorities (and lower courts) refused Zabrus' claims, deciding that the 5-year limitation period that would otherwise have applied was overridden, relying on the principles of "the unity of tax inspections" and legal certainty: in respect of the period already subject to inspection, no irregularity concerning VAT contributions had been found and the inspection bodies did not adopt any measure laying down steps to be taken by Zabrus.

The Romanian Court of Appeal referred questions to the CJEU, which reformulated them as asking whether the PVD and the principles of effectiveness, fiscal neutrality and proportionality precluded national rules, which, by way of derogation from the 5-year limitation period in national law for the correction of VAT returns, prevented, in the circumstances of the case, a taxable person from making such a correction in order to claim his right of deduction on the sole ground that that correction relates to a period that has already been the subject of a tax inspection. After the familiar recitation of principles/rules, the CJEU held as follows:

- the principle of effectiveness precluded national legislation in so far as it was liable to deny, in the circumstances of the case, a taxable person the opportunity to correct his VAT returns when he had been the subject of a tax inspection concerning the tax period relating to that correction, even though the 5-year limitation period otherwise applicable to corrections had not yet expired. Where (as here) the tax inspection began immediately or shortly after the filing of a tax return, the taxable person was deprived of the opportunity to correct his VAT return, so that the exercise of the right to deduct VAT by the taxable person became impossible in practice or, at the very least, excessively difficult. The fact that national legislation deprived the taxable person of the opportunity to correct his VAT return by shortening the time available to him for that purpose was incompatible with the principle of effectiveness.

- The legislation also infringed the principle of neutrality. That principle required deduction of input tax to be allowed if the substantive requirements were satisfied, even if the taxable person had failed to comply with some of the formal requirements. It was failure to comply with certain formal requirements that resulted in deduction being refused. The non-compliance with formal requirements, which could be remedied, was not such as to call into question the proper functioning of the VAT system. The application of the national legislation would result in a part of the VAT burden remaining definitively with the taxable person, contrary to the principle of neutrality.

- The legislation also infringed the principle of proportionality. Member States may attach penalties to the formal obligations of taxable persons to encourage them to comply with formal obligations, to ensure the proper working of the VAT system. Accordingly, an administrative fine (inter alia) could be imposed on a negligent taxable person who corrected his VAT return by relying on documents proving his entitlement to a VAT deduction which were in his possession at the time his VAT return was filed or following the discovery of a recording error altering the amount of VAT to be reimbursed. However, proportionality required Member States to employ means which, while enabling them effectively to attain the objective pursued by national legislation, were the least detrimental to the principles laid down by EU legislation, such as the fundamental principle of the right to deduct VAT. Therefore, in a situation such as that at issue, and in view of the dominant position which the right of deduction has in the common system of VAT, a penalty consisting of an absolute refusal of the right of deduction appeared disproportionate where no evasion or detriment to the budget of the State was ascertained.

- The national legislation was not justified by the "principle of a single tax inspection" or the principle of legal certainty. The national tax inspection

system, which did not allow a taxable person to correct his VAT return, but provided for such correction where made by implementing a measure of the tax authorities and for the tax authorities to be able to conduct a review where they had new information, was not intended to safeguard the rights of taxpayers and did not serve the application of the principle of legal certainty: the system was implemented mainly to ensure the effectiveness of tax inspections and the functioning of the national administration.

Comment

First, all four cases reiterate the fundamental importance of the right to deduct in the common system of VAT. The reference in *Zabrus* to "dominant position" of the right to deduct is new and will no doubt reappear in future cases. The CJEU continues to look favourably on any "innocent" taxpayer (i.e. one not engaged in evasion, avoidance or abuse) seeking to exercise the right who can satisfy the two critical substantive conditions for the right, i.e. that the input supply must take place between two taxable persons and that the taxpayer must use the input supply to carry out his own taxable transactions. National formal requirements seem to be viewed as necessary evils rather than integral parts of a coherent system.

Second, the CJEU's reasoning is not entirely clear in places:

- In *Volkswagen* and *Biosafe*, it is not clear what degree of knowledge or notice the CJEU had in mind when referring to the claimants' "lack of awareness that VAT was due"; or what part that played in the overall decisions. It may perhaps be inferred that (1) because any sum charged by supplier to customer in respect of "VAT" is a matter of contract and, save in exceptional cases, the customer is not itself liable to the tax authority for VAT on a supply and (2) the transactions were not abusive or intended to evade VAT, that "lack of awareness" was simply a reflection of what appeared (or did not appear) on the original invoices; and that the customer was not to be criticised if it did not dictating to the supplier the VAT treatment of the supply.

- In *Zabrus*, the reasoning in respect of the principle of effectiveness seems circular; the reasoning in respect of neutrality seems little more than assertion.

Third, the cases are unlikely to have any significant impact in the UK:

- Underlying *Dobre* is the unsurprising notion that charging customers VAT when unregistered for VAT and not submitting VAT returns accounting for that VAT are generally Bad Things; anyone refused the right to deduct

in such circumstances can expect little sympathy. (It may be noted that assessments under section 73(1) VATA are of net sums, taking into account both outputs and inputs).

- The national limitation periods at issue in *Volkswagen* and *Biosafe*, which ran from the date when VAT became chargeable (*i.e.* the dates of the original supplies) may be compared with the 4-year time limit on late input tax claims in regulation 29(1A) of the VAT Regulations 1995, which links the running of the limitation period to the taxpayer's holding of the document (VAT invoice, etc.) required to exercise the right to deduct.

- Likewise, and by contrast to the national rules in *Zabrus*, the time limit in regulation 29(1A) is generally applicable and not overridden where the taxpayer is subject to a "tax inspection". In principle, a taxpayer may make unlimited late claims to deduct within the relevant 4-year period. (An analogy might also be drawn here with *John Wilkins (Motor Engineers) Ltd v RCC* [2010] STC 2418, where the Court of Appeal held that there was nothing – procedurally – in section 78 VATA to stop a taxpayer making successive claims for "compound interest").

Fourth, *Biosafe* is an interesting case in that the reference was made in the course of commercial litigation between private parties, rather than tax litigation between taxpayer and tax authority. It is also interesting to note that the CJEU did not qualify its judgment by suggesting that it was for Flexipiso, alone, to decide whether to assert a directly effective right against the tax authority to have the national time limit disapplied.

Fifth, it remains to be seen what impact *Volkswagen* and *Biosafe* have on the *Zipvit* litigation, currently before the Court of Appeal on appeal from *Zipvit Ltd v HMRC* [2016] STC 1782 (and the judgment in which may have been handed down by the date of publication). At first sight (and pace various dicta of the Upper Tribunal), it is difficult to see how Zipvit can claim to deduct input tax in circumstances where its supplier, Royal Mail, did not purport to charge Zipvit VAT on its supplies (in the belief that those supplies were exempt, even though they should properly have been standard rated), did not include VAT on its invoices to Zipvit (which described the supplies as exempt) and did not claim any further charge from Zipvit in respect of VAT when the correct VAT treatment of those supplies had been ascertained. The Upper Tribunal's decision was based on the reasonableness of HMRC's refusal to accept "other evidence" of a claimed "charge to VAT" in the absence of VAT invoices: *Volkswagen* and *Biosafe* suggest that the UT was correct, but for the wrong reasons. But we will see.

The comments made in this case note are wholly personal and do not reflect the views of any other members of Monckton Chambers, its tenants or clients.

Monckton Chambers
1 & 2 Raymond
Buildings
Gray's Inn
London, WC1R 5NR

Tel: +44 (0)20 7405 7211
Fax: +44 (0)20 7405 2084
Email: chambers@monckton.com
www.monckton.com