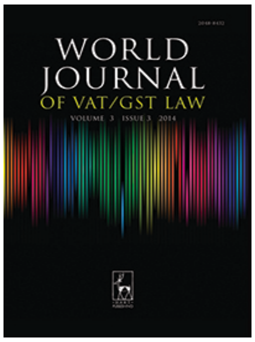

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VAT deduction and member state sovereignty: (still) a good idea?

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ABSTRACT

It is admirable how much work the European Commission is currently doing in the area of VAT. The work of the European Commission, however, does not comprise the rules for VAT deduction. This is an area where Member States have still a lot of competences to set the rules. Because non-deductible VAT is a cost for businesses it will affect a business' competitive position directly and differences in rules on VAT deduction between Member States can positively or negatively impact a business' position. In this article I will address the areas where Member States have competences in the area of VAT deduction and will discuss whether there is a need for more harmonisation in the area of VAT deduction to ensure the proper functioning of the internal market now and in the future. This research is done in light of the 39th recital of the preamble to the VAT Directive which states that the objective of the directive is to harmonise the rules governing deductions to the extent that they affect the actual amounts collected.

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1. Introduction

It is admirable how much work the European Commission is currently doing in the area of VAT. With proposals on e-commerce in 2016[1] (agreed in 2017[2]), the definitive VAT system for intra-EU trade[3] and the proposals for administrative cooperation[4] in 2017

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[1]Commission, 'Proposal for a Council Directive amending Directive 2006/112/EC and Directive 2009/132/EC as regards certain value added tax obligations for supplies of services and distance sales of goods' COM (2016) 757, 1 December 2016; Commission, 'Proposal for a Council Regulation amending Implementing Regulation (EU) No 282/2011 laying down implementing measures for Directive 2006/112/EC on the common system of value added tax' COM (2016) 756, 1 December 2016; Commission, 'Proposal for a Council Regulation amending Regulation (EU) No 904/2010 on administrative cooperation and combating fraud in the field of value added tax' COM (2016) 755, 1 December 2016.

[2]Council Directive 2017/2455 of 5 December 2017 amending Directive 2006/112/EC and Directive 2009/132/EC as regards certain value added tax obligations for supplies of services and distance sales of goods, OJ L 348/7.

[3]Commission, 'Proposal for a Council Directive amending Directive 2006/112/EC as regards harmonizing and simplifying certain rules in the value added tax system and introducing the definitive system for the taxation of trade between Member States' COM (2017) 569, 4 October 2017; Commission, 'Proposal for a Council Implementing Regulation amending Implementing Regulation (EU) No 282/2011 as regards certain exemptions for intra-Community transactions' COM (2017) 568, 4 October 2017; Commission, 'Proposal for a Council Regulation amending Regulation (EU) No 904/2010 as regards the certified taxable person' COM (2017) 567, 4 October 2017.

[4]Commission, 'Amended proposal for a Council Regulation amending Regulation (EU) No 904/2010 as regards to strengthen administrative cooperation in the field of value added tax' COM (2017) 706, 30 November 2017.

and the VAT rates proposal[5] and proposal for SMEs[6] in 2018, we are currently at a moment in time the EU VAT system may fundamentally change. With these proposals the EU intends to make the VAT system fit for the current and future era, where digitalisation and globalisation are key elements. The work of the European Commission, to my knowledge, does not comprise the rules for VAT deduction. This is an area where Member States have still a lot of competences to set the rules. Because non-deductible VAT is a cost for businesses it will affect a business' competitive position directly and differences in rules on VAT deduction between Member States can positively or negatively impact a business' position. Since the EU's objective is to establish an internal market (art. 3 (1) (b) TFEU) and that internal market is defined as an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured (art. 26 (2) TFEU), taxes such as VAT should not be a hindrance for businesses to compete with businesses established in other Member States.

In this article I will address the areas where Member States have competences in the area of VAT deduction and will discuss whether there is a need for more harmonisation in the area of VAT deduction to ensure the proper functioning of the internal market now and in the future. In this respect it should be noted that pursuant to the 39th recital of the preamble to the VAT Directive the objective of the directive is to harmonise the rules governing deductions to the extent that they *affect the actual amounts collected*. Harmonisation of the rules on VAT deduction therefore does not cover situations where there is, for example, a difference as regards the moment of deduction, but no difference in the actual amount that can be deducted. The author stresses however that situations like this may result in cash flow differences which also affect the competitive position of entrepreneurs. It should be noted that cash flow positions (and how to improve them) have increasingly been in the spotlights.[7] It could therefore be worth taking a look at by the European Commission. However, as this article will show there is work to be done in the area of harmonisation of the rules on VAT deduction that lead to actual differences of deductible amounts. Since these differences affect the competitive position more than cash flow differences, the focus of the Commission should be in that area first. Therefore, the objective of the 39th recital of the preamble to the VAT Directive will be at the heart of this article. It will not cover situations where competencies of Member States do not affect the amount of deductible VAT: for example, the moment of deduction (art. 167 and 66 VAT Directive), conditions for the right of deduction (art. 178-182 VAT Directive)[8] and how Member States deal with excesses (art. 183 VAT Directive). Derogations granted to Member States under art. 395 VAT Directive will be outside the scope of this article.[9] Derogations granted under this provision may not, except to a negligible

[5]Commission, 'Proposal for a Council Directive amending Directive 2006/112/EC as regards rates of value added tax' COM (2018) 20, 18 January 2018.

[6]Commission, 'Proposal for a Council Directive amending Directive 2006/112/EC on the common system of value added tax as regards the special scheme for small enterprises' COM (2018) 21, 18 January 2018.

[7]See, e.g. Edwin van Loon, 'De meetbare Indirect Tax Functie' (The measurable indirect tax function), (2014) *Vakblad Tax Assurance*, no. 1.

[8]In this respect it should be noted that conditions may affect the amount of VAT to be deducted if a taxable person is unable to meet those conditions. However, the CJEU has in many cases, in respect of VAT deduction particularly in the cases of Senatex (Case C-518/14, *Senatex*, EU:C:2016:691) and Barlis 06 (Case C-516/14, *Barlis 06*, EU:C:2016:690) ruled that in case formal requirements are not met, but the taxable person meets the material requirements for e.g. VAT deduction it cannot be refused that right.

[9]See, for example, Cases C-177/99 and C-181/99, *Ampafrance and Sanofi*, EU:C:2000:470.

extent, affect the overall amount of the tax revenue of the Member State collected at the stage of final consumption.

The competencies that have to be looked at from the perspective of the fact that they may affect the VAT amount to be deducted can be divided into four topics which will be discussed in the order that we find them in the VAT Directive:

(1) Rules on private use and private expenditure
(2) Rules on deductible proportion.
(3) The exclusion of VAT deduction due to cyclical economic reasons.
(4) Adjustment rules

This article will focus on these four areas. The research method used in this article is a study of literature and case law combined with examples from practice on how different rules are being applied by Member States today and in the past. It is not an objective of this article to give an overview of how the 28 Member States have made use of their competencies. Economic studies into the materiality of the differences will be necessary to establish to what extent they distort competition. This article points out areas where further research is necessary.

In the following, each of the four topics defined above will be discussed more in-depth (Sections 2–5). Section 6 provides some concluding remarks.

2. Rules on private use and private expenditure

Art. 176 VAT Directive clearly intends to harmonise the rules on limitations of the right to deduct VAT, because it states that the Council shall determine the expenditure in respect of which VAT shall not be deductible. In the meanwhile Member States may retain all the exclusions provided for under their national laws[10] at 1 January 1979 or on the date of the accession of a Member State to the European Union. The provision is a so-called standstill clause meaning that Member States cannot extend the scope of the limitations on the right to deduct VAT after 1 January 1979 or their accession date[11] or even reintroduce limitations.[12] Member States can however reduce the scope of existing restrictions, for example, by replacing a total exclusion with a partial deduction.[13] It becomes clear from the provision itself and the legislative history[14] that the limitations are intended for expenditures that do not have a strict business character. The CJEU, however, ruled that it allows for restrictions on the right to deduct VAT on means of transport which constitute the tool of the trade of a taxable person also.[15] The scope of the provision is

[10]This includes a consistent practice of the public authorities on the basis of a ministerial circular, Case C-409/99, *Metropol*, EU:C:2002:2. Compare: Case, C-371/07, *Danfoss*, EU:C:2008:711.

[11]Cases, C-40/00, *Commission v France*, EU:C:2001:338; C-155/01, *Cookies World*, EU:C:2003:449, para 66; C-414/07, *Magoora*, EU:C:2008:766. See on the Magoora case: Krzysztof Lasinski-Sulecki, 'Standstill Provisons under EU VAT – Fuel for Polish Passenger Cars' (2008) *International VAT Monitor* January/February, 22-26; Cases C-460/07, *Puffer*, EU:C:2009:254, para 87; C-124/12, *AES-3C Maritza East 1 EOOD*, EU:C:2013:488, para 45.

[12]*Commission v France* (n 11); Pawel Selera and Rafal Lipniewicz, 'Polish VAT on Passenger Cars' (2012) *International VAT Monitor* March/April, 120.

[13]Case C-345/99, *Commission v France*, EU:C:2001:334.

[14]Commission, 'Proposal for a sixth Council Directive on the harmonization of Member States concerning turnover taxes', Bull EC Suppl. 11/73, 18.

[15]Cases C-43/96, *Commission v France*, EU:C:1998:304; C-305/97, *Royscot Leasing*, EU:C:1999:481.

therefore wider. However, Member States do not have unlimited discretion to exclude all or just any goods and services from the system. They must adequately define the nature or the purpose of the goods and services for which a limitation of deduction applies.[16,17]

Limitations of deduction based on art. 176 VAT Directive are various. As the table below shows these limitations concern mainly expenses on (motor) vehicles (including petrol), food and beverages, accommodations including holiday homes, restaurant and catering services and entertainment and representation expenses.[18] VAT deduction may be excluded completely or partially. The table below is intended to provide a high-level comparative analysis of the categories of expenses for which limitations on deduction apply in the EU. It is by no way intended to give a complete overview of all exceptions to the main rule under which the right to deduct VAT is restricted.

Country	Expenses on motor vehicle (including petrol)	Entertainment expenses	Representation expenses	Tobacco and alcoholic beverages	Accommodation	Meals and beverages (restaurant and catering)	Transport and taxi services	Other
Austria	X	X						
Belgium	*	X		X	X	X		
Bulgaria	X	X						
Croatia	*	X						
Cyprus		X						
Czech Republic		X	X					
Denmark	*				X	X		Nursery, day care, after-school care, payments in kind
Estonia	*							
Finland	X	X		X	X		X	
France	X				X		X	
Greece	X	X		X	X	X	X	
Hungary	X	X			X	X	X	Parking services and highway tolls, telephone and mobile phone costs
Ireland	*	X			X	X		
Italy	*	X			X	X		

(*Continued*)

[16]Cases C-538/08 and C-33/09, *X Holding and Oracle*, EU:C:2010:192, para 44. See also *Royscot Leasing* (n 15); Cases C-74/08, *PARAT*, EU:C:2009:261; C-434/03, *Charles and Charles-Tijmens*, EU:C:2005:463, para 33; C-395/09, *Oasis East*, EU:C:2010:570; C-438/09, *Dankowski*, EU:C:2010:818; C-132/16, *Iberdrola Inmobiliaria Real Estate Investment*, EU:C:2017:683, para 21.

[17]For an extensive discussion of art. 176 VAT Directive and the CJEU case law on this provision the author refers to Joep Swinkels, 'Transitional Restrictions on the Right to Deduct EU VAT', (2009) *International VAT Monitor* March/April, 111-119.

[18]These exclusions can be found in for example, art. 45 of the Belgian VAT code, section 39 and 42 of the Danish VAT Act, art. 16 of the Dutch VAT Act combined with Deduction Exclusion Decree, section 124 of the Hungarian VAT Act, art. 60 (2) of the Irish VAT Consolidation Act 2010, art. 54 (1) of the Luxembourgian Law Concerning VAT, art. 62 (2) of the Lithuanian Law on VAT and art. 15 and 16 of the Swedish VAT Act. The author also refers to Walter van der Corput, 'VAT Options to be Exercised by the New Member States', (2014) *International VAT Monitor* September/October, 327.

Continued.

Country	Expenses on motor vehicle (including petrol)	Entertainment expenses	Representation expenses	Tobacco and alcoholic beverages	Accommodation	Meals and beverages (restaurant and catering)	Transport and taxi services	Other
Latvia	*	X	*			X		Recreation
Lithuania	X	*	*				X	
Malta	X	X	X	X			X	Works of arts, collector's items and antiques, expense related to vessels and aircrafts
The Netherlands		X				X		Employee benefits in kind
Poland	*				X	X		
Portugal	*	X	*	X	X	X		Expenses on boats and aircrafts, travel expense and tolls
Romania	*			X				
Slovenia	X	X			X	X		Expenses related to vessels and aircrafts
Spain	*	X		X	*	*		Gifts, jewels and precious stones, travel expense
Sweden	*	*			X		X	
UK	*	X						

X = non recoverable VAT; * = partially recoverable VAT.

Germany, Luxembourg and Slovak Republic do not have any limitations on the right to deduct VAT based on art. 176 VAT Directive. They are therefore not included in this table.

The European Commission has on three occasions made an attempt to harmonise the rules on VAT deduction for expenditure that is not eligible for deduction of VAT: in 1983,[19] 1998[20] and 2004.[21] In the 1983 and 1998 proposals the distortion of competition

[19]Commission, 'Proposal for a Twelfth Council Directive on the harmonization of the laws of the Member States relating to turnover taxes – Common system of value added tax: expenditure not eligible for deduction of value added tax' COM (82) 870 final, 2, point 4, 25 January 1983. The proposal of the Commission has been withdrawn on 4 January 1997 with the mere observation that the Council had taken no decision and it was no longer topical, OJ 1997 C 2/2.

[20]Commission, 'Proposal for a Council Directive Amending Directive 77/388/EEC as regards the rules governing the right to deduct VAT' COM (1998) 377 final, 17 June 1998. The proposal of the Commission has been withdrawn on 17 March 2006 together with many other proposals under the observation that the Member States were unlikely to make further progress in the legislative process or the proposals were found to be no longer topical for objective reasons, OJ 2006, C 64/3.

[21]Commission, 'Proposal for a Council Directive laying down detailed rules for the refund of value added tax, provided for in Directive 77/388/EEC to taxable persons not established in the territory of the country but established in another Member State' COM (2004) 728 final, 29 October 2004. This proposal was withdrawn in 2014 OJ 2014, C 153/3.

was mentioned by the Commission as a reason for harmonisation. Taxable persons in Member States which allow for a full deduction for all expenditure except non-business expenditure enjoy an advantage compared to taxable persons of Member States where some categories of expenditure are excluded from the right to deduct.[22] The objective of the 2004 proposal is different. Its objective is to create more clarity and facilitate the functioning of the proposed refund procedure by limiting the categories of goods and services for which Member States can implement limitations to the right to deduct VAT.[23]

The European Commission's remarks on distortion of competition in 1983 and 1998 show the exact reason why there is a need for more harmonisation in respect of these rules. In case a taxable person can deduct VAT whereas another taxable person cannot, the prices of the latter will most likely be higher due to the fact that he will try to pass on the non-deductible VAT to the next link in the supply chain. Market conditions may however make it impossible to pass on the non-deductible VAT. This will result in lower profit margins for the taxable person in question. The call for more harmonisation in respect of limitation of deduction is even more necessary now than it was in 1983 and 1998 due to globalisation. Businesses operate more and more internationally and are thus faced with competitors from other Member States.

Differences can however be limited in practice. The deemed supplies of art. 16, 18 and 26 VAT Directive mitigate the differences between Member States that have and Member States that do not have limitations of deduction under art. 176 VAT Directive. Once a taxable person has deducted VAT he will be required to report VAT on private use under art. 16, 18 or 26 VAT Directive, that are applicable depending on the situation at hand. However, the deemed supplies cannot rule out difference entirely as the following example based on the actual VAT legislation in Germany and Belgium shows:

A company purchases a car of 30,000 euros including an amount of 6,000 euros in VAT. The car is used for 60% for business purposes and for 40% for private purposes. Under German legislation the VAT can be deducted in full if the company car is attributed to the business assets. The German taxable person will be required to report deemed supplies of services under the German equivalent of art. 26 VAT Directive for the private use. Under Belgian legislation the VAT deduction is limited to the actual use for business purposes, meaning it is limited to 60% of the VAT on the purchase of the company car. Belgium has availed itself of the option under art. 168a (2) VAT Directive to limit VAT deduction to the private use of movable property. The exercising of this option only provides the German taxable person with a financing advantage compared to the Belgian taxable person.[24] *However under the provision of art. 176 VAT Directive Belgium also caps the VAT deduction at 50%, art. 45(2) Belgian VAT code. The Belgian taxable person will therefore only be able to deduct 50% of the 6,000 euros in VAT, while the German taxable person in the end has deducted 60% of the VAT.*

It is therefore the author's opinion that the European Commission should try to harmonise the rules on limitations of deduction to prevent distortion of competition.

[22]Commission (n 19) 2, Commission (n 20) 11.

[23]It was then up to Member State to determine whether they would implement a full or partial restriction on the right to deduct VAT and if they chose a partial deduction to what extent VAT would be deductible, the proposed art. 17a. Commission (n 21) 8.

[24]This financing advantage was recognised by the CJEU in the Puffer case (*Puffer* (n 10)). Financing advantages do not accrue to differences in the amount of VAT deduction and are therefore not within the scope of harmonisation of the rules on VAT deduction (see Section 1).

On the other hand, the author realises that budgetary implications for Member States will probably stand in the way of such a harmonisation, as history has often shown.[25]

3. Rules on deductible proportion

3.1. Introduction

There are number of powers granted to Member States when it comes to the rules on the deductible proportion. These are:

(1) The option to include subsidies in the denominator of the deductible proportion that have no direct link to the price (Art. 174(1) VAT Directive) which will be discussed in Section 3.2.
(2) The option to implement methods of calculating the deductible proportion that derogate from the main rule to calculate the deductible proportion based 0n turnover which will be discussed in Section 3.3.
(3) The competence to determine that if the non-deductible VAT is insignificant this need not be taken into account. This option will not be discussed in this article. The fact that the non-deductible VAT must be insignificant means that the effects on the amount of deductible VAT will be insignificant too and that the distortion of competition will be minimal if not absent.
(4) Maintaining the existing rules on the provisional deductible proportion, dating from before 1 January 1979. Since a provisional deductible proportion will be adjusted at the end of the year this power granted to Member States will not affect the amount of deductible VAT. As discussed in the introduction these situations are beyond the scope of this article.

3.2. Subsidies

Under art. 174(1) VAT Directive Member States can stipulate that subsidies that are not linked to the price can be included in the denominator of the deductible proportion. This, hence, regards subsidies that are not the consideration for a supply. If a Member State includes subsidies in the denominator of the deductible proportion it will reduce the latter and, thus, diminish the right of deduction. Compared with entrepreneurs in Member States where the Member State has not availed itself of this option, these entrepreneurs are in a less favourable position.

When we are looking for the reason behind this option it does not become clear from either the legislative history or CJEU case law what the objective of the provision is. According to Advocate-general Poires Maduro, the provision was introduced to prevent a subsidised body which was not authorised to carry out taxable transactions from being able, by performing a purely, symbolic taxable activity to obtain reimbursement of VAT.[26] It is important to note that the provision only applies for mixed

[25]Commission (n 21) 8.
[26]Case C-204/03, *Commission vs Spain*, ECLI:EU:C:2005:146, Opinion of AG Poires Maduro. Different: Ben JM Terra/Julie Kajus, 'A guide to the Recast VAT Directive', *IBFD Database*, section 10.3.2.1. who call it a hidden tax burden. See also

taxable persons (taxable persons providing taxable and exempt supplies)[27] and when the general rule for calculating the deductible proportion based on total turnover applies.[28]

Member States that currently make use of this option are, for example, Bulgaria,[29] Greece,[30] Lithuania,[31] Slovenia,[32] and Hungary.[33] Romania has only implemented the option to include subsidies in the denominator of the deductible proportion for subsidies that are used to finance exempt activities or activities that are outside the scope of VAT.[34]

The deductible proportion is a way of calculating to what extent a taxable person performs taxable and exempt supplies. It is an approximation of the extent to which goods and services are used for taxable transactions and should thus give a right to deduct VAT. Not taking into account subsidies that are not directly linked to the price, but that can be linked to one of the activities of the taxable person can in the author's opinion cloud that approximation and run counter to the objective of the deductible proportion, which is to reflect as much as possible the extent to which goods and services are used for taxable activities.[35] In that respect, it is her view that those subsidies should not only be added to the denominator of the deductible proportion, but also to the nominator in case the subsidy relates to taxable activities only.

Even though the author believes that there is good ground for the provision if extended as she proposes, the mere fact that it is an optional provision to Member States distorts competition, as subsidies may consist of considerable amounts. For that reason, the European Commission should look into harmonising the rules in this respect.[36] If the Commission makes it obligatory to include subsidies in the deductible proportion the provisions should be extended to include subsidies that relate to taxable supplies in the nominator and denominator of the deductible proportion. However, because the deductible proportion is an approximation of the VAT attributable to taxable supplies, Member States can also consider abolishing the provision altogether.

3.3. Calculation of the deductible proportion

Under art. 173 (2) VAT Directive Member States can deviate from the main rule for calculating the deductible proportion: the turnover method. Pursuant to the Explanatory

Ignacio Arias and Antonio Barba, 'The Impact of Subsidies on the Right to Deduct VAT: the Spanish Experience' (2004) *International VAT Monitor* January/February, 15.

[27]Case C-204/03, *Commission v. Spain*, EU:C:2005:588. See also Case C-243/03, *Commission v. France*, EU:C:2005:589.

[28]Case C-25/11, *Varzim Sol*, EU:C:2012:94.

[29]Art. 73 (4) (6) of the Bulgarian VAT Act.

[30]Art. 31 (1) of the Greek VAT Act.

[31]Art. 60 (1) Lithuanian VAT Act.

[32]Art. 65 (2) (b) Slovenian VAT Act.

[33]Schedule No. 5 to Act CXXVII of 2007 (2).

[34]Art. 300 (6) (b) of the Romania VAT Act.

[35]See for example: Dutch Supreme Court 23 February 2018, 16/04051, NL:HR:2018:267 where an institute for higher education could take into account the tuition fees that it received from students as exempt turnover in the deductible proportion, while it was not required to take into account government funds it received for providing education to those students.

[36]Already in 1983 the Commission noted that the problems of subsidies under the VAT system needs to be thought out afresh: Commission, 'First report from the Commission to the Council on the application of the common system of value added tax' COM (83) 426 final, 39, 14 September 1983.

Memorandum of the Proposal for the Sixth Directive, these options are aimed at avoiding inequalities in the application of the tax.[37] The options granted to Member States under art. 173 (2) VAT Directive are:

(1) authorise the taxable person to determine a proportion for each sector of his business, provided that separate accounts are kept for each sector;
(2) require the taxable person to determine a proportion for each sector of his business and to keep separate accounts for each sector;
(3) authorise or require the taxable person to make the deduction on the basis of the use made of all or part of the goods and services;
(4) authorise or require the taxable person to make the deduction in accordance with the rule laid down in the first subparagraph of art. 173 (1) VAT Directive, in respect of all goods and services used for all transactions referred to therein;[38]
(5) provide that, where the VAT which is not deductible by the taxable person is insignificant, it is to be treated as nil.

Pursuant to CJEU case law, the objective of the methods[39] deviating from the main rule for calculating the deductible proportion is to permit Member States to achieve greater accuracy by taking into account the specific characteristics of the taxable person's activities.[40] As becomes clear from the twelfth recital in the preamble of the VAT Directive, the objective is that the deductible proportion is calculated in a similar manner in all Member States. A similar manner does not mean an identical manner, as the CJEU has pointed out in the Royal Bank of Scotland case.[41] To uphold the principle that the deductible proportion is calculated in a similar manner the CJEU has ruled in the BLC Baumarkt case that the deviating methods cannot be used as main rule for calculating the deductible proportion for all goods and services. They can however be used as a primary method for calculating the deductible proportion on specific goods and services. The method prescribed must guarantee a more precise determination of the deductible proportion of input VAT than that arising from the application of the main rule for calculating the deductible proportion.[42] It does however not need to be the most precise possible.[43]

It is important to note that the deductible proportion calculated using the main rule is an approximation of the amount of VAT that is attributable to the taxable person's taxable and exempt activities.[44] The actual use of the goods and services does not need to correspond to the deductible proportion calculated using that main rule.[45] At the outset, all

[37]Commission, 'Proposal of a Sixth Council Directive on the harmonization of Member States concerning turnover taxes', Bull EC Supplement 11/73, 18.
[38]This provision is subject of case C-378/15, *Mercedes Benz Italia*, EU:C:2016:950.
[39]The majority of the VAT Committee is also of the opinion that the methods should be used on the basis of strictly objective criteria, Guidelines resulting from the 13th meeting of 15-16 December 1981, XV/37/82, point 4.
[40]Cases C-488/07, *Royal Bank of Scotland*, EU:C:2008:750, para 24; C-186/15, *Kreissparkasse Wiedenbrück*, EU:C:2016:452, para 35.
[41]*Royal Bank of Scotland* (n 40) para 26.
[42]Cases C-511/10, *BLC Baumarkt*, EU:C:2012:245, para 24; C-183/13, *Banco Mais*, EU:C:2014:2056, para 30; C-332/14, *Wolfgang und Wilfried Rey*, EU:C:2016:417, para 32.
[43]*Wolfgang und Wilfried Rey* (n 42) para 33.
[44]Albert H Bomer, 'From Skandia to Larentia: National Jurisdiction to Deviate from the VAT Directive' (2016) *Intertax* vol. 44 8/9, 660 in this respect notes that the CJEU views the exceptions as a more precise provision aimed at achieving the purpose of the main provision.
[45]Case C-378/15, *Mercedes Benz Italia*, EU:C:2016:484, Opinion of AG Saugmandsgaard, para 30.

taxable persons in all Member States are treated in the same manner, because their deductible proportion will be calculated on general turnover and applied to all costs that have a link to their taxable and exempt activities. However, because of the options provided by art. 173 (2) VAT Directive (and the provision for subsidies, see Section 3.2) taxable person A established in Member State 1 may have a different deductible proportion compared to taxable person B established in Member State 2 despite the fact that their activities are the same. If A then supplies goods or services to customers in Member State 2 it may be in a more advantageous or less advantageous position than its local competitor B. However, since the objective of the VAT Directive in this respect is to have a similar and not identical manner for calculating the deductible proportion, the mere existence of a difference is not enough to consider the outcome not similar.

It has not been defined in the VAT Directive or by the CJEU what similar in respect of the rules on deductible proportion means. It becomes clear from the 39th recital from the preamble of the VAT Directive that it is the calculation that should take place in a similar manner. Since this point of view has been added to the preamble of the Directive the author feels that the Member States when adopting the provision on the deductible proportion were of the mind that a similar calculation of the deductible proportion was ensured. However, the CJEU case law on the matter shows that calculation of the deductible proportion can provide for a wide variety in calculation methods.[46] It is the authors opinion therefore that it needs to be evaluated to see whether the provision still meets its objective of similar calculation of the deductible proportion.

4. Exclusions for cyclical economic reasons

Under art. 177 VAT Directive Member States may totally or partly exclude all or some capital goods or other goods from the system of deductions for cyclical economic reasons. The VAT Committee must be consulted before a Member State can implement such an exclusion on the right to deduct VAT.[47] The consultation enables the Commission and the other Member States to control the use of the possibility to derogate from the general system of deducting VAT by checking in particular whether the national measure in question satisfies the condition of adoption for cyclical economic reasons.[48] Member States are obliged to provide sufficient information to enable the VAT Committee to deliberate on the proposed measure with full knowledge of the facts.[49] The Member States do not need a favourable outcome from the VAT Committee to apply the measure.[50] Measures adopted under art. 177 VAT Directive must be of a temporary nature intended to cope with the temporary situation of a Member State's economy at a given moment. It does not authorise a Member State to adopt measures excluding goods from the system of deducting VAT that are not limited in time and/or which form part of a package of structural adjustment measures whose aim is to reduce the budget deficit and allow State debt to be paid.[51] The exclusion of the VAT deduction can be accompanied by a measure taxing manufactured or acquired goods. This provisions deals with the

[46]Compare in particular cases *BLC Baumarkt* (n 42) and *Wolfgang und Wilfried Rey* (n 42) to *Banco Mais* (n 42).
[47]*Cookies World* (n 11) para 67.
[48]*Metropol* (n 10) para 61.
[49]Case C-228/05, *Stradasfalti*, EU:C:2006:578, para 30.
[50]ibid para 31.
[51]*Metropol* (n 10) paras 68 and 69.

situation where the VAT deduction is excluded for certain goods, but the taxable person produces these goods himself. Without the provision in the latter case there would be no limitation of deduction (since the taxable person buys the materials to make the goods, not the goods for which the right to deduct is excluded), while there is in the situation where a taxable person buys those goods instead of manufacturing them.[52]

What are cyclical economic reasons has not been defined by the CJEU. Advocate-general Sharpston points out that the fiscal measure must be aimed at counteracting cyclical fluctuations. The measure forms part of the economic policy of a Member State. In this context, she understands economic policy to mean the influencing, through the government budget, of macroeconomic quantities such as production, consumption and import/export volumes over short periods of time, often no more than one or two years in length.[53] Advocate-general Geelhoed points out that there cannot be much scope for entirely unilateral reliance on art. 177 VAT Directive, because of the economic and monetary Union.[54]

From information published by the VAT Committee it becomes clear that between 1978 and 2017 the VAT Committee was consulted on art. 177 VAT Directive 19 times by: Italy (8), Austria (4), Romania (3), Poland (2), Belgium (1) and Germany (1).[55] It also becomes clear that Member States have consulted the VAT Committee on the provision of art. 177 VAT Directive for two reasons: 1. budgetary reasons[56] and 2. to stimulate or contain the purchase of certain capital goods.[57]

The author agrees with Terra and Kajus that the provision of art. 177 VAT Directive strikes at the roots of the VAT system, where taxable persons have the right to deduct VAT, which should prevent distortion of competition.[58] The instrument of art. 177 VAT Directive should in her opinion not be used or be used as a last resort. It seems to her that there are many measures that a government can take to improve its economic situation without using a tax that should be neutral to those charging VAT on their transactions. The Commission in her opinion should consider a proposal to abolish art. 177 VAT Directive altogether.

5. Adjustment rules

5.1. Introduction

The adjustment rules leave wide discretion to the Member States and only include a few mandatory provisions. There are therefore a great number of powers granted to Member States when it comes to the rules on the deductible proportion. These are:

[52]VAT Committee, 'Working Paper 377' TAXUD/2439/2002, 2, 12 December 2002.

[53]Case C-288/05, *Stradasfalti*, EU:C:2006:425, Opinion of AG Sharpston, para 73.

[54]Case C-409/99, *Metropol*, EU:C:2001:508, Opinion of AG Geelhoed, para 61. I also refer to art. 120 and 121 TFEU. See also: Explanatory Statement of the Committee of Economic and Monetary Affairs to the Resolution of the European Parliament of 17 November 1983 Doc. 1-903/83 (PE84.113/fin), *Intertax* 1984/8, 310.

[55]Consultations of the VAT Committee, <https://ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/taxation/vat/key_documents/vat_committee/consultations_vat_committee_en.pdf> accessed 17 January 2018.

[56]See, for example, the consultation by Germany, Working paper XV/252/81 of the VAT Committee, consultations by Poland, Working paper 631 of 9 September 2009 of the VAT Committee, TAXUD.d.1.(2009)210167 and Working paper 723 of 7 February 2012 of the VAT Committee, TAXUD.c.1(2012),153021, the consultation by Romania, Working paper 683 of 15 November 2010 of the VAT Committee, TAXUD.c.1(2010)899520 and the consultation by Italy, Working Paper XXI/899/90 of the VAT Committee.

[57]See, for example, the consultation by Belgium on the limitation of deduction for investment that is neither job-creating or supplementary, Working paper XV/272/79 of the VAT Committee and the Consultation by Austria, VAT Committee, 'Working Paper 558', 15 October 2007, TAXUD/2156/08, 3.

[58]Terra/Kajus (n 26) section 10.4.3.

(1) Member States may determine that in the case of transactions remaining totally or partially unpaid or in the case of theft adjustments must be made, art. 185 (2) second sentence VAT Directive.
(2) The power to determine the term and start of the adjustment period, art. 187 (1) VAT Directive.
(3) In case a capital good is supplied within the adjustment period and that supply is an exempt supply Member States may waive the requirement for adjustment in so far as the purchaser is a taxable person using the capital goods in question solely for transactions in respect of which VAT is deductible, art. 188 (2) last sentence VAT Directive.
(4) The power to adopt specific rules as regards the adjustment rules for capital goods, for example, to define capital goods, art. 189 (a) VAT Directive. See also art. 190 VAT Directive that stipulates that Member States may treat certain services as capital goods.

I will not discuss in this section the powers provided to Member States to deal with situations where the practical effect of the adjustment rules is negligible (art. 191 VAT Directive) and the situation where there is a transfer from a special scheme to normal taxation or vice versa (art. 192 VAT Directive). The first will not be discussed because the fact that the effect is negligible means that the effects on the amount of deductible VAT will be insignificant too and the distortion of competition will be minimal if not absent. The second situation will not be discussed because it is a particular situation while the objective of this article is to provide for a more general view on the effect of powers granted to Member States in respect of the right to deduct VAT on the competition between taxable persons coming from different Member States.

5.2. Adjustments in cases of thefts or unpaid debts

A taxable person can execute his right to deduct VAT immediately taking into account the intended use when goods or services are not put to use immediately.[59] Adjustments must however be made when the deduction was higher or lower than the deduction the taxable person was entitled to, art. 184 VAT Directive. Art. 185 (1) VAT Directive particularly points out that adjustments must be made when changes occur after the VAT return was filed in factors that are used to determine the amount of VAT to be deducted, in particular price reductions or cancellations. Under art. 185 (2) VAT Directive no adjustments shall however be made in the case of transactions remaining totally or partially unpaid or in the case of destruction, loss or theft of property duly proved or confirmed, or in the case of goods reserved for the purpose of making gifts of small value or of giving samples, as referred to in Article 16 VAT Directive. Member States however have the power to determine that in case of theft or when transactions remain totally or partially unpaid adjustments must be made. It is this power that will be addressed in this paragraph.

[59]Case C-97/90, *Lennartz*, EU:C:1991:315.

It is important to look at the situation where transactions remain totally or partially unpaid and the situation of theft separately, because—as the case law discussed will show—the power granted to Member States has a different scope.

The rules for adjustments in case of totally or partially unpaid adjustments must be read in conjunction with art. 90 VAT Directive.[60] Art. 90 and 185 VAT Directive are two sides of the same medal and should be interpreted consistently.[61] The provisions however differ, because the main rule of art. 90 (1) VAT Directive is that the taxable amount is reduced in case of total or partial non-payment. This results in a VAT refund for the supplier. Member States can derogate from that main rule under art. 90 (2) VAT Directive. Under art. 185 (2) VAT Directive no adjustments will be made in case of total or partial non-payment. So on the customer side non-payment in principle does not result in a VAT correction, where non-payment at the side of the supplier as a main rule does. Member States can however derogate from the main rule for adjustments and require an adjustment in case of total or partial non-payment.

The reason behind the derogation of art. 90 (2) VAT Directive is that in case of total or partial non-payment the purchaser remains liable for paying the agreed price and the seller continues to have a right to receive payment, unlike situations of, for example, cancellations.[62] The derogation provided under art. 90 (2) VAT Directive does however not contain the power to exclude the right to reduce the taxable amount altogether.[63] At some point in time Member States must allow the reduction of the taxable amount. An Italian rule where reduction of the taxable amount was allowed only after an insolvency procedure had ended, was sanctioned by the CJEU in the Di Maura case.[64]

The same reasoning should be applied to art. 185 (2) VAT Directive. It cannot result in an adjustment never taking place when it is clear that the transaction will never be paid for. Advocate-general Sugmandsgaard[65] in this respect notes that in case the taxable amount is reduced pursuant to art. 90 (1) VAT Directive that in itself is a change that results in an adjustment under art. 185 (1) VAT Directive. Because the adjustment must take place when it is clear that a transaction will never be paid the fact that a Member State has availed itself of the option under art. 185 (2) VAT Directive only results in an obligation to adjust the deducted VAT at an earlier stage. The amount of VAT deducted is therefore not affected by the provision of art. 185 (2) VAT Directive, but only the moment the deducted VAT needs to be paid back to the tax authorities. As described in Section 1 of this article the objective of the VAT Directive is only to achieve harmonisation in respect of the amount of VAT to be collected, which does not cover the moment of deduction or adjustment of that deduction.

The situation is different in case of theft. The reason why adjustments can be made in cases of theft is that the stolen goods can no longer be used by the taxable person for

[60]Case C-396/16, *T-2*, EU:C:2018:109.
[61]ibid para 35.
[62]Cases C-337/13, *Almos Agrárkülkereskedelmi*, EU:C:2014:328, para 25; C404/16, *Lombard*, EU:C:2017:759; C-246/16, *Di Maura*, EU:C:2017:887, para 16.
[63]*Di Maura* (n 62) paras 21 and 22.
[64]ibid paras 25 and 27.
[65]Case C-396/16, *T-2*, EU:C:2017:763, Opinion of AG Saugmandsgaard, paras 59-61 and 64.

output transactions.[66] Adjustments do not have to be made when the theft is duly proved or confirmed. Member States can deviate from that latter rule by requiring a taxable person to make an adjustment even in cases the theft is duly proved or confirmed.[67] The author agrees with Terra and Kajus that using this power to derogate from the provision results in a hidden tax burden for the taxable person.[68] In case of theft duly proved it is clear that the goods are not used by a taxable person at all and a situation of theft is beyond that taxable person's control. To prevent a taxable person from suffering a tax loss next to an economic loss, adjustments should in the author's opinion not take place in case of theft duly proved. In case the circumstances surrounding the claimed theft remain vague the author can understand a required adjustment. CJEU case law shows that a taxable person has to provide tax authorities with objective information to establish the taxable persons' entitlement to VAT deduction.[69] Requiring a taxable person to duly prove that there is a situation of theft to keep its entitlement to VAT deduction is in line with that.

In case a Member State has made use of the option of art. 185 (2) VAT Directive for theft this will have animpact on a taxable persons' VAT position. How substantial the impact is, depends on the value of the stolen goods. If another Member State has not availed itself of that option a taxable person from that latter Member State will be in a more advantageous position. In the author's opinion the option to require an adjustment in case of duly proved theft should be abolished. Mainly because of the hidden tax burden that should not be encountered by taxable persons.

5.3. Term and start of the adjustment period

For capital goods adjustments take place over a longer period of time of—in principle—five years including the year the goods were acquired or manufactured, art. 187 VAT Directive. Member States may base the adjustment on a period of five full years starting from the time at which the goods are first used. The adjustment period can be extended for immovable property up to 20 years by Member States. For capital goods annual adjustments take place taking into account one-fifth or if the adjustment period is extended the fraction corresponding with the adjustment period. Adjustments take place by comparing the entitlement to deduct VAT in the current year to the entitlement to deduct VAT in the year the goods were acquired, manufactured or first put to use.

There is no legislative history or CJEU case law on the power granted to Member States to start the adjustment period at the moment the goods are first used. Therefore, it is unclear why this power has been granted to Member States. However, there are two reasons that can explain the provision:

66Case C-550/11, PIGI, EU:C:2012:614.

67Compare: Ivan Vargouleve, 'The Bulgarian VAT System To Be Evaluated by the ECJ' (2012) *International VAT Monitor* January/February, 35.

68Terra/Kajus (n 26) para 10.6.2.

69Case C-268/83, *Rompelman*, EU:C:1985:74.

(1) As Terra and Kajus point out, the main rule on the start of the adjustment period results in a situation where if the good is purchased on e.g. 31 December 2017, the first year of the adjustment period (2017) comprises one day.[70] The derogation allows the Member State to start the adjustment period at 31 December 2017 (assuming that is also the day of the first use) for five full years. This means that the first year comprises 31 December 2017-30 December 2018.
(2) Starting the adjustment period at the moment of first use makes it possible to take into account the use of the good during the full five year period. Under the main rule if a good is not used for e.g. two years, the use of the good is only taken into account for three years.[71]

Looking at Member States' VAT legislation it can be noted that the legislation in this area is quite diverse. There are many Member States applying the main rule starting the adjustment period in the year goods were acquired or purchased, for example, Denmark,[72] Estonia,[73] Croatia,[74] Ireland[75] and Luxembourg.[76] Other Member States however use the derogation and start the adjustment period at the moment of first use, for example: Germany,[77] the Netherlands,[78] Hungary,[79] Poland,[80] Portugal[81] and Slovenia.[82] Then there is a third category of Member States that use both options depending on the situation at hand. For example, Italy and Slovak Republic start the adjustment period for immovable property at the time of first use, but for other capital goods at the moment of purchase or acquisition.[83]

Using the option affects the amount of VAT that can be deducted as the following example will show:

A taxable person A acquires an immovable property on 1 June 2018 for 1,000,000 euros + 200,000 euros VAT. The adjustment period in A's Member State is 10 years starting at the date of purchase. A taxable person B acquires a similar immovable property on 1 June 2018 for 1,000,000 euros + 200000 euros. B's Member State applies a 10 year adjustment period for immovable property too, but the adjustment period starts at the moment of first use. Both A and B have the intention to use the property fully for taxable supplies and start using the property at 1 January 2019. In the period 2019-2023 the property is used fully for taxable supplies. In the

[70] Terra/Kajus (n 26) section 10.6.3.
[71] The recent judgment of the CJEU in the Imofloresmira case shows that non-use of a good is not a reason for adjusting the VAT deducted (Case C-672/16, *Imofloresmira*, EU:C:2018:134).
[72] Art. 44 Value Added Tax Act.
[73] Art. 32 (4.1) Value Added Tax Act.
[74] Art. 64 (1) Value Added Tax Act.
[75] Art. 63 (1) Value Added Tax Consolidation Act.
[76] Art. 53 (2) Value Added Tax Act.
[77] Art. 15a (4) Value Added Tax Act.
[78] Art. 15 (4) Value Added Tax Act.
[79] Art. 135 (1) Act CXXVII of 2007 on Value Added Tax.
[80] Art. 91 (2) Act of 11 March 2004 on Goods and Services Tax.
[81] Art. 24 (1) and (2) Value Added Tax Act.
[82] Art. 69 (2) Value Added Tax Act
[83] For Italy compare art. 19bis2 (2) and (8) Presidential Decree No 633 of 26 October 1972. For Slovak Republic see art. 54 (4) of the Slovakian Value Added Tax Act.

period 2024-2028 the property is used for exempt supplies. The table below shows A's and B's right to deduct VAT.

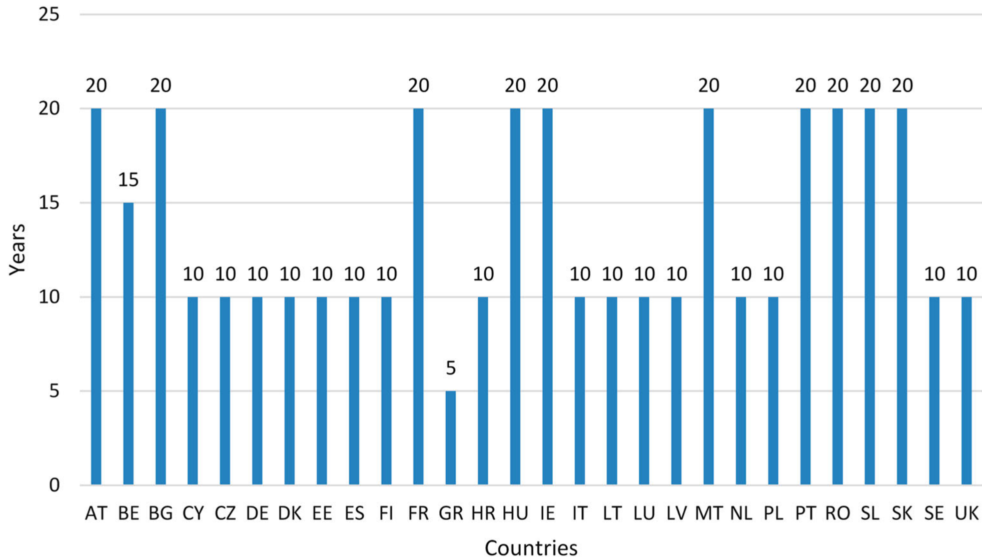
Year	A		B	
	Deductible	*Non-deductible*	*Deductible*	*Non-deductible*
2018	€ 200,000		€ 200,000	
2019-2023	100%, no correction		100%, no correction	
2024		€ 20,000		€ 20,000
2025		€ 20,000		€ 20,000
2026		€ 20,000		€ 20,000
2027		€ 20,000		€ 20,000
2028	Adjustment period ended			€ 20,000
VAT deduction in total	€ 200,000	€ 80,000	€ 200,000	€ 100,000
On balance	€ 120,000		€ 100,000	

As the example shows A has deducted 20,000 euros more VAT than B. This is because the adjustment period for A starts on 1 June 2018 and for B on 1 January 2019 and therefore comprises the year 2028 for B, where it does not for A. This difference may distort competition and in the author's opinion would need to be looked at and dealt with. Her preference would be to start the adjustment period at the moment goods are first put to use. That way the deduction is determined based on the use of those goods during the first 5 (up to 20) years. However, applying an adjustment period for each capital good based on the date it has been put to first use will be burdensome for taxpayers. They must make adjustments during the year depending on when their capital goods were first put to use. It would, in her opinion, therefore be best to apply the adjustment rules as of the year the goods were first put to use, the year the goods being put to use being considered the full first year even if the goods are first put to use during the year. This means applying the main rule of art. 187 (1) VAT Directive, but from the moment of first use.

As regards the adjustment period for capital goods CJEU case law sheds some light on the matter. The adjustment rules as such are intended to enhance the precision of deductions to ensure neutrality of VAT.[84] Changes in use are particularly significant in the case of capital goods which are used over a number of years.[85] In 1995 a Directive was adopted that—amongst others—made it possible for Member States to extend the adjustment period for immovable property up till 20 years. Until then the Member States could use an adjustment period of 10 years maximum.[86] The extension was justified by referring to the duration of the economic life of immovable property.[87] The graphic[88] below shows the extent to which Member States have made use of the option to extend the adjustment period for immovable

[84]Cases C-63/04, *Centralan*, EU:C:2005:773, para 57; C-234/11, *TETS Haskovo*, EU:C:2012:644, para 31; C-550/11, *Pigi*, EU:C:2012:614, para 25; C-107/13, *FIRIN*, EU:C:2014:151, para 50.
[85]Cases C-184/04, *Uudenkaupungin Kaupunki*, EU:C:2006:214, para 25; C-500/13, *Gmina Międzyzdroje*, EU:C:2014:1750, para 20; C-229/15, *Mateusiak*, EU:C:2016:454, para 30.
[86]Council Directive 95/7/EC of 10 April 1995 amending Directive 77/388/EEC and introducing new simplification measures with regard to value added tax - scope of certain exemptions and practical arrangements for implementing them, OJ L 102, 0018-0024.
[87]9th recital of the preamble of Directive 95/7/EC (n 86).
[88]This graphic does not take into account the definition of immovable property by Member States which varies per Member State. As a result of that what may be considered an immovable property in one Member State does not qualify as such in another Member State. Specific situations where the deduction period might be different are also not included in this graphic.

property.



As shown by the graphic almost all Member States have availed themselves of the option to extend the adjustment period for immovable property. Most Member States have extended this period to 10 years. Others have extended the period up to 20 years. Only Belgium uses an adjustment period of 15 years. A different adjustment period may result in a different VAT deduction in total, since changes are taken into account during the whole adjustment period. This may concern substantial amounts in case of immovable capital goods and may distort competition. In that respect it is unclear to the author why this has not been harmonised. Another option would be to use the depreciation period that applies for (corporate) income tax purposes or the depreciation period that is used to prepare the commercial accounts. This depreciation period would best reflect the economic life of immovable property. For some (immovable) goods using the depreciation period may however increase the administrative burden if a good has a longer life cycle than the adjustment period currently applicable.

5.4. No adjustment in case of exempt supply to taxable person with full right to deduct

Capital goods can be supplied during the adjustment period. In that case art. 188 VAT Directive provides for a final settlement of the adjustment period. In case the supply of the capital good is a taxable supply the good is presumed to have been used for taxable supplies only during the remaining adjustment period. In case of an exempt supply the capital good is presumed to have been used for exempt supplies during the remainder of the adjustment period. The adjustment in case of a supply of capital goods within the adjustment period is made only once in respect of all the time covered by the remaining adjustment period.

In case of the supply of a capital good is an exempt supply art. 188 (2) VAT Directive allows the Member States to waive the exemption provided the purchaser is using the good solely for transactions for which he can deduct the VAT. An explanatory memorandum on this provision is missing and it has never been addressed in CJEU case law. With Terra and Kajus[89] the author believes that the objective of the provision is to prevent accumulation of VAT. In case the supply is exempt and the seller will need to adjust the VAT downwards it will most likely include this non-deductible VAT in the selling price. The purchaser will take into account this higher cost when determining his prices and will thus indirectly charge VAT on that non-deductible VAT.

Even though the purpose of this provision is clear and fits well in the VAT system, it should not be an optional provision to Member States, because it results in differences between Member States that have and Member States that have not implemented this provision. In the first group of Member States the accumulation of VAT will be prevented and the cost price of the purchaser will most likely be lower[90] than in the second group of Member State. To prevent accumulation of VAT the author suggests to make the provision an obligatory provision for Member States to implement.

5.5. Specific rules for adjustments for capital goods

Art. 189 VAT Directive provides Member States with a number of powers as regards the adjustment scheme for capital goods. Under the provision Member States may:

(1) Define the concept of capital goods. This power will be discussed in conjunction with the power granted by art. 190 VAT Directive that allows Member State to treat services which have characteristics similar to those normally attributed to capital goods as capital goods.
(2) Specify the amount of the VAT which is to be taken into consideration for adjustment.
(3) Adopt any measures needed to ensure that adjustment does not give rise to any unjustified advantage.
(4) Permit administrative simplifications.

These powers granted to Member States together with the powers discussed in the previous sections make that each Member State has its own system for adjustments. It is beyond the scope of this article to discuss all 28 adjustment systems in the EU. In this paragraph the author will discuss the powers in general and use Member State's legislation as examples. All of the powers of art. 189 VAT Directive were included in the Sixth Directive, but were adopted without any explanation.

5.5.1. Definition of capital goods

In the VNO case[91] the CJEU defined the concept of capital goods under the Second Directive. According to the CJEU the term capital goods covers goods used for the purpose of some business activity that are distinguishable by their durable nature and their value in

[89]Terra/Kajus (n 26) section 10.6.4.
[90]Assuming the supplier will try to increase its price to cover the non-deductible VAT, but may not be able to do so due to market conditions such as price elasticity.
[91]Case C-51/76, *Verbond nederlandse ondernemingen*, EU:C:1977:12.

such a way that the acquisition costs are not normally treated as current expenditure but written off over several years. Later CJEU case law also stresses the fact that capital goods are used over a number of years.[92] Terra and Kajus argue that the VNO case has lost its importance by virtue of art. 189 (a) VAT Directive that allows Member States to define the concept of capital goods.[93] It is the author's opinion that there may be some limitation to the Member States sovereignty that makes the judgment in the VNO case still of relevance. In this respect she refers to the CJEU case law on building land. Building land is a concept that Member States can define under art. 12 (2) VAT Directive. The CJEU however limited this power of Member States in the gemeente Emmen and Woningstichting Maasdriel case to a great extent.[94] The neutrality principle could also limit the scope of Member State's powers.[95] Nevertheless, the power granted by art. 189 (a) VAT Directive may result in some Member States treating certain goods as capital goods while others do not. Since the use of these goods may change over time, this may result in differences in the amount of deductible VAT and hence result in a distortion of competition.

The provision of art. 190 VAT Directive that allows Member States to treat certain services as capital goods for the application of the adjustment rules has a more recent history. It was introduced by Directive 2006/69/EC.[96] Pursuant to the fifth recital of the preambule to this directive, the reason why this provision was added is to include certain services with the nature of capital items in the adjustment scheme. This allows adjustments during the lifetime of the asset, according to its actual use. The provision must also be read at the background of the purpose of the directive to provide Member States with powers to deal with situations of tax evasion or avoidance. If the adjustment period of a service does not match it lifespan it is conceivable that taxable persons use the service in the first year only for taxable transactions, allowing them a full right to deduct VAT, and then for exempt supplies during the rest of the lifespan of the service. With no adjustment rules after the first year the full VAT deduction is definitive after the first year. There are some Member States that have implemented this provision defining what needs to be considered a service comparable to capital goods.[97] There are also Member States that have not implemented this provision.[98] Other Member States have implemented the provision, but with a limited scope.[99] Since services may involve major investments, the author believes it is incomprehensible that this is left at the discretion of the Member States. The adjustment period should apply to investments made by entrepreneurs which are

[92] *Uudenkaupungin Kaupunki* (n 85) para 25; *Gmina Międzyzdroje* (n 85) para 20; *Mateusiak* (n 85) para 30.
[93] Terra/Kajus (n 26) para 10.6.5.1.
[94] Cases C-468/93, *gemeente Emmen*, EU:C:1996:139; C-543/11, *Woningstichting Maasdriel*, EU:C:2013:20.
[95] See, for example, *BLC Baumarkt* (n 42) para 16.
[96] Council Directive 2006/69/EC of 24 July 2006 amending Directive 77/388/EEC as regards certain measures to simplify the procedure for charging value added tax and to assist in countering tax evasion or avoidance, and repealing certain Decisions granting derogations, OJ L 221/9.
[97] For example, in Belgium Art. 6 Royal Decree n0 3. Only assets that are depreciated in five years or more are considered capital goods for which a longer adjustment period applies: Circulaire AFZ 3/2007 (AFZ/2006-0362 – AFZ/2006/0718), para 53.
[98] For example, in the Netherlands. The Dutch Supreme Court explicitly rejected adjustments for services. HR 23 October 1991, case 27.053, BNB 1992/44, HR 19 November 2011, case 08/01021, BNB 2011/42 and HR 8 March 2013, no. 11/00701, BNB 2013/111.
[99] In Romania, for example, a longer adjustment period only applies to construction services and refurbishment of immovable property that are capitalised, if the value of the services is at least 20% of the total value of the property after transformation, art. 305 (1) (a) of the Romanian Value Added Tax Act.

used to perform taxable supplies for a longer period of time, irrespective of whether or not the investment should be classified as a supply of a good or a service.

5.5.2. Specifying the amount of VAT to be taken into account in respect of adjustment rules

There is no guidance in CJEU case law or the legislative history of the VAT Directive on art. 189 (b) VAT Directive. This makes it hard to interpret this provision. Normally the basis for adjustment on capital goods is the total amount of VAT charged for those capital goods, The amount that is deducted at the outset is compared with the amount that could be deducted looking at the use in the current year. The wording of the provision suggests that Member States may take into account a different amount of VAT to compare with the use in the current year.

The Amsterdam Court of Appeal ruled that the Dutch adjustment of capital goods in the year of first use that takes into account the full amount of VAT on the purchase instead of one-fifth or one-tenth can is based on the provision of art. 189 (b) VAT Directive.[100] A provision like the Dutch provision does not result in a different amount of VAT to be deducted, but can result in a financing advantage or disadvantage, as the example below will show. It is therefore the author's opinion that it can't be justified under art. 189 (b) VAT Directive).

X established in the Netherlands purchases a movable property of 100,000 euros + 20,000 euros VAT on 31 December 2017. The adjustment period is five years and starts at the moment the property is first put to use, which is in February 2018. X's estimation in 2017 is that he will use the property for 50% for taxable transactions. In February 2018 X uses the property for 40% for taxable transactions and this doesn't change during the rest of the adjustment period.

	With taking into account the full amount of VAT in the year of first use	Without taking into account the full amount of VAT in the year of first use
2017	VAT Deduction: € 10,000	VAT Deduction € 10,000
2018	Adjustment € 2,000 = 50% x € 20,000 -/- (40% x € 20,000)	Adjustment: € 400 = 1/5 x (50% x € 20,000 -/- (40% x € 20,000))
2019	No adjustment	Adjustment € 400
2020	No adjustment	Adjustment € 400
2021	No adjustment	Adjustment € 400
2022	No adjustment	Adjustment € 400
Total VAT deduction	€ 8,000 (€ 10,000 -/- € 2,000)	€ 8,000 (€ 10,000 -/- (5x € 400))

Actually taking into account a different amount of VAT to apply the adjustment rules seems to infringe with the principle that the rules on VAT deduction should be harmonised to the extent they affect the amount of VAT to be collected. It is with this in mind that the Member States should, according to the author, use this provision. It should therefore not result in a difference as regards the amount of VAT that is deducted in the end.

5.5.3. Prevent unjustified advantages

There is nothing to be found in the legislative history or CJEU case law on the provision that allows Member States to implement measures to prevent unjustified advantages.

[100]Amsterdam Court of Appeal 10 January 2017, 16/00255, NL:GHAMS:2017:159.

What already strikes the author when reading the provision is that it does not allow Member States to implement measures to prevent unjustified *disadvantages*. It therefore seems to be a one-way street. A question that also comes to the author's mind is whether the provision allows Member States to implement general measures in their legislation to prevent unjustified advantages applying to all taxable persons and thus deviating from the main rules for VAT adjustments or only to implement measures for specific groups or individual taxable persons.

According to the Haarlem district court the provision of art. 189 (c) VAT Directive allows for an adjustment of the total VAT amount in the Netherlands in the tax period of the first use of a capital good when a Member State has availed itself of the option to start the adjustment period at the moment of first use as described under 2 above.[101] The provision however does not only prevent advantages (if a financial advantage is already to be regarded as an advantage under art. 189 (c) VAT Directive), but also prevents disadvantages and therefore in the author's opinion is not able to stand ground on art. 189 (c) VAT Directive alone.[102]

In Germany, a shorter useful life of the investment good is taken into account.[103] When the use of the capital good ends in the adjustment period, the latter is abbreviated. This also has consequences for the adjustments applied in previous years.[104] Such a rule, deviating from the mandatory adjustment period may also be justified on the grounds that it prevents unjustified advantages.[105] However, again, such a provision does not only prevent unjustified advantages, but may also prevent unjustified disadvantages.

Again it is the author's view that art. 189 (c) VAT Directive should be used by Member States taking into account the mandatory rules for VAT adjustments and the objective of the VAT Directive to achieve harmonisation in respect of the VAT amounts to be deducted. The neutrality principle should also be kept in mind.

5.5.4. Administrative simplifications

Again, there is nothing but the wording of this provision to interpret this power granted to Member States. Looking at the phrase 'administrative simplifications' what is most likely meant is simplifications in respect of bookkeeping or filing VAT returns. When exercising this power Member States in the author's opinion again must take into account the mandatory provisions on VAT adjustments as well as the objective of the VAT Directive to achieve harmonised rules as regards to the amount of VAT that taxable persons can deduct. For example, a provision implemented by a Member State that allows for an adjustment period on a capital good for one year may be an administrative simplification (i.e. a taxable person will not have to keep track of the use of this goods after the first year or report yearly adjustments after that year), but infringes with the obligatory adjustment period of five years of art. 187 (1) VAT Directive. When taking into account the objective of harmonisation an administrative simplification should not distort competition. The same must be true for art. 186 VAT Directive[106] that allows Member States to lay down

[101]Haarlem District Court 25 May 2016, AWB - 15 _ 187, NL:RBNHO:2016:5017.
[102]JPWHT Becks comment on Haarlem District Court 25 May 2016, AWB-15?187, NTFR 2016/2050.
[103]Manfred-Holger Stadie, *Umsatzsteuergesetz* (Otto Schmidt, 3rd edn 2015), 1132.
[104]ibid 1148.
[105]It may also be based on Cases C-322/99 and C-323/99, *Fischer and Brandenstein*, EU:C:2001:280, para 91.
[106]Compare: Case C-532/16, *SEB Bankas*, EU:C:2018:228, para 48.

detailed rules for applying the adjustment rules of art. 184 and 185 VAT Directive. In this respect the author also refers to art. 394 and 395 VAT Directive that allow Member States to introduce special measures for derogation from the provisions of this Directive, in order to simplify the procedure for collecting VAT or to prevent certain forms of tax evasion or avoidance. This however may not affect, except to a negligible extent, the VAT revenues.

6. Concluding remarks

In this article the author addressed four areas where Member States have powers that affect the amount of VAT that can be deducted and which may potentially distort competition. Economic studies into the materiality of the differences will be necessary to establish the extent to which distortion of competition occurs. The objective of this article is to point out areas where further economic research is necessary and harmonisation should be considered.

The areas discussed are:

(1) Rules on private use and expenditure
(2) Rules on deductible proportion
(3) The exclusion of VAT deduction due to cyclical economic reasons
(4) Adjustment rules

As regards the rules on private use and expenditure the author discussed the stand-still clause of art. 176 VAT Directive. This provision distorts competition as has been recognised by the European Commission. The deemed supplies of art. 16, 18 and 26 VAT Directive mitigate the consequences of differences in Member States to some extent. However, not in full. It is the author's opinion that the European Commission should try to harmonise the rules on limitations of deduction to prevent distortion of competition, but she also realises that this is difficult because of the budgetary implications for Member States.

The author has discussed two provisions on the deductible proportion: the option to include subsidies in the denominator of the deductible proportion and the option to implement methods for calculating the deductible proportion that derogate from the main rule to calculate the deductible proportion based on turnover. Even though the author believes there are good reasons for including subsidies in the deductible proportion, the mere fact that it is an option may cause distortion of competition. It is therefore her opinion that it is necessary to harmonise the rules in this respect.

As regards the methods of calculating the deductible proportion it becomes clear from the 39th recital of the preamble of the VAT Directive that deductible proportions should be calculated in a similar manner. The author believes that at the outset Member States were of the opinion that with the rules provided by art. 173 VAT Directive that objective was reached. However, CJEU case law shows that the provision of art. 173 (2) VAT Directive can provide for a wide variety in calculation methods. It is the author's opinion that it is necessary to evaluate whether art. 173 VAT Directive and its options still provide for a similar calculation of the deductible proportion.

Next the author discussed art. 177 VAT Directive which allows Member States to totally or partially exclude all or some capital goods or other goods from the system of deduction for cyclical economic reasons. The author is of the opinion that there are many measures a government can take to improve its economic situation without using a tax that should be neutral to those charging VAT on their transactions. The European Commission in her opinion should consider abolishing art. 177 VAT Directive altogether.

Member States have many discretions as regards the application of adjustment rules. It is the author's opinion that the provision allowing Member States to require an adjustment in case of theft duly proved should be abolished. The author suggests an adjustment period for capital goods starting at the year of first use. To limit taxpayer's administrative obligation the year of first use can count as a whole year even if the capital good was first used during that year. Differences in the length of adjustment periods of immovable capital goods can also distort competition. It is unclear to the author why this is left to Member States. The power granted to Member States by art. 188 (2) VAT Directive has a clear purpose and fits well within the VAT system, because it prevents accumulation of the tax. However, the mere fact that it is an optional provision can distort competition. The author suggests to make it a mandatory provision. Last but not least, the author discussed the powers granted to Member States under art. 189 and 190 VAT Directive. It is in her opinion incomprehensible that it is left to Member State to decide whether or not they apply adjustment rules to services comparable to capital goods. The capital good adjustment scheme should be applicable to investments made by taxable persons that are used for a longer period of time, regardless of whether the investment is a good or a service. There is not much clarity on the provisions of art. 189 (b)-(d) VAT Directive. The author argues that when exercising the powers granted under these provisions Member States should take into account the mandatory provisions on VAT adjustments as well as the objective of the VAT Directive to achieve harmonised rules as regards to the amount of VAT that taxable persons can deduct.

Disclosure statement

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