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The Evolution of European VAT Jurisprudence and its Role in the EU Common VAT System

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Introduction: The Growth in VAT Cases

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The case law of the Court of Justice of the European Union has not always occupied such a pivotal position in the EU's VAT system. After the adoption of the Sixth VAT Directive in 1977, the issues around VAT did not trouble the Court greatly and cases involving VAT were limited to one or two a year. Indeed some years went by without even a single VAT-related case appearing on the list. In retrospect however, this time can now almost be seen as the calm before the storm.

From about 1984 onwards, there was a gradual but steady increase in VAT cases and by the end of that decade their annual number was in double figures. At the turn of the century, we were seeing around 25 to 30 VAT cases each year, increasing in recent years to between 60 and 70. Infringement proceedings initiated by the European Commission, account for only a rather small proportion of these cases with most of them having their origins in referrals from the courts or tribunals of Member States.

There are now in excess of 500 Court decisions dealing with VAT. The list continues to grow and becomes so long as to present issues for tax administrations as well as taxpayers and their advisors on how to keep abreast of them. The impact of these decisions has become an essential concern to a very wide audience. Not all of this audience may necessarily have formal professional qualifications in law or accountancy or as tax advisors but they may nonetheless need to be informed on questions in the specialized field of taxation which are of increasing importance in their work.

To help in promoting uniform application of the common VAT system, Art. 398 VAT Directive (formerly Article 29 of the Sixth Directive) sets up an advisory committee on value added tax – the so-called VAT Committee. Its role is to handle the consultation procedure foreseen in certain places in the Directive but also to consider questions raised by Member States or by the Commission concerning the application of VAT legislation with the intention of facilitating a common understanding.

1 The views expressed here are those of the authors and should not be taken as representing the position of the European Commission.

As a result, the VAT Committee has over the years fulfilled a role as a forum where the judgments of the Court are discussed with national tax administrations. In recent years this has become an increasingly transparent process[2] but there are constraints on the opportunities for such discussions in a committee which brings together representatives of 28 Member States and where the available resources can at best sustain only 2 or 3 meetings per year. The number of cases which can be analysed in the Committee in the course of a year does not in practice exceed single figures.

This limitation is unfortunate and means that the Committee goes only some way to meeting the demands of those who seek a greater understanding of what the Court has said in the area of VAT. Not only has the volume of cases increased in absolute numbers, but VAT cases have generally become more complex. The topics addressed in early cases generally involved relatively straightforward questions on the interpretation of specific provisions. Today, the cases before the Court can involve complex business models which often have ramifications which extend across two or more Member States. Understanding them and applying them in practice requires effort.

Notwithstanding that the number of VAT cases dealt with by the Court has increased greatly in the last few years (and comfortably exceeds the number of direct tax cases), informed expert analysis of the consequences of these cases has lagged behind other areas of tax law. Dealing with this has prompted the Commission to engage with the Institute for Austrian and International Taxation of the Vienna University of Economic and Business (WU) in organizing a conference which addresses VAT and meets the needs of a growing audience.

It is also timely to give consideration to the reasons behind the rapid and seemingly ineluctable growth in VAT related litigation. Any such analysis has to be considered against the increasing difficulty in reaching agreement in the Council on modernizing legislation. The VAT system can never be regarded as riding serenely at anchor in a world where commerce and public finance move with the tide or even more disruptive forces. Recent reactions from the Court have confirmed that it does not see its role as compensating for legislative failings.

To at least some extent, the Commission's legislative initiatives in VAT have had in common the objective of improving the functioning of the VAT system and, as a consequence, reducing the need for litigation. All too often however, Member States have either addressed the legislative process without being prepared for compromises in the Council, or have reached conclusions which add rather than

2 One of the first steps taken in the context of the Commission's 2011 Communication on the Future of VAT was in response to stakeholders' requests for greater transparency. The complete VAT Committee guidelines are available at http://ec.europa.eu/taxation_customs/ resources/documents/taxation/vat/key_documents/vat_committee/guidelines-vat-committee-meetings_en.pdf.

remove complications. These outcomes do little to reduce the burden of the Court. The Commission cannot by itself resolve all the issues resulting from out-of-date legislation. It can propose the necessary measures but only the legislator can ensure that they enter into law. It can indeed sustain its role as initiator and facilitator of modernization but this is a difficult role if Member States continue to resist change.

Recently, an increasing number of decisions have been issued without previously having sought the opinion of the Advocate General. Even if this trend might be understood against the overload of new cases pending before the Court, it appears that this must be seen as a loss from a strictly interpretative perspective. Many of the VAT cases handled by the Court are extremely complex and it is not always easy to understand them and to apply them in practice. Taxpayers complain about delays and the time taken to reach a decision in their cases. There are many factors which contribute to the Court's workload and the unsatisfactory state of VAT legislation is merely one of these. **Where does the increase in VAT cases come from?**

For the most part, the increase in litigation can be attributed to the failure to keep legislation abreast of changes in the wider world. By far the greater part of the Court's burden can be attributed to the need for clarification on how the legislation should be understood when it comes to the application of the tax. This happens because legislation that is nearly 40 years old is poorly adapted to modern commerce and probably also to the exigencies of effective and efficient modern tax collection. There is also an argument to be made that provisions have been consciously accepted as obscure to accommodate consensus across different positions in the Council, something which inevitably leaves much scope for interpretation and dispute.

The legislation in the VAT Directive for the most part dates from the 1970s. Although measures were taken to accommodate inter alia the abolition of internal frontiers in 1992 as well as developments in e-commerce and telecommunications, most of the provisions predate the major changes that influence the way in which economic activities are transacted today. Factors such as changes in technology, the growth of the service sector, the impact of globalization, (notably in financial services), deregulation and changes in the relationship between the public and private sectors are just some of the developments which create stress in the un-modernized VAT system. Even the very wide-ranging transitional rules adopted in 1992 are frequently cited by commentators as creating unnecessary obstacles to intra-EU business and as not fully aligned with the commercial drivers for exploiting the internal market. All of these shortcomings create tensions which encourage the search for litigated solutions. The Commission is, however, currently exploring options to replace the 1992 rules with a regime based on taxation at destination for B2B supplies which, if successful, would greatly simplify the system.

Exemptions – of which there are far too many – are the single most significant source of litigation. The economic activities covered by individual exemptions have become more complex as well as more significant in their scope since the legislation was first enacted and as a consequence are poorly adapted to modern circumstances.

Exemptions contribute both directly and indirectly to the Court's burden. The number of cases directly related to exemptions is substantial but a great many more have their origins there, particularly since exemptions have an impact on the capacity of taxpayers to recover input tax. Put simply, exemption means output is untaxed but input VAT is not recoverable, an outcome offensive to the basic logic of VAT. Businesses carrying on exempt activities which do not have full recovery will have an incentive to litigate the interpretation of other provisions of the VAT Directive – e.g. those relating to taxable persons and to the tax base – in order to increase the potential for recovering input VAT and thereby reduce their overall tax burden.

What can be done about this? How can the ever-increasing flow of litigation be brought under control? In 2011, the Commission adopted a Communication on the future of VAT which said that the future VAT regime should be simpler, more efficient and more robust. Going beyond mere aspirations, one major objective here is to broaden the tax base. This means looking critically at exemptions to see whether the economic, social or technical reasons for them are still valid and whether the way they are applied can be improved.

Other than the tendency to encourage litigation, the deficiencies associated with VAT exemptions are well-rehearsed. They distort input choices for businesses (when prices may reflect unrecovered taxation) and create a bias towards self-supply with organizational structures being dictated by considerations other than purely economic ones. Less commented on, is the capacity for exemptions to compromise the destination principle in circumstances such as the intra-EU supply of financial services where unrecovered input tax accrues where the supplier of the service is located rather than where the service is used.

Unsurprisingly, exemptions have long been decried by commentators. Maurice Lauré (often referred to as the father of the European VAT system) has described the exemptions as 'the cancer of the VAT system' and more recently another writer on VAT referred to exemptions as 'the fundamental imperfection of the common VAT system'. It is notable that countries with VAT systems which are perceived as particularly efficient (such as New Zealand) have very few exemptions. Where this model is followed, the costs of compliance and the need for litigated resolution of problems are substantially lower than in the EU.[3]

3 See for instance http://comparativetaxation.treasury.gov.au/content/report/index.asp.

Specific problems – financial services

The exemption for financial services and insurance is probably the single most important source of VAT issues presented to the Court – both in absolute numbers and in economic significance. The latter factor ensures that this area is rife with efforts to reduce the amount of tax paid by businesses.

It will not be easy to improve this situation. Previous attempts by the Commission to rationalize and/or modernize individual exemptions – e.g. postal services and financial services – have been met with lukewarm responses in the Council and it is unlikely that either will come to fruition. Both financial services and insurance have proven to be a rich source of litigation in VAT and no doubt will continue to serve this purpose as long as the legislation remains unreformed.

The exemption for financial services has long been recognized as a source of difficulty, both real and potential. The number of court cases here, some of which have been fairly high profile, confirms this. The best long term solution by far would be to get rid of this exemption – it would solve many problems with one blow and remove what many would consider to be the single most significant source of litigation before the Court. The Commission looked at this, notably in the 1990s and established that it was technically possible to end exemption. For a variety of reasons – notably the lack of political will – this did not happen. With little option other than to accept that Member States were cautious about radical change to the VAT system, the Commission, in 2007, settled on an attempt to modernize and streamline the exemptions for financial services and insurances. The rather modest objectives included making the exemptions easier to apply by making them more understandable and formulating them in a manner consistent with other regulatory obligations in these sectors. The hope was that this would increase legal certainty for Member States and for operators and, in so doing, reduce the administrative burdens in VAT compliance.

To make the changes more politically acceptable, the proposal set out neither to expand nor reduce the limits of the exemptions thus avoiding unwelcome budgetary consequences. A cautious approach was adopted, drawing on the interpretations of the Court and, in many instances, proposing that the wording of the Court in key judgments be codified verbatim in the legislation, notably in the case of decisions concerned with outsourcing. Here, the majority of Member States were clear about favouring a narrow interpretation although there were strong policy arguments based on fiscal neutrality and non-discrimination between different organizational structures (i.e. outsourced or in-house) which pointed in other directions.

Only in rare instances did the Commission propose a departure from previous case law. The most notable example was measures to exempt the transfer of portfolios of insurance and reinsurance contacts which would have reversed the

conclusions of the Court in the Swiss Re case. This was based on the view that arguments for neutrality of treatment between similar activities should be recognized.

In the end this attempt met with no success in the face of disagreement in the Council, rooted in fundamental differences of opinion on policy issues. Although the 2007 proposals have been discussed extensively and successive Council presidencies have devoted considerable effort here, discussions have been stalled for the last couple of years and there is little sign that Member States have any great appetite to return to the process.

Unfortunately, all of this means that the legislation in this complex and economically sensitive area will continue for the indefinite future to be a source of conflicting interpretation and, inevitably, both tax administrations and tax payers will have only one path to follow in resolving their differences – this path leads to the Court in Luxembourg and will only serve to add to its burden.

It is worth pointing out that the Commission's draft legislative proposals were seen at the time as encouraging by many professional advisors. Even if it was never likely that Member States would accept those parts of the proposal that contained measures favourable to business, there was a general acceptance that the extensive and precise descriptions of what services should and should not fall within the various exemptions would reduce the grounds for dispute.

Several of the matters on which Member States in Council could not reach agreement have inevitably found their way to the CJEU in the absence of legislated solutions. For example, some but not all of the remaining matters of ambiguity and uncertainty in relation to the management of investment funds and pension funds have now been disposed of, at least judicially, in the cases of Wheels[4] and PPG[5].

It is less than satisfactory that the Court is repeatedly called to address issues which have stagnated in the Council and the search for remedies to this situation is directed elsewhere. Although the objective of modernizing the legislation should have led to a reduction in litigation, a more pessimistic perspective might conclude that whatever the form in which new legislation might have emerged, it would be inevitable that in due course fresh difficulties would arise, creating a new generation of CJEU decisions for study and debate. This could be seen as a further argument for getting rid of exemptions.

4 CJEU, case C-424/11.
5 CJEU, case C-26/12.

Other exemptions

Even for exemptions which were originally conceived purely for social reasons, the correct tax treatment creates uncertainty when faced with new models for delivering these services, giving fresh impetus to litigated solutions. Among such exemptions, particularly those considered as based on merit reasons – activities in the public interest, hospital and medical care and other closely related activities – the legislators probably imagined that they were creating something non-controversial that would be easily administered.

When the boundaries of these exemptions were inevitably challenged, the Court, invoking the principle that exemptions must be strictly interpreted, concluded that medical care could be VAT exempt only if it has the scope of diagnosing, treating and, in so far as is possible, curing diseases or health disorders. This can however extend to treatment given by qualified persons who are not medical doctors where such treatment is given as a service ancillary to hospital or medical care.

Without examining the issue in detail, it is sufficient to note here that the magnitude of the concept of "medical care" has and will continue to be challenged both by tax authorities and tax payers. This reflects the reality that in modern economies, where medical care implies outsourcing, significant capital investment as well as competition between public and private bodies, this well-intentioned exemption may prove to be outdated and may no longer meet the objectives on which it was founded in 1977. Is the remedy to be found in a succession of questions to the Court or can we not resolve this more sensibly through good legislation?

A common feature of most exemptions is that they lead to non-recoverable VAT which has to be absorbed as a cost by entities which carry out exempt activities. This tax charge lies at the heart of disputes over the rules for applying the exemptions whose resolution so greatly occupies the Court. These restrictions on the recovery of input VAT – which are a direct consequence of exemption – are very complex, difficult to understand and apply and are not applied consistently across the European Union.

There is indeed very little transparency about how this tax charge falls. We can say that operators who carry out exempt activities bear a certain proportion of VAT but there is no way of knowing what this is or should be. This burden is moreover not consistent between competing operators who carry on similar activities as the impact of the tax will vary according to how the business is organized – essentially the degree of vertical or horizontal integration but also the extent of access to certain reliefs such as that available for cost sharing arrangements. Some of these reliefs, although foreseen in the VAT Directive, are not available consistently in all Member States. The result is an unknown and gener-

ally unpredictable amount of input VAT incurred by financial institutions, determined by the ratio between bought-in infrastructure and external services used as inputs on the one hand and employee costs not susceptible to VAT on the other hand but also determined by the impact of the rules governing deduction as interpreted in individual Member States

It is hardly surprising therefore that these measures are a source of irritation for taxpayers and lead so easily to litigation. The main consequence of the exemptions is to complicate the system and create incentives for taxpayers to manipulate it or to challenge the rules in court. The benefits from doing either of these successfully include both price advantages in the market or enhanced profitability. The incentives to push out the boundaries are strong.

The Court

The CJEU is not a court that is specialized in tax law but seems to have acquired a particular role here. It faces challenges in developing a coherent body of case law for VAT – especially as the sheer number of judgments on VAT issues now exceeds 500 having expanded considerably since the 1970's. For exemptions in particular, the problem is aggravated by the lack of a clear and consistently implemented rationale for many of the exemptions. The explanatory memorandum to the Sixth VAT Directive addresses but a fraction of all the exemptions and that in a generally cursive manner which does not shed much light on their justification.

In considering the role of the Court, some mention of the doctrine of judicial restraint is required as well as the principle of institutional balance which requires that each of the EU institutions must exercise its powers with due regard for the powers of the other institutions. This however leaves open the question of how the Court should deal with the failure of the legislature satisfactorily to update VAT legislation over the past 35 years.

In recent months, the Court has expressed its exasperation with the pace of legislative reform, most notably in relation to the application of the special scheme for travel agents.[6]

The Commission had made strenuous efforts in the Council over 10 years to reform the VAT rules applicable to travel agents. These proposals, if accepted, would have resolved most of the inherent difficulties and also addressed problems caused by new business models including internet sales. Although the differences between Member States were not really earth-shattering, it seems that final agreement was elusive. Faced with this impasse, the Commission referred several Member States to the Court because of non-compliance with existing legislation. In the event, the Court rejected these complaints but in doing so expressed in no

6 CJEU, Joined cases C-189/11, C-193/11, C-236/11, C-269/11, C-293/11, C-296/11, C-309/11 and C450/11.

uncertain terms its frustration over the unwillingness of Member States to engage constructively in the process of sorting out the shortcomings in the legislation.

Here, the Advocate General, Miss Sharpston, went so far as to say that the Court found itself in an invidious position with the impression that it was being called up to sort out issues of VAT policy and legislative drafting which had proven to be beyond the capacity or willingness of Member States in the Council.

This has to be seen as a fairly strong and forthright response to an issue which has been dragging on for far too many years. It is, not to put it any stronger, an unsatisfactory state of affairs and moreover is not limited to the travel agents file. Member States need to face up to their responsibilities in enacting legislation and cannot assume that the Court is there to provide back-up support.

Conclusions

Some steps have been taken to try to improve the uniform application of the VAT Directive. Recently the Commission proposed and the Council has adopted, an implementing regulation on VAT.[7] This is a significant innovation and potentially a very important tool to avoid litigation. It has however shown its limits, still requiring adoption by unanimity in the Council and can only deal with topics where consensus between Member States has already been achieved.

Behind all of these problems, the elephant in the room is the requirement of unanimity in the Council for all legislation in the tax area. It is becoming more and more difficult to reach agreement and all too often this can only be achieved by compromises that lead to complicated and convoluted legislation. The obligation of unanimity applies not only to new measures but also to measures badly needed to ensure existing legislation can continue to function in a changing world. Unanimity should however be seen as a special case under the rules set out in the treaties for voting on Council decisions where qualified majority is the norm. Such a departure from normal procedures, even if well justified in sensitive and limited policy fields, has to be deployed responsibly and should not be freely invoked to deflect from difficult functional necessities particularly when the consequence may oblige another institution to fill the vacuum. Failure to resolve the uncertainty created by inadequate or outdated tax legislation does little for the attractiveness of Europe as a destination for mobile investment in a highly competitive international environment.

In conclusion, it may be worth making reference to the vision of the founding fathers of what has become the European Union and who clearly understood that market integration requires tax policy coordination but at the same time saw that political constraints acted as a break on the EU's limited legislative authority in

7 Council Implementing Regulation (EU) No 282/2011 of 15 March 2011 laying down implementing measures for Directive 2006/112/EC on the common system of value added tax.

this area. The EC Treaty gives some law making powers to EU institutions in taxation (essentially the right of initiative) with strictly defined procedural constraints. Such legislation must be predicated on the functioning of the internal market and the need to avoid distortion of competition. It mandates the Council to harmonize national tax laws for one purpose only: to ensure the proper functioning of the Single Market. In contrast to many other policy fields, any suggestion to introduce qualified majority voting in taxation has invariably been killed before birth by sovereignty-minded member states. It is difficult to avoid the conclusion that some governments have a strong desire to keep the European Union weak in the area of taxation. The EU VAT system however, when looked at independently of the rights of Member States to raise revenue (and which should not be put in question), is an essential component of the Single Market. Given this role, the question surely arises as to whether it is legitimate to leave its care and maintenance in the hands of the Court?

'*To tax and to please, no more than to love and to be wise, is not given to men*'. These words were spoken more than 200 years ago by Edmund Burke[8], an Anglo-Irish politician and political philosopher, and continue to ring true today. Tax will always be a source of contention between governments and taxpayers and litigation over tax issues will always be with us.

8 Delivered in the course of a speech to the British parliament in April 1774, occasioned by the American colonists' vigorous reaction to the burden of taxation.