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OPINION STATEMENT

Opinion Statement FC 2/2019 concerning the implications of the decision of the Court of Justice of the EU in case C-132/16 *Iberdrola* on input tax deductions

Prepared by the CFE Fiscal Committee
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This Opinion Statement discusses the implications of the decision of the Court of Justice of the EU in the case of C-132/16 *Iberdrola*, and seeks to analyse why the right to deduct input tax should not be unduly restricted. On some points, the Statement reflects the views of the entire Committee and on other points it reflects the views of the overwhelming majority of the Committee.

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1. General Remarks

In the case of C-132/16 *Direktor na Direktsia 'Obzhalvane i danachno-osiguritelna praktika' — Sofia v Iberdrola Inmobiliaria Real Estate Investments' EOOD,* the Court of Justice of the EU ("CJEU") decided that *"a taxable person has the right to deduct input value added tax in respect of a supply of services consisting of the construction or improvement of a property owned by a third party when that third party enjoys the results of those services free of charge and when those services are used both by the taxable person and by the third party in the context of their economic activity, in so far as those services do not exceed that which is necessary to allow that taxable person to carry out the taxable output transactions and where their cost is included in the price of those transactions."* In that case, a developer of holiday homes was accordingly entitled to recover input tax on works that it undertook on a water pumping station owned by a local authority which would be used by the holiday homes it was developing.

The judgment suggests that the CJEU considered it was important that:

a) the service, and in fact the repaired property, were subsequently used not only by the owner, in that case the local authority, but also by the taxable person that had repaired it;

b) those services did not exceed the necessary level for allowing the taxable person to provide his taxable supplies; and

c) the costs of these services were included in the price of those taxable supplies.

When these conditions are not satisfied, it is clearly possible that the right to recover input tax may be restricted. An example would be if greater works were undertaken for purely philanthropic reasons. However, especially if account is taken of the services provided to the authority when the developer determines what charges to impose for selling its land, we consider that it would be unfortunate if the failure to satisfy these criteria automatically resulted in a restriction in the right to deduct input tax in cases where the developer is in practice required to incur the expenditure in order to develop its own land with a view to making taxable supplies. Allowing a deduction in these circumstances accords with the CJEU's observations that the deductibility of the expenditure depends on "all the circumstances surrounding the transactions": see paragraph 31.

The principles upon which input tax can be recovered were reconsidered by the CJEU in C-153/17 *HMRC v Volkswagen Financial Services,* where the Court observed that:

> 40 The deduction system is intended to relieve the trader entirely of the burden of the VAT payable or paid in the course of all his economic activities. The common system of VAT consequently ensures complete neutrality of taxation of all economic activities, whatever the purpose or results of those activities, provided that they are themselves subject to VAT (judgment of 22 June 2016, *Gemeente Woerden*, C-267/15, EU:C:2016:466, paragraph 32).
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> 41 In accordance also with the Court's settled case-law, the existence of a direct and immediate link between a particular input transaction and a particular output transaction or transactions giving rise to the right to deduct is necessary, in principle, before the taxable person is entitled to deduct input VAT and in order to determine the extent of such

entitlement. The right to deduct VAT charged on the acquisition of input goods or services presupposes that the expenditure incurred in acquiring them was a component of the cost of the output transactions that gave rise to the right to deduct (judgment of 14 September 2017, *Iberdrola Inmobiliaria Real Estate Investments*, C-132/16, EU:C:2017:683, paragraph 28 and the case-law cited).

42 A taxable person also has a right to deduct even where there is no direct and immediate link between a particular input transaction and an output transaction or transactions giving rise to the right to deduct, where the costs of the services in question are part of his general costs and are, as such, components of the price of the goods or services which he supplies. Such costs do have a direct and immediate link with the taxable person's economic activity as a whole (judgment of 14 September 2017, *Iberdrola Inmobiliaria Real Estate Investments*, C-132/16, EU:C:2017:683, paragraph 29 and the case-law cited)."

In the light of those principles, when assessing whether there is a right to deduct VAT:

- it is not ownership of the works that is crucial, but whether the developer incurred the expenditure in order to make taxable supplies;
- input tax on supplies which a developer is required to incur, for example on land owned by a local authority, as a commercial or legal precondition to making their supplies should be considered to have a "*direct and immediate link*" with the supplies that the developer makes to its customers, because it is a cost incurred in order to make its supplies to its customers and is therefore a cost component of those supplies;
- purchases incurred in order to encourage or facilitate the making of taxable output supplies should also be eligible for VAT deduction. The right of recovery should not be made dependent on physical use by the developer provided that the input tax facilitates their development and sales. Such costs are similarly incurred in order to make its taxable supplies and are therefore a cost component of those transactions.

We consider these issues further below.

2. Cases Where the Works Need to be Undertaken as a Condition for Approval

It is common practice for local authorities to require developers to undertake works on schools, playgrounds and roads and other infrastructure free of charge "*as a condition for"* granting a developer permission for other developments that they propose to sell. Frequently these works on infrastructure will be on land owned by the authority. It is not uncommon for developers to be required to construct works in a completely different area as a condition for obtaining a mandatory permission or a certificate for their development.

The Court did not specifically consider this situation in its judgment in *Iberdrola.* The CJEU's jurisprudence suggests that expenditure can only be deducted on the basis that input tax is "*directly attributed to a supply*", rather than as an overhead, if there is a "*direct and immediate link*". In such circumstances, we consider that there is a direct and immediate link between the input tax incurred

and the taxable supplies made by the supplier, since the works are a legal and commercial precondition to the developer being able to make its other supplies. To use the words of the Court in *Iberdrola,* they can be fairly considered a "*component of the cost of the output transactions*" since it is a cost that has to be incurred in order to make the supplies. The Court, at paragraph 33, observed that "*reconstruction was essential for completing that project and that, consequently, in the absence of such reconstruction, Iberdrola would not have been able to carry out its economic activity*". The Court, at paragraph 34, observed that: *"those circumstances are likely to demonstrate the existence of a direct and immediate link",* because they show that the works, to quote paragraph 39 of the judgment, are *"objectively necessary to allow [the developer] to carry out its taxed transactions".* Precisely the same points arise in favour of allowing a deduction in these circumstances. Assuming the developer is making taxable supplies, even if the expenditure is not deductible on the basis that there is a direct link to taxable supplies, which we consider should generally be the position[1], the expenditure should alternatively be deductible as an overhead, assuming it is not being incurred for philanthropic or non-business reasons.

Although the issue did not receive explicit consideration from the Court, the issue of whether a direct link exists in such circumstances did receive some consideration from Advocate General Kokott. She clearly did not consider that there was a sufficiently direct link between the works on the water pumping station undertaken by Iberdrola and its sale of holiday homes. If there was a right to recovery, she instead considered that it was on the basis that a supply was being made to the Local Authority. This is an issue considered further below. However, she clearly took a more restrictive approach than the Court, since, unlike the Court, she took the view that Iberdrola had no right of recovery on account of its sale of holiday homes. Although it did not specifically consider the issue, for the reasons outlined above, the Court's reasoning does suggest that a direct and immediate link exists in these circumstances. We do not consider that it would be correct to read the concluding comments, that input tax may not be deductible when "*works relating to that pump station exceeded the needs created solely by the buildings constructed by Iberdrola*", as precluding a deduction in these circumstances.

Allowing a deduction in such circumstance is also consistent with paragraph 53 of Advocate General Kokott's latter opinion in C-502/17 *C&D Foods Acquisition ApS v Skatteministeriet,* where she observed that a direct link between an input and supplies should be considered to exist if "*the input services are economically and objectively linked to the taxable activity, in such a way that the extent of the profit depends on it*". The Court, at paragraphs 37-38 of its judgment, also suggests that such a link will exist if "*the direct and exclusive reason for that transaction*" was its taxable supplies, although it considered that linkage was lacking on the facts of that case. That link exists, in the case of a developer seeking permission to develop and sell land, because the works on the authority's land are a legal and commercial precondition to the developer being able to make its supplies of selling developed land.

Although Advocate General Kokott considered that there was not a sufficiently direct link to Iberdrola sales of holiday homes for the expenditure on the repairs to the pumping station to be considered deductible input tax for that reason, she did consider that the repairs to the pumping station might alternatively be deductible on the basis that the municipality was providing consideration to Iberdrola by giving it permission to develop its land. However, we would respectfully question whether the grant

[1] The Indirect Tax Committee consider that this input tax should be considered to be deductible on the basis that there is a direct link to taxable developmental sales.

of permission should be considered consideration for a supply by a developer. It is important to appreciate that an authority, when granting permission, will invariably be performing a statutory duty. In these circumstances, we would suggest that the giving of consent should not be regarded as having the necessary direct link or reciprocity to become consideration for a supply: see Case 102/86 *Apple and Pear Development Council v Customs and Excise Comrs* and Case C-36/16 *Minister Finansów v Posnania Investment SA.* As a precondition to granting permission, an authority may require works to be done on the developer's own land. While such works may be a condition to the grant of permission, we would suggest that they should not properly be considered consideration for a supply. It is *"unilateral"* in nature and *"a compulsory charge imposed by the sovereign power of the public authorities*" similar to the taxes in issue in the *Posnania Investment SA* case. If that is the correct analysis when the works are done on land owned by the developer, we have difficulty in seeing why a different analysis should automatically be applied because the land is not owned by the developer. In both cases we would suggest that the works should be viewed as a condition that needs to be fulfilled in order to develop the land, rather than as consideration for the grant of permission to develop the land.

3. Other Cases Where Works Are Undertaken

We have explained, at section 2 above, why undertaking works for an authority generates deductible input tax when the works are a condition for approval. However, there are also cases where in practice a developer may informally agree to undertake works even though they are not made an explicit condition for approval. In such circumstances, when the evidence objectively shows that the developer is only informally agreeing to undertake the works in order to facilitate the obtaining of permission, we consider that the expenditure should be deductible. This is because, in such circumstances, there is a direct link between the expenditure and the supplies. These items usually have a significant value, so any developer will take account of them when assessing its charges. However, we entirely accept that the position would be different if the works are done for philanthropic reasons, and the Court was therefore correct to highlight that input tax would not be deducted in those circumstances.

The case for claiming a deduction is particularly strong when the works provide infrastructure that will be of direct use to individuals buying property from the developer, for example because it improves access to the property being sold, and thereby makes it more attractive for purchasers to buy the property. In such cases, the situation will effectively be the same as in the *Iberdrola* case. Similar points can be made for the provision of schools or nursery schools near greenfield sites, where the existence of such infrastructure will attract families who may not otherwise want to purchase property from the developer.

Whether there is objective evidence of such a necessity will obviously depend on the facts of any case. However, when it is clear that such a link had been established, we consider that input tax incurred should be recoverable. We consider this conclusion is consistent with C268/83 *Rompelman v Minister van Financiën* and C400/98 *Finanzamt Goslar v Brigitte Breitsohl,* which establish that it is the purpose for which expenditure is incurred that is crucial when determining its deductibility and that a right of deduction can arise even if there are no taxable supplies that are in fact made because the business is aborted. We also consider that it is supported by cases such as C-465/03 *Kretztechnik AG v Finanzamt Linz*, where the Court accepted that input tax could be deducted on financing costs, even

though such costs could most directly be attributed to the out of scope activity of raising finance. The Court instead focused on the substance of the position.

We do not consider that the fact that such expenses are not directly reflected in the state of the developed property is a reason for denying a deduction. Expenses can frequently be directly linked to specific outputs even though they do not form part of the product that is actually sold. An example would be an advertising campaign to promote a product. Billboards or marketing campaigns are generally understood to be recoverable, even though they may not be on the land being sold and, in the case of goods or land, are not physically necessary for the production of what is being sold. For that reason, the fact that the expenditure is on land that is not being sold by the developer is not a reason for denying a deduction when the sole purpose of the expenditure is to facilitate such sales. Particularly when they make a development more attractive to purchasers, infrastructure works should be considered to be similar in nature.

It is possible that Advocate General Kokott's Opinion reflects a concern that allowing a deduction will undermine the neutrality of the tax because the municipality would not be entitled to a deduction if it incurred the expenditure. This point obviously does not arise in jurisdictions that entitle public authorities to recover VAT charged to them. In any event, the difference between a developer and the municipality is that the municipality is not incurring the expenses in order to make taxable supplies while the developer is incurring them for that purpose. In this regard, it is worth highlighting that this issue clearly will have arisen in the *Iberdrola* case, because the facilities did not just benefit those living in the holiday village. However, the CJEU clearly did not envisage that this automatically precluded a deduction. We consider that the Court was correct to accept that the neutrality of the tax does not automatically require a restriction in the right of deduction in these circumstances. This is because any developer incurring such costs will inevitably take account of such costs when deciding what charges to impose on its customers. These charges will also be subject to VAT if there is a right to recover the input tax on these costs. Therefore, restricting a right of deduction in fact undermines the neutrality of the tax.

The CJEU did not suggest that *Iberdrola* had any output tax liabilities. In cases where the developer provides construction services to an authority, we do not consider that any liabilities should arise under Article 26 of the 2006 Directive because the input tax is being used solely for business purposes. It is akin to the food being eaten at a business meeting, which the CJEU accepted was deductible expenditure in C-371/07 *Danfoss A/S and another v Skatteministeriet*. As in the *Danfoss* case, we do not consider Article 26 of the 2006 Directive to be relevant because what is being provided is a free service. We again consider that this conclusion accords with the neutrality of the tax. Double taxation will effectively arise if the developer is treated as making a supply to the municipality, since there will be a charge on the supply to the municipality and a further VAT liability on the price charged by the developer, who will inevitably have taken account of the expenses when calculating its charges for selling the land it is developing to its customers.

Rather than providing construction services, in some cases developers transfer the ownership of land to an authority after construction works have been undertaken. We have addressed the issue of whether consideration could be considered to be provided for any transfer in section 2 above. However, if the correct analysis is that no consideration is being provided, it then becomes necessary to consider whether there is a "disposal free of charge", for the purposes of Article 16 of the 2006

Directive. It is clear from C-48/97 *Kuwait Petroleum (GB) Ltd v Customs and Excise Comrs* that the concept of a "disposal free of charge" can extend to gifts made for business purposes even if there a contractual obligation to make the gift. However, we do not consider that it follows from this decision that Article 16 should apply to all supplies of goods unless consideration for VAT purposes can be attributed to the supply. For example, it is not clear that any consideration can be attributed to supplies of goods made to satisfy contractual warranty and indemnity claims, since the consideration will in such cases have been attributable to the initial supply. However, we do not consider that such supplies can properly be analysed as a "disposal free of charge", to which Article 16 applies. We consider that it is necessary to look at the substance of the underlying relationship when determining whether there is a "disposal free of charge", and the mere fact that no consideration can be attributed to a supply of goods for VAT purposes is not, by itself, automatically sufficient to engage Article 16 of the 2006 Directive. At least in cases where the supply is conditional upon obtaining permission, we would suggest that the transfers should not be considered a "disposal free of charge". Unlike in the *Kuwait Petroleum (GB) Ltd* case, the inputs are not promotional gifts, but instead represent a legal condition for permission to undertake the works, which would not naturally be described as a "gift" or a "disposal free of charge", but is instead expenditure incurred on satisfying a condition that needs to be satisfied to make the taxable supplies[2]. We also observe that the Court of Cassation in Italy in case no. 11344/2016 *Alama SRL v Agenzia delle Entrate* (31/05/2016) considered that Article 16 of the 2006 Directive should not impose a charge in circumstances where a developer had to make the transfer as a condition to being able to make its supplies. Similarly, in case 6000/2015 *Agenzia delle Entrate v Viola di Viola* (27/03/2015) the Court of Cassation in Italy accepted that it was open to a trader to recover input tax in relation to works on land that it owned no interest in.

For the reasons explained above, the CFE considers that input tax should be deductible when, for non-philanthropic reasons, expenses are incurred in relation to land that is not owned by a developer in order to obtain permission to develop other land. The indirect tax committee also can see force in arguments that no output tax liabilities should, as a general rule, arise in such circumstances.

[2] In C-36/16 *Minister Finansów v Posnania Investment SA* the Court, at paragraph 39, and the Advocate General, at paragraph 45, clearly considered that article 16 could deem a supply to occur if input tax had been recovered by the Company and it then uses the property to discharge its tax liabilities. However, it is important to note that this was on the assumption that the transfer of the property resulted in it being "applied for purposes other than those of the business". In this case, by contrast, the land is being transferred to facilitate the business, so different considerations apply.