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Case C-204/03

Commission of the European Communities

v

Kingdom of Spain

(Failure of a Member State to fulfil obligations — Articles 17 and 19 of the Sixth VAT Directive — Subsidies — Limitation of the right to deduct)

Opinion of Advocate General Poiares Maduro delivered on 10 March 2005

Judgment of the Court (Third Chamber), 6 October 2005

Summary of the Judgment

Tax provisions – Harmonisation of laws – Turnover taxes – Common system of value added tax – Deduction of input tax – Limitations on the right to deduct – Subsidies – National legislation providing for a deductible proportion of tax for taxable persons who carry out only taxable transactions, and limiting the right to deduct tax on the purchase of goods and services which are subsidised – Not permissible

(Council Directive 77/388, Arts 17(2) and (5), and 19)

A Member State which, in the context of subsidised activities, provides for a deductible proportion of value added tax for taxable persons who carry out only taxable transactions, and which lays down a special rule which limits the right to deduct value added tax on the purchase of goods and services which are subsidised, fails to fulfil its obligations under Community law, and, in particular, Articles 17(2) and (5) and 19 of Sixth Directive 77/388 on the harmonisation of the laws of the Member States relating to turnover taxes.

(see para. 31, operative part)

JUDGMENT OF THE COURT (Third Chamber)

6 October 2005 (*)

(Failure of a Member State to fulfil its obligations – Articles 17 and 19 of the Sixth VAT Directive – Subsidies – Limitation of the right to deduct)

In Case C-204/03,

ACTION under Article 226 EC for failure to fulfil obligations, brought on 14 May 2003,

Commission of the European Communities, represented by E. Traversa and L. Lozano Palacios, acting as Agents, with an address for service in Luxembourg,

applicant,

v

Kingdom of Spain, represented by N. Díaz Abad, acting as Agent, with an address for service in Luxembourg,

defendant,

THE COURT (Third Chamber),

composed of A. Rosas, President of the Chamber, J.-P. Puissechet, S. von Bahr (Rapporteur), J. Malenovský and U. Löhmus, Judges,

Advocate General: M. Poiares Maduro,

Registrar: R. Grass,

having regard to the written procedure,

after hearing the Opinion of the Advocate General at the sitting on 10 March 2005,

gives the following

Judgment

1 By its application, the Commission of the European Communities seeks a declaration from the Court that, by providing for a deductible proportion of value added tax ('VAT') for taxable persons who carry out only taxable transactions, and by laying down a special rule which limits the right to deduct VAT on the purchase of goods and services which are subsidised, the Kingdom of Spain has failed to fulfil its obligations under Community law, and, in particular, Articles 17(2) and (5) and 19 of Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes – Common system of value added tax: uniform basis of assessment (OJ 1977 L 145, p. 1), as amended by Council Directive 95/7/EC of 10 April 1995 (OJ 1995 L 102, p. 18; 'the Sixth Directive').

Legal framework

Community legislation

2 Article 11A(1)(a) of the Sixth Directive provides that the taxable amount shall be:

'in respect of supplies of goods and services ... everything which constitutes the consideration which has been or is to be obtained by the supplier from the purchaser, the customer or a third party for such supplies including subsidies directly linked to the price of such supplies'.

3 Article 17(2)(a) of the directive, in the version resulting from Article 28f thereof, provides that, '[i]n so far as the goods and services are used for the purposes of his taxable transactions, the taxable person shall be entitled to deduct from the tax which he is liable to pay ... value added tax due or paid within the territory of the country in respect of goods or services supplied or to be supplied to him by another taxable person'.

4 Article 17(5) provides that:

'As regards goods and services to be used by a taxable person both for transactions covered by paragraphs 2 and 3, in respect of which value added tax is deductible, and for transactions in respect of which value added tax is not deductible, only such proportion of the value added tax shall be deductible as is attributable to the former transactions.

This proportion shall be determined, in accordance with Article 19, for all the transactions carried out by the taxable person.

...'

5 Article 19(1) of the Sixth Directive, entitled 'Calculation of the deductible proportion', states that:

'The proportion deductible under the first subparagraph of Article 17(5) shall be made up of a fraction having:

- as numerator, the total amount, exclusive of value added tax, of turnover per year attributable to transactions in respect of which value added tax is deductible under Article 17(2) and (3);
- as denominator, the total amount, exclusive of value added tax, of turnover per year attributable to transactions included in the numerator and to transactions in respect of which value added tax is not deductible. The Member States may also include in the denominator the amount of subsidies, other than those specified in Article 11A(1)(a).

...'

National legislation

6 Article 102 of Law No 37/1992 of 28 December 1992 on value added tax (BOE No 312 of 29 December 1992, p. 44247), as amended by Law No 66/1997 of 30 December 1997 (BOE No 313 of 31 December 1997, p. 38517; 'Law No 37/1992'), is devoted to the proportion rule governing deduction of that tax. The first paragraph of that article states that:

'The proportion rule shall apply where the taxable person in the course of his trade or business carries out both supplies of goods or services in respect of which value added tax is deductible and other transactions of a similar nature in respect of which it is not.

The proportion rule shall also apply where the taxable person receives subsidies which, in accordance with Article 78(2)(3) of this Law, do not form part of the taxable amount, inasmuch as they are intended to fund the taxable person's trade or business activities.'

7 Article 104 of Law No 37/1992 refers to the general proportion. The second paragraph of Article 104(2)(2) states that:

'Capital subsidies shall be included in the denominator of the proportion, but they may be imputed in fifths to the tax year during which they were received and to the four following tax years. Nevertheless, capital subsidies granted in order to fund the purchase of certain goods or services, acquired in connection with transactions that are taxable and not exempted from VAT, will reduce exclusively the amount of the deduction of VAT borne or paid in respect of those transactions, to the precise extent to which they have contributed to their funding.'

Pre-litigation procedure

8 The Commission initiated the infringement procedure under Article 226 EC by a letter of formal notice sent to the Spanish Government on 20 April 2001, in which it maintained that Article 102 and the second paragraph of Article 104(2)(2) of Law No 37/1992 restrict, contrary to Articles 17(2) and (5) and 19 of the Sixth Directive, the right to deduct VAT.

9 The Kingdom of Spain submitted its observations in response to that letter of formal notice by letter of 28 May 2001.

10 Unsatisfied with that response, the Commission sent a reasoned opinion on 27 June 2002 requesting that Member State to adopt the measures necessary to comply with the opinion within two months of its notification.

11 By letter of 20 September 2002, the Kingdom of Spain replied to the reasoned opinion, reiterating its disagreement with the position adopted by the Commission.

The action

Preliminary considerations

12 It should be noted that the provisions of Law No 37/1992, referred to in paragraphs 6 and 7 of the present judgment, contain a general rule and a special rule.

13 Under the general rule, laid down in Article 102 of the Law read in conjunction with the first sentence of the provisions of Article 104 of that same law, cited in paragraph 7 of the present judgment, subsidies to finance the trade or business of a taxable person, which do not form part of the basis of VAT assessment, are taken into account in the calculation of the deductible proportion in so far as they are part of the denominator of the portion which that proportion results from. Those subsidies thus generally diminish the right to deduct enjoyed by taxable persons. The latter consist not only of taxable persons who use the goods and services obtained as inputs to carry out, at the same time, transactions in respect of which VAT is deductible and other transactions of a similar nature in respect of which it is not ('mixed taxable persons'), but also taxable persons who use goods and services exclusively to carry out transactions in respect of which VAT is deductible ('fully taxable persons').

14 The special rule is contained in the second sentence of the provisions of Article 104 of Law No 37/1992, cited in paragraph 7 of the present judgment. Under that rule, subsidies granted specifically to fund the purchase of certain goods or services acquired in connection with transactions that are taxable and not exempted from VAT reduce exclusively the amount of the deduction of VAT borne or paid in respect of those transactions, to the precise extent to which they have contributed to their funding. Consequently, in the case of a subsidy amounting, for example, to 20% of the purchase price of a good or service, the right to deduct the VAT specifically imposed on that good or service is reduced by 20%.

Arguments of the parties

15 The Commission submits that the general rule laid down by Law No 37/1992 unlawfully extends the restriction of the right to deduct laid down in Article 17(5), read in conjunction with Article 19 of the Sixth Directive, by applying that restriction not only to mixed taxable persons but also to fully taxable persons. In addition, the special rule set out in that Law introduces a mechanism of deduction which is not provided for in the Sixth Directive and is thus contrary to it.

16 The Spanish Government considers, for its part, that the Commission gives the Sixth Directive a literal interpretation which fails to take account of the objectives of the text and, in

particular, the principle that VAT should be neutral.

17 According to that government, Article 19 of the Sixth Directive does not simply constitute a rule for calculating the proportion mentioned in Article 17(5) of that directive aimed at calculating, in the case of mixed taxable persons, the proportion of taxed activities in respect of which VAT is deductible in relation to the total amount of the taxable person's taxed and exempted activities. By providing in Article 19 that Member States may include in the denominator of the proportion subsidies which are not directly linked to the price of the transactions and which are therefore not included in the taxable amount as defined in Article 11A(1)(a) of that directive, the legislature introduced an exception to the rule laid down in Article 17(5) as regards mixed taxable persons by allowing restrictions of the right to deduct of fully taxable persons.

18 The Spanish Government submits that the purpose of Article 19 of the Sixth Directive is to allow Member States to re-establish the balance as regards competition and, in doing that, to observe the principle that tax should be neutral. In support of that view it cites the example of a transporter who obtains a subsidy to purchase a vehicle. The subsidy allows him to reduce the cost of his service and, thus, the amount of VAT applicable to it. Furthermore, if, with the help of that subsidy, the transporter can deduct the whole VAT on the amount spent on inputs, he gains a further advantage over his competitors who have not received subsidies.

19 The Spanish Government adds that the special rule laid down in Law No 37/1992 provides for a restriction of the right to deduct which is more limited than that which results from the application of Article 19 of the Sixth Directive, since it concerns the deduction of VAT relating only to the goods or services obtained with the help of the subsidy and it has no impact on the deduction of tax as regards other goods or services obtained by the taxable person.

20 As an ancillary point, the Spanish Government requests the Court, should it not agree with the interpretation which that government puts forward, to limit the effects in time of its judgment. The non-retroactive application of the effects of the judgment is justified, first, by the fact that the Spanish authorities acted in good faith in adopting the legislation at issue and, second, by the problems which the Court's judgment could give rise to.

Findings of the Court

21 Article 17(2) of the Sixth Directive sets out the principle of the right to deduct VAT. The latter concerns input tax on the goods and services used by taxable persons for the needs of their taxed transactions.

22 Where the taxable person carries out, at the same time, transactions in respect of which VAT is deductible and exempted transactions in respect of which it is not, Article 17(5) of the directive states that only such proportion of the VAT shall be deductible as is attributable to the taxed transactions. That proportion is calculated according to the method laid down in Article 19 of the directive.

23 As the Court has repeatedly pointed out, any limitation of the right to deduct VAT affects the level of the tax burden and must be applied in a similar manner in all the Member States. Consequently, derogations are permitted only in the cases expressly provided for in the Sixth Directive (see, in particular, Case 50/87 *Commission v France* [1988] ECR 4797, paragraph 17, Case C-62/93 *BP Supergas* [1995] ECR I-1883, paragraph 18, and Case C-409/99 *Metropol and Stadler* [2002] ECR I-81, paragraph 42).

24 In that regard, it must be noted that Article 19 of the Sixth Directive, entitled 'Calculation of the deductible proportion', refers expressly to Article 17(5) of that directive, to which it is wholly

related.

25 The provisions of the second indent of Article 19(1) on subsidies other than those specified in Article 11A(1)(a) of the Sixth Directive, that is to say subsidies which are not included in the price of the good or service provided and which do not form part of the taxable amount, must be read in the light of Article 17(5). However, as is clear from its wording, Article 17(5) only applies to mixed taxable persons. It follows that, given that it is not an exception applicable to both mixed and fully taxable persons, the second indent of Article 19(1) permits limitations of the right to deduct, taking account of the subsidies thus defined, only in the case of mixed taxable persons.

26 Consequently, by extending the restriction of the right to deduct to fully taxable persons, the general rule laid down in Law No 37/1992 introduces a restriction which goes beyond the one expressly provided for in Articles 17(5) and 19 of the Sixth Directive and infringes the provisions of the directive.

27 In relation to the special rule set out in the Law, it is sufficient to point out that it introduces a mechanism for limiting the right to deduct which is not provided for in Articles 17(5) and 19 of the Sixth Directive or in any other provision of the directive. Consequently, such a mechanism is not authorised by the directive.

28 The Spanish Government's argument that its interpretation of Article 19 of the Sixth Directive enables balance in terms of competition, and hence the principle that VAT should be neutral, to be observed must be rejected. The Member States are required to apply the Sixth Directive even if they consider it to be less than perfect. As indicated in Case C-388/98 *Commission v Netherlands* [2001] ECR I-8265, paragraphs 55 and 56, even if the interpretation put forward by certain Member States better served certain aims of the Sixth Directive, such as fiscal neutrality, the Member States may not disregard the provisions expressly laid down in that directive by introducing, in this case, limitations of the right to deduct other than those laid down in Articles 17 and 19 of that directive.

29 As regards the restriction of the effects in time of the Court's judgment requested by the Spanish Government, it must be noted that it is only exceptionally that the Court may, in application of the general principle of legal certainty inherent in the Community legal order, be moved to decide on such a restriction.

30 In that regard, and as pointed out by the Advocate General in paragraph 24 of his Opinion, it must be established that the State authorities were prompted to adopt legislation or conduct contrary to Community law because of objective and significant uncertainty regarding the implications of the Community provisions concerned (see, to that effect, Case C-359/97 *Commission v United Kingdom* [2000] ECR I-6355, paragraph 92). However, there was no such uncertainty in this instance. It is thus not necessary to restrict the effects in time of the present judgment.

31 In the light of those considerations, it must be held that, by providing for a deductible proportion of VAT for taxable persons who carry out only taxable transactions, and by laying down a special rule which limits the right to deduct VAT on the purchase of goods and services which are subsidised, the Kingdom of Spain has failed to fulfil its obligations under Community law, and, in particular, Articles 17(2) and (5) and 19 of the Sixth Directive.

Costs

32 Under Article 69(2) of the Rules of Procedure, the unsuccessful party is to be ordered to pay the costs if they have been applied for in the successful party's pleadings. Since the Commission

has applied for costs and the Kingdom of Spain has been unsuccessful in its pleas, the latter must be ordered to pay the costs.

On those grounds, the Court (Third Chamber) hereby:

1. **Declares that, by providing for a deductible proportion of value added tax for taxable persons who carry out only taxable transactions, and by laying down a special rule which limits the right to deduct VAT on the purchase of goods and services which are subsidised, the Kingdom of Spain has failed to fulfil its obligations under Community law, and, in particular, Articles 17(2) and (5) and 19 of Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes – Common system of value added tax: uniform basis of assessment, as amended by Council Directive 95/7/EC of 10 April 1995;**
2. **Orders the Kingdom of Spain to pay the costs.**

[Signatures]

* Language of the case: Spanish.