CFE News

Opinion Statement of the CFE Task Force on ECJ Cases on the Case *Banca Popolare di Cremona Regional Tax on Productive Activities (IRAP)* (Case C-475/03)

Paper submitted by the Confédération Fiscale Européenne to the Council, the European Commission and the Parliament in 2005

This is an opinion statement prepared by the Task Force on ECJ Cases[1] of the Confédération Fiscale Européenne (CFE) on the European Court of Justice (ECJ) Case C-475/03 (Banca Popolare di Cremona) concerning the Regional Tax on Productive Activities (IRAP). The CFE is the leading European association of 28 national tax advisory organizations representing over 150,000 tax advisers.

1. BACKGROUND AND THE QUESTION REFERRED

In 2001, the Revenue Office of Cremona rejected the request for reimbursement of IRAP (the Regional Tax on Productive Activities) relating to 1998 and 1999 filed by *Banca Popolare di Cremona*: the claim for the reimbursement was based on the argument that the tax is not lawful as it conflicts with Art. 33 of the Sixth VAT Directive.

On 13 November 2001, *Banca Popolare di Cremona* challenged the refusal of the Revenue Office before the *Commissione Tributaria Provinciale* of Cremona (hereinafter: the "Referring Court").

On 9 October 2003, the Referring Court remitted the case to the European Court of Justice asking

> whether Art. 33 of Directive 77/388 CEE (as amended by Directive 91/680 CEE) should be interpreted in the sense that it prohibits to levy IRAP on the net value of production deriving from the habitual exercise of an activity autonomously organized aimed at the production or at the trade of goods or at the provision of services.

On 17 March 2005, Advocate General Jacobs delivered his Opinion concluding that the IRAP conflicted with the principles of the Sixth Directive. The EU Commission and the Italian State Attorney filed written observations with the Court in the case.

* * *

In his Opinion the Advocate General also addressed the issue of the possibility of a temporal limitation on the effect of the judgment, concluding that the effects of the Court decision should be subject to a temporal limitation by reference to a date to be fixed by the Court: this interesting and important matter will be examined in a separate paper.

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On 21 October 2005, at the request of several governments, the Court decided to reopen the oral procedure and scheduled the re-hearing for 14 December 2005.

The Court stated that, before ruling on the question referred, it is necessary to discuss in depth the notion of a tax having the features of value added tax pursuant to Art. 33, No. 1 of the Sixth Directive as well the possibility to set temporal limitations on the effects of the Court's decisions.

2. IRAP: MAIN FEATURES

IRAP was introduced in 1998 replacing several taxes, both direct and indirect, including local income tax (ILOR). IRAP is not deductible for income tax purposes. IRAP is levied with few exceptions on resident taxpayers engaging in any business or professional activity.

The taxable base is different depending on the activity performed. For a business activity, the base is the difference between the value of production in the tax year (i.e. gross proceeds plus the increase in inventory plus work in progress) and the cost of production (i.e. the cost of raw and other materials, the cost of services, depreciation of tangible and intangible assets, the decrease of inventory of raw and other materials, provisions for doubtful liabilities and miscellaneous costs). The cost of personnel, losses on bad debts, and interest paid are not deductible.

1. The Task Force consists of Stella Raventós-Calvo, Philip Baker, Bruno Gangemi, Daniel Gutmann, Luc Hinnekens, Michael Lang, Isabelle Richelle, Albert Rädler and Friedrich Rödler. The members of the Task Force participate in their personal capacity: this statement represents a composite view and does not necessarily represent the opinion of any particular member of the Task Force.

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The taxable base for a profession is the difference between the fees received during the tax year and the related expenses, including depreciation of tangible and intangible assets. The cost of personnel and interest paid are not deductible.

Special rules apply to banks, financial and insurance companies where the base is calculated as the difference between:
- the sum of the interest receivable and other similar revenues, income from participation in investment funds, commissions receivable, proceeds from financial transactions, and other proceeds from management activities; and
- the sum of interest payable and similar charges, commissions payable, depreciation of tangibles and intangibles, administrative and management costs other than those relating to the personnel, and losses arising from financial transactions.

Also for these taxpayers, the cost of personnel is not deductible.

The tax is due yearly based on the results of the financial statements, adjusted pursuant to the IRAP criteria.

Taxpayers carrying on a business or profession in more than one region by employing personnel in each region for more than three months must apportion their taxable base amongst the regions on the basis of the remuneration paid to personnel employed in each region.

3. THE VIEWS OF THE REFERRING COURT

In submitting the case to the Court of Justice, the Referring Court pointed out that:

(1) IRAP applies in general to all commercial transactions involving production of, or trade in, goods or provision of services carried out in the habitual exercise of a business or a professional activity;

(2) the tax base of IRAP coincides with that of VAT: whilst the tax base of VAT is calculated by deducting the input tax from the output tax, the tax base of IRAP is calculated by deducting the costs from the proceeds. The VAT amount due to the government measures the added value; the same holds true for IRAP, although the method of calculation is different;

(3) like VAT, IRAP is levied at every stage of the production or distribution process: every entrepreneur or professional which produces taxable added value is liable to IRAP; and

(4) as in the case of VAT, the total amount of IRAP collected at the various stages up to final consumption is equal to the rate of IRAP applied to the price charged to the final consumer, so that it amounts to a general and proportional tax on the price at which goods or services are sold to the consumer.

4. THE VIEWS OF THE ADVOCATE GENERAL

The Opinion of the Advocate General substantially coincided with the memorandum submitted in March 2004 by the EU Commission.

For the sake of simplicity, reference is made here only to the comments expressed by the Advocate General.

The Advocate General states:

> It is common ground that, in order to be caught by the prohibition in Art. 33 of the Sixth Directive a national tax must display all of the essential features of VAT which, according to the Court's case–law are four in number, corresponding closely to the definition in Art. 2 of the First Directive:
> - it applies generally to supplies of goods or services;
> - it is imposed on the value added to the goods and/or services in question;
> - it is charged at each stage of the production and distribution process; and
> - it is proportional to the price of those goods or services, whatever the number of transactions carried out.

(1) General application to supply of goods and services

The statement "all traders registered for VAT are subject to IRAP" (32) is not totally correct: there are professionals (small firms) who are not subject to IRAP but are VAT liable, whilst the activities of certain public administrations are subject to IRAP but not to VAT.

In this regard, the Advocate General relied on the *Dansk Denkavit* case, arguing that

> where a tax has substantially the same scope as VAT, the fact that it extends also to other areas not covered by VAT does not detract from its resemblance to the latter tax for the purposes of its assessment under Art. 33 of the Sixth Directive. Thus, only if its scope were substantially narrower would IRAP lack the essential feature of general application.

In our opinion, the crucial element, which has been overlooked, is that VAT applies to "supplies of goods and services".

IRAP is not levied on the occasion of the supply of goods and services; it is a tax levied annually and assessed on the results shown in the financial statements irrespective of whether goods and services are sold or supplied.

Moreover, it is worth mentioning that the tax is levied and collected in the Region where the manufacturing plant or the offices/premises of the enterprise are located rather than in the place where the goods are sold or the services are rendered.

In this regard, the Advocate General argues

> thus, if IRAP may be levied at a time before goods are actually supplied, that does not prevent it from burdening the subsequent supply as if it had been levied at that moment, *with a result exactly equivalent to that of VAT.*

The above statement of the Advocate General is questionable:

(i) the time at which the tax is levied: if a tax is levied before, and irrespective of, the supply/sale, it may be reasonably argued that the tax is not a consumption tax. The timing at which a tax is levied impacts on the nature of the tax and in no way is the result "exactly equivalent to that of VAT" if the tax is levied before and irrespective of the sale; and

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(ii) the reference to the burden of the subsequent supply pertains to the shifting of the burden of the tax; in principle, it is a conclusion, which can be extended to all types of taxes including income and corporate tax.

The issue of the shifting of the tax burden should not be confused with the "taxable event" issue. In this regard, see also point (4) below.

The Advocate General also claims that the *Denkavit* case confirms his theory:

> the Court found to be contrary to Art. 33 of the Sixth Directive a tax which it noted was levied as a percentage of the total sales effected and services provided by each undertaking during a specified period, less the purchases of goods and services by that undertaking during that period.

Based on that, he further concludes that this is: "a description of a mechanism clearly very close to that by which IRAP is calculated": in reality the reference to the *Denkavit* case does not seem appropriate. Indeed, the *Denkavit* case addresses a tax which is levied *as a percentage of total sales less purchases of goods and services*. This is not how IRAP is assessed (see point 2. above); again, IRAP is not levied and paid *in connection* with the supply of goods and services, but rather on the results of year-end financial statements: by no means is a tax levied on the supply of goods and services.[2]

(2) Imposed on the value added on goods and services supplied

The IRAP is said to be a tax[3] on added value although the method of calculation of the added value is completely different from the calculation used for VAT purposes. In the Opinion of the Advocate General, however, such differences are not material:

> It seems from the information in the case-file that the base of assessment for IRAP is essentially the difference between the proceeds and the costs (not counting wages or certain financial costs) of the taxpayer's productive activities during a given tax period – normally, it appears, a calendar year. That may clearly be viewed as one, though not the only, way of defining the value added by the taxpayer to the goods and services he supplies.
>
> VAT on the other hand is in theory levied on the full value of each taxable supply made, its amount being reduced by that of the tax already paid on the cost components of that supply (again excluding wages and many financial costs, which are exempt). In practice, however, the tax due on all supplies made in a given tax period – of up to one year – is aggregated, as is the tax paid on all cost components acquired during that period, and the latter is deducted from the former.
>
> Thus, there is little difference between the two in practice, and perhaps even less in results even though VAT is conceived as being assessed on a transaction-by-transaction base. And the existence of what the referring court describes as "trivial accounting points of negligible consequence" cannot in my view be sufficient to overcome that essential similarity if the prohibition of other duties or charges having the nature of VAT is to have any teeth at all.

It appears to us that the Advocate General misses another crucial element which characterizes VAT: its neutrality.

Input tax can always be deducted or, in case of insufficient output tax in a tax period, it can be refunded or carried forward. VAT is never a cost for the taxpayer as it is intended to fall on the final consumer who should bear the tax burden. The IRAP, on the contrary, due to the way it is calculated, may or may not be a burden depending on the market conditions, the area of activity and other elements which may or may not allow the shifting of the burden of the tax. Moreover, depending on the economic cycle and on the volume of inventories, substantial time may elapse before the burden is recovered.

> It is true that the right to deduct is an expression of the central principle that VAT must be completely neutral as regards the burden on all the taxable economic activities of a business, and as such an essential part of the VAT system.
>
> However, the fact that another tax does not use such a mechanism, and may thus not have the same degree of fiscal neutrality, does not affect the question whether it is levied on the value added by the taxpayer (51-52).

Quite frankly, the conclusion of the Advocate General seems an oversimplification, which does not properly take into account:

(i) the way the mechanism of the tax works; and
(ii) the reasons which led the EU Commission and the Council to select and introduce the value added tax, with the typical features and technicalities set forth in the Sixth Directive, which could not be described as "trivial accounting points of negligible consequences".

(3) Charged at each stage of the production and distribution process

This is correct. IRAP is paid, with few exceptions, by any and all persons involved in the production or supply chain.

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2. In this regard, the Court of Justice has always been adamant stating that: "Art.33 of the Sixth Directive seeks to prevent the functioning of the common system of VAT from being compromised by fiscal measures of a Member State levied on the movement of goods and services and charged on commercial transactions in a manner comparable to VAT" (Decision 370/95, *Coreda*). "In order to decide whether a tax, duty or charge can be characterized as a turnover tax within the meaning of Article 33 of the Sixth Directive, it is necessary, in particular, to determine whether it has the effect of jeopardizing the functioning of the common system of VAT by being levied on the movement of goods and services and on commercial transactions in a way comparable to VAT. The Court has stated in this regard that taxes, duties and charges must in any event be regarded as being imposed on the movement of goods and services in a way comparable to VAT if they exhibit the essential characteristics of VAT (see Case C-200/90, *Dansk Denkavit and Poulsen v. Skatteministeriet* [1992] ECR I-2217)", *Erma Pelzl* and other relevant cases C-338/97, C-334/97 and C-390/97.

3. The Referring Court supports its statement by quoting the Decision of the Italian Constitutional Court of 10 May 2001. In reality the Constitutional Court states that the IRAP, although it is not levied on income, does not conflict with the constitutional principle of ability to pay of taxpayers ("*capacità contributiva*"); indeed the "added value produced is nothing else but the new wealth generated by the enterprise and subject to IRAP even before it is distributed to remunerate the various productive factors".

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(4) Proportional to the price of goods and services, whatever the number of transactions

In this respect, the Advocate General starts by quoting the Referring Court:

> In this regard, the Referring Court notes that "the amount of IRAP collected in the various stages of the cycle, from production up to the final consumer, is equal to the rate of IRAP applied to the selling price of goods and services charged to the final consumer. Despite its fractional base, therefore, IRAP in fact acts as a general and proportional tax on the price of transferring goods of services to the consumer.

The Advocate General cannot honestly accept this broad statement and admits:

> However, the global nature of IRAP undoubtedly allows economic operators a greater degree of flexibility than is the case with VAT. They may modulate the way in which they pass the burden of the tax on to their customers, or may even choose not to pass the burden on at all. VAT by contrast must be charged at the appropriate rate on each individual supply.
>
> Consequently, whereas the VAT system requires the amount of tax to be a specified proportion of the price charged on each supply of goods or services, so that at least for accounting purposes it remains strictly "proportional, wherever the number of transactions", that may not be literally true in respect of IRAP, whose amount as a proportion of the price of any given supply may vary considerably or may be even impossible to determine.

Unexpectedly, he concludes: "I do not, however, considered that point to be very relevant to the overall assessment."

His reasoning is as follows:

> first, as a matter of economic reality, the burden of a tax levied at any stage in a trading chain will in general be passed on down the chain. Exceptionally and in the short term, some economic operators may for a variety of reasons have opted to absorb the burden of IRAP without passing it on to their customers but in the long term it is likely that each operator's margin will adjust and the burden will ultimately be borne at the end of the chain.

This conclusion may apply to any tax, including personal and corporate income taxes, social contributions and in general to any and all duties imposed on entrepreneurs. The price of the goods and services must absorb such taxes and duties, otherwise the taxpayer is rapidly out of business.

The distinct feature of VAT is that the tax is evidenced separately from the price of each supply of goods or services. Only this way is the proportionality requirement met.

In the IRAP system such proportionality is "impossible to determine" due to the specific assessment mechanism of IRAP: it may be transferred on all, or only on some of the goods or services supplied by the taxpayers: again it depends on the market situation of each good and service at a certain point in time.

The Advocate General further supports his theory quoting the *Careda* decision (C-370/95):

> The Court specifically stated that in order to be characterized as a turnover tax, within the meaning of Art. 33 of the Sixth Directive, the tax in question must be *capable of being passed on* to the consumer, but that it is not necessary for the relevant national legislation expressly to provide that it may be so passed on, or for such passing on to be recorded in an invoice or equivalent document.

However, the Advocate General avoids quoting the subsequent sentence of the same Decision, which states

> for the purposes of the application of the aforesaid provision, it is for the national court to establish whether the tax at issue *is capable of being charged on the movement of goods and services in a manner comparable to VAT*,

where the emphasis is on the "movement of goods and services".

The Advocate General fails to quote the decision in *Erna Pelzl and others* (Joined Cases C-338/97, C-344/97 and C-390/97), where the Court, examining the case of an Austrian tax levied on tourist activities, states that the tax is not levied in a way comparable to VAT since

> the charges are not passed on [to] the final consumer in a manner characteristic of VAT. Even on the assumption an undertaking selling to [the] final consumer will take account, in fixing its price, of the amount of the charge included in its general expenses, not all undertakings have the possibility of thus passing on, or passing on in full, the burden of the tax.

It seems correct to conclude that a tax, in order to be considered equivalent to VAT, must be *actually* shifted on the final consumer, rather than being merely "capable" of being shifted.

5. ART. 33 OF THE SIXTH DIRECTIVE: ITS ULTIMATE GOAL

We believe that the Advocate General's Opinion is based on a misunderstanding: the IRAP is a tax levied on enterprises/professionals engaging in the production of goods/provision of services but it is not a turnover tax within the meaning of Art. 33 of the Sixth Directive.

Art. 33 of the Sixth Directive reads as follows:

> Without prejudice to other Community provisions, in particular those laid down in the Community provisions in force relating to the general arrangements for the holding, movement and monitoring of products subject to excise duty, this Directive shall not prevent a Member State from maintaining or introducing taxes on insurance contracts, taxes on betting and gambling, excise duties, stamp duties and, more generally, any taxes, duties or charges which cannot be characterized as turnover taxes provided however that those taxes, duties or charges do not, in trade between Member States, give rise to formalities connected with the crossing of frontiers.

The best (in terms of clarity) interpretation of Art. 33 can be found in the Court of Justice Decision C-252/86 (*Gabriel Bergandi*) where, addressing the question:

> must Art. 33 of Directive 77/388/EEC (the Sixth VAT Directive) be interpreted as prohibiting member states

> from continuing to levy turnover taxes on the supply of goods or the provision of services once such activities become liable to VAT?,

it is clearly stated:

> in order to answer the question, it is necessary to consider Art. 33 of the Sixth Directive in the *light of the objectives pursued by the introduction of a common system of VAT.*
>
> According to the preamble to the First Council Directive (67/227/EEC) of 11 April 1967, on the harmonization of legislation of member states concerning turnover taxes, the purpose of harmonization of the legislation concerning turnover taxes is to establish a common market within which there is healthy competition and whose characteristics are similar to those of a domestic market *by eliminating tax differences capable to distort competition and hinder trade.*
>
> A common system of VAT was introduced by the Second Council Directive (67/228/EEC) on the harmonization of legislation of member states concerning turnover taxes – structure and procedures for application of the common system of Value Added Tax, and by the Sixth Directive. That system was to contribute to that objective by introducing, on a base common to all the member states, *a general tax on consumption levied on the supply of goods, the provision of services, and imports in proportion to their price*, regardless of the number of transactions taking place as far as the final consumer, the tax being imposed only on the value added at each stage and *being definitively borne by the final consumer.*
>
> To achieve equality of tax conditions for a given transaction regardless of the member state in which it takes place, the common system of VAT was intended, according to the preamble to the Second Directive, to replace the turnover taxes in force in the member states.
>
> Accordingly, Art. 33 of the Sixth Directive permits a member state to maintain or introduce taxes, duties or charges only if they cannot be characterized as turnover taxes.
>
> Consequently, it must be stated in reply to the first question that Art. 33 of the Sixth Directive must be interpreted as meaning that as from the introduction of the common system of VAT the member states are no longer entitled to *impose on the supply of goods, the provision of services or imports liable to VAT, taxes, duties or charges which can be characterized as turnover taxes.*

Which are the "forbidden" turnover taxes?

Clearly those which conflict with the "objectives pursued by the introduction of a common system of VAT": this is the only logical way to interpret Art. 33 of the Directive.

Consequently, the "forbidden" turnover taxes are those cumulative, multi-stage taxes levied in the member states prior to the introduction of VAT: these taxes were incompatible with the establishment and the functioning of the internal market, being capable of distorting competition: these are the same taxes which needed to be harmonized pursuant to Art. 93 of the Treaty.[4]

The EU Commission in Case 295/84 (*S.A. Rousseau Wilnot*) submitted to the Court the following statement:

> According to the Commission, Article 33 of the Sixth Directive must be interpreted in the context of the process of harmonizing turnover taxes initiated by the First Directive on that subject, adopted in 1967 (Directive 67/227/EEC, official journal, English special edition 1967, p. 14). It is clear from the preamble to the First Directive that the purpose of that harmonization is to bring about the abolition of cumulative multi-stage taxes and the adoption by all Member States of a common system of value added tax.
>
> Consequently, the turnover taxes which are the subject of the harmonizing Directives are taxes levied on the movement of goods and services. They do not include a social security levy, which is not directly chargeable on transactions.

By the same token, the IRAP – not being levied directly on transactions – does not fall within the scope of the harmonization and, consequently, of Art. 33.

In conclusion, the taxes which may fall under the scope of Art. 33 are taxes:
- on consumption imposed on the supply of goods and the provision of services;
- which are charged in proportion of the price of the goods/services supplied;
- which are borne by the final consumer; and
- which may distort the competition within the internal market.

These are the features of the tax, which must be analysed in order to assess whether the tax may conflict with the common system of VAT and, ultimately, is capable of distorting competition and hindering trade among member states.

The IRAP does not possess any of such characteristics and, prima facie, any of the features of the "old" turnover taxes which could distort the competition.

The fact that it is levied on a base represented by the value added produced by the entrepreneurs/professional does not allow it to be classified amongst the forbidden turnover taxes.

* * *

It is worth mentioning that the *Commissione Tributaria Provinciale* of Padua (decision No. 34 of 20 September 2005) has ruled on the same issue, i.e. the compatibility of IRAP with VAT, and has reached a totally different result, stating, inter alia, that IRAP

> is not, not even technically, a turnover tax ... rather a tax levied on the ability to pay of the enterprise, of the professions, of the companies and entities, calculated as the net value of the production.

Brussels, 12 December 2005

4. In the sense that the Art. 33 addresses turnover taxes having the features of the "old" turnover taxes, see the authoritative analysis of Hans Georg Ruppe "Verbot mehrwertsteuergleicher Abgaben im EG-Recht: – Kritische Bemerkungen zur EuGH-Judikatur bet. Art. 33 Abs. 1 der 6. Ust-Richtlinie", *Unternehmen Steuern – Festschrift für Hans Flick* (Köln: Verlag Dr. Otto Schmidt).

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