RIGHT TO DEDUCT VAT ON LEASES AND FINANCIAL LEASES

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With the main objective of harmonising the laws of the Member States of the European Union (EU) relating to turnover taxes by replacing their present system for a common system of Value Added Tax (VAT), on April 11, 1967 the Council of the European Union adopted the first two VAT Directives.

Later on May 17, 1977 the Sixth VAT Directive was adopted establishing a uniform VAT regime, including the provisions of the second VAT Directive that were still applicable. This was replaced by Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax (the principal VAT Directive) giving a clearer overview of EU VAT legislation currently in force.

In this area the European Court of Justice (ECJ) rulings are important to the extent that they contribute to the understanding of the common system of VAT within the EU, because those decisions explain the Court's interpretation of EU law.

The ECJ's ruling in *Eon Asset Management*[2] is an important judgment and has provided a clearer perspective on certain aspects of the VAT scheme in operation in the EU, in particular, relating to the definitions of the supply of goods and services concerning financial leases.

Background

The case concerned a Bulgarian company, *Eon Asset Management* (the taxpayer). It entered into a one-year lease contract of a car and a four-year finance lease

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2 ECJ, 16 Feb. 2012, Case C-118/11, *Eon Asset Menidjmunt OOD v Direktor na Direktsia "Obzhalvane i upravlenie na izpalnenieto" ("Eon Asset Management")*[2012] ECR I-0000 (not yet reported).

contract for another car and deducted all the VAT charged in respect of both transactions. The taxpayer provided both cars to its managing director for the purpose of transportation to and from work, free of charge.

The Bulgarian Tax Authority sought to disallow recovery of the VAT incurred on the cars and the Administrative Court of Varna referred questions to the ECJ for a preliminary ruling. The Court summarised the questions as follows:

1. Under which conditions does the VAT Directive enable a taxable person to deduct VAT paid, first, in respect of a leasing contract and, second, in respect of a financial leasing contract, and at what time must those conditions must be satisfied in order to give rise to the right to deduct.
2. Whether Articles 168 and 176 of the VAT Directive preclude national legislation, which provides for the exclusion from the right to deduct for goods and services intended to be supplied free of charge or for activities outside the scope of the taxable person's economic activity.

To provide an answer to these questions, the ECJ had to analyse what kind of supply the lease contract and the financial leasing contract fall into.

Since 1967, the VAT Directives have defined the terms "supply of goods" as the transfer of the right to dispose tangible property as owner[3], and "supply of services" as any transaction which does not constitute a supply of goods[4]; a residual definition which means that all that is not considered to be supply of goods is considered to be a supply of services.

Supply of goods or services

Beginning with the leasing contract of a vehicle, and according to the residual definition given in the VAT Directive, the ECJ categorized this leasing contract as supply of services as a general rule since this kind of transaction did not transfer the right to dispose tangible property as owner; a condition which is required to constitute a supply of goods according to Article 14 (1) of the VAT Directive.[5]

In the case of the financial leasing contract, however, the ECJ adopted a deeper analysis in coming to its conclusion. One might think that since it was a lease and, therefore, did not transfer the title to the goods; it should be regarded also as a supply of services. The ECJ suggested, however, that according to the criteria

3 Art. 14 (1) VAT Directive.

4 Art. 24 (1) VAT Directive.

5 *Eon Asset Management*, paragraph 33.

presented by the national court and having regard to the circumstances of the case, the national court could determine that it should be treated as supply of goods.[6] Considering that the main requirement for the supply of goods is the transfer of ownership, the ECJ held in this case that the concept not only refers to the transfer of ownership but also includes any transfer of tangible property by one party which empowers the recipient actually to dispose of it as if the recipient were the owner of the property.[7] The ECJ used similar reasoning in cases like *Auto Lease Holland*[8] and *British American Tobacco International Ltd*[9].

The ECJ supported its argument with the International Accounting Standard 17 (IAS 17) relating to leases, highlighting that this standard states that a finance lease is distinguished from an operating lease on the basis that under a finance lease substantially all the risks and rewards of ownership of an asset are transferred to the lessee.[10] That is, if a lease transfers substantially all risks and rewards incidental to ownership we are in the presence of a finance lease contract and if they are not transferred the lease will be treated as an operating lease.

In this particular case, even though a financial leasing contract may not provide that the lessee acquires those goods at the end of the lease period, the financial leasing contract transfers substantially all the rewards and risks incidental to legal ownership and because of that the Court held that it should be treated as supply of goods.

This approach may also be seen in *Safe*[11], where the Court noted that "It is clear from the wording of this provision that "supply of goods" does not refer to the transfer of ownership in accordance with the procedures prescribed by the applicable national law but covers any transfer of tangible property by one party which empowers the other party actually to dispose of it as if he were the owner of the property."[12]

"Consequently, the answer to the first question must be that "supply of

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6 *Eon Asset Management*, paragraph 41.

7 *Eon Asset Management*, paragraph 39.

8 ECJ, 6 Feb. 2003, Case C-185/01, *Auto Lease Holland BV v. Bundesamt für Finanzen ("Auto Lease Holland")* [2003] ECR I-1317, paragraph 32.

9 ECJ, 14 Jul. 2005, Case C-435/03, *British American Tobacco International Ltd and. Newman Shipping & Agency Company NV v. Belgische Staat ("British American Tobacco International Ltd")* [2005] ECR I-7077, paragraph 35.

10 *Eon Asset Management*, paragraph 38.

11 ECJ, 8 Feb. 1990, Case C-320/88, *Staatssecretaris van Financien v. Shipping and Forwarding Enterprise Safe BV* ("*Safe*")[1990] ECR I-285.

12 *Safe*, paragraph 7.

> goods" in art 5(1) of the Sixth Directive [actual Article 14(1) of the VAT Directive] must be interpreted as meaning the transfer of the right to dispose of tangible property as owner, even if there is no transfer of legal ownership of the property."[13]

Right to deduct

Once the nature of the supply was determined, the ECJ examined when the right to deduct arose.

Under Article 63 of the VAT Directive, VAT becomes chargeable when the goods or the services are supplied, and under Article 167 a right of deduction arises at the time the deductible tax becomes chargeable. That means that the time when the VAT becomes chargeable generates their corresponding right to a deduction. It is a general rule then that the right of deduction must be exercised immediately and in respect of all the taxes charged on transactions relating to inputs, and where no output tax can be collected, input tax cannot be deducted.

Pursuant to those articles, in relation to a lease contract, the time when the right to deduct arises is on the expiry of the period to which each payment relates. The reasoning of the Court in this case is in accordance with those provisions when it mentions "the existence of a direct and immediate link between a particular input transaction and a particular output transaction or transactions giving rise to entitlement to deduct is, in principle, necessary before the taxable person is entitled to deduct input VAT" or where costs are cost components of the price of the goods or services the taxable person supplies, because these costs have a direct and immediate link to the person's economic activity as a whole.[14]

Private use

The question formulated by the Bulgarian Court, additionally, concerned supplies for activities other than the economic activity of the taxpayer. In this respect the ECJ stated that the fact that an employee must travel between his home and his workplace to perform his duties is not conclusive evidence that the transport was considered to be for the employee's private use and accordingly, it was provided for purposes of the business[15] so that it can be used for VAT purposes.

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13 *Safe*, paragraph 9.

14 *Eon Asset Management,* paragraphs 46 and 47.

15 *Eon Asset Management,* paragraphs 51 and 52.

On a financial leasing contract, being a transaction consisting on supply of goods, the ECJ concluded that the taxpayer has a choice on how to treat the acquisition of capital goods, that is to say, for business or private use or partly for business and partly for private use. This gives three possibilities that affect the right to deduct VAT depending on how the acquisition of capital goods is treated. It can be said that if the acquisition is treated as:

1. Business assets, then the taxpayer can ask for full input VAT recovery.
2. Private assets, then the taxpayer cannot ask for input VAT recovery.
3. Business assets to the extent they are used for business and the rest as private assets, so that the taxpayer can ask for the proportion of input VAT for the goods used as business assets.

This thinking by the ECJ, in relation to the third option, is confirmed by *Armbrecht*,[16] a case which involved a taxpayer who sold a building he owned which was used as a guesthouse, restaurant and had some private use. The ECJ ruled that the taxpayer did not act as a taxable person with respect to the sale of the part of the property which he had chosen to reserve for his private use.

That reasoning can be contrasted with what the Court ruled in *Lennartz*[17], a case where a tax consultant as an employed and self-employed person purchased a car which was used for non-business purposes. Later he opened his own business and contributed the car to the business. The taxpayer claimed retroactively a deduction of the total VAT which was paid for the purchase of the car.

In this respect the ECJ indicated that for instance the taxable person does not get a right to deduct in respect of his non-taxable transaction, that is to say goods used for his private consumption[18]. But, the Court continued by saying that, in this case the transaction comprises of preparatory activities[19], because he first acquired the capital goods in his capacity as a taxable person and only later allocated them to his economic activity.[20] The Court concluded that the taxable person is entitled to deduct the tax due or paid in respect of those goods.

With regard to that reasoning, it can be observed that although a taxpayer has the

16 ECJ, 4 Oct. 1995, Case C-291/92, *Dieter Armbrecht v. Finanzamt ("Armbrecht")* [1995] ECR I-2775, paragraph 20.

17 ECJ, 11 Jul. 1991, Case C-97/90, *Lennartz v. Finanzamt München III* ("*Lennartz*")[1991] ECR I-3795.

18 *Lennartz*, paragraph 12.

19 *Lennartz*, paragraph 13.

20 *Lennartz*, paragraph 17.

option of choosing whether or not an asset is for his private use, this does not impede him from using capital goods for both for business and private purposes and treating them as a whole as business goods, having the consequence that the VAT, in principle, is wholly deductible. And with that outcome, the acquisition of goods determines the application of the VAT system and the deduction, and the use that is given to those goods determines the extent of the deduction.

Thus, one of the main reasons why the national court decided to request a preliminary ruling was because, under its national legislation, services provided for free were not considered to be deductible for tax purposes. Therefore, the taxpayer could allocate capital goods for both business and private purposes and deduct the related VAT or to retain them as his private assets, which made the input VAT not deductible.

This analysis can be supported by article 168(a) of the VAT Directive, which provides that the initial deduction in respect of immovable property used for both business and private purposes must be limited in proportion to the business use of the property.

On the other hand, and in respect of activities carried out free of charge, article 176 of the VAT Directive covers restrictions on input tax deduction by preventing its recovery on not strictly business expenditure (i.e. luxuries, amusements and entertainment), but in none of those categories does the supply covered by the transactions of this particular case fit in.

Pursuant to those provisions, and in relation to the analysis made by the ECJ, in respect of the second question referred, concluded that Articles 168 and 176 of the VAT Directive must be interpreted as not precluding national legislation which provides for the exclusion from the right to deduct in relation to goods and services intended to be supplied free of charge or for activities outside the scope of the taxable person's economic activity, provided that goods categorised as capital goods are not allocated to the assets of the undertaking.[21]

The ECJ stressed that domestic rules cannot refuse to allow taxpayers to treat capital goods used for both business and private purposes as business assets and to deduct input VAT in full which is payable on the acquisition of those goods.

The ECJ has taken a similar approach in various cases, such as *Charles and Charles-Tijmens*[22] in respect of the VAT treatment of capital goods (purchase of a

21 *Eon Asset Management*, paragraph 74.

22 ECJ, 14 Jul. 2005, Case C-434/03, *P. Charles and T.S. Charles-Tijmens v. Staatssecretaris van Financiën* [2005] ECR I-7037, paragraph 24.

holiday bungalow) used partly for business and partly for private purposes. The ECJ held that a taxpayer who chose to treat capital goods used for both business and private purposes as business goods, could deduct the input VAT due on the acquisition of those goods in full.

Place of supply

It is important to mention that, even though the ECJ did not make the analysis in *Eon Asset Management*, different tests are applied to determine the location of supplies of goods and services. As a general rule, the place of supply of goods is usually where the goods are located, and the place of supply of services is determined by reference to the location of the recipient. For VAT purposes, the "place of supply" determines which Member State's VAT rules should be used. That is one of the most important reasons why the ECJ first of all had to determine the type of supply that was involved in this particular case.

The situation where a specific transaction is treated as a supply of goods or services can lead to a difference in VAT treatment. That is the case, for example, in *RBS Deutschland Holding*[23]. This case concerned the recovery of VAT on the purchase of cars which were leased from a company based in Germany to a UK company. The UK considered the rental payments as a supply of services and Germany regarded them as a supply of goods. The difference between German and UK VAT law resulted in the German company being able to recover VAT on the purchase of these cars without needing to account for VAT on the rental payments. The ECJ found that the mere fact that no tax is collected does not prevent recovery of input tax where the VAT in question is attributable to supplies that, in the country in which the input tax is incurred, are taxable transactions. Because of these circumstances, the ECJ found that given the commerciality of the arrangements, the taxpayer was entitled to structure his business in such a way as to limit his tax liability.

With the outcome of the *Eon Asset Management* case the fact that a financial leasing contract has to be considered as a supply of goods, allows the taxpayer to have certainty in the Member State he must charge and account for VAT and also to exercise his right to deduct, being the Member State where the goods or recipient is located, whether this concerns a supply of goods or a supply of services.

23 ECJ, 22 Dic. 2010, Case C-277/09, *Commissioners for Her Majesty's Revenue and Customs v. RBS Deutschland Holdings GmbH* [2011] ECR I-13805.

Conclusion

The common system of VAT seeks to ensure the complete neutrality of taxation of all economic activities, whatever their purpose or results, provided that all services and goods bought and sold for consumption within the EU are subject, in principle, to VAT and allow those taxpayers to deduct from their VAT accounts the amount of the tax which they have paid to other taxpayers on their purchases for commercial purposes.

The judgment of the ECJ in *Eon Asset Management* works as a reference in deciding whether different lease contracts are considered to be a supply of goods or a supply of services, and additionally it limits the right to deduct input VAT for taxpayers when assets are used only partly for business purposes.