CASE C-277/09 RBS DEUTSCHLAND EUROPEAN COURT OF JUSTICE

(UNREPORTED, JUDGMENT OF 22ND DECEMBER 2010)

RAYMOND HILL
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Deduction of input tax – Article 17(3)(a) of the Sixth VAT Directive - cross-border leasing transactions in principle taxable – but no output tax in fact accounted for in other Member State involved – permissibility of exploitation of differences in implementation of VAT in different Member States - fiscal neutrality - abuse of rights

In *RBS Deutschland*, the Court of Justice had to consider the permissibility of "arbitrage" – the exploitation of differences in the implementation of VAT in different Member States. In doing so, it has provided further guidance on the scope of the general principles of fiscal neutrality and abuse of rights.

FACTS

RBS Deutschland ("RBSD") was a member of the Royal Bank of Scotland Group, which operated a vehicle leasing business. It was established in Germany, but was registered for VAT in the UK as a non-established taxable person.

One of RBSD's customers was an unconnected UK-established company, Vinci plc ("Vinci"), which wished to lease cars from RBSD. RBSD purchased cars in the UK and then leased them to Vinci for a term of two years. At the same time, RBSD entered into a put option agreement under which it could require one of Vinci's subsidiaries, Vinci Fleet Services Ltd, to buy the cars back from RBSD. However, RBSD was entitled to sell the cars entirely at its discretion to any buyer other than Vinci

plc. In fact, the put option was subsequently exercised and the cars were bought by Vinci Fleet Services Ltd.

Under Schedule 4, paragraph 1(2) of the Value Added Tax Act 1994, there is a supply of goods if the possession of goods is transferred under agreements which expressly contemplate that the property also will pass at some time in the future. HMRC did not regard the leases as providing for ownership of the cars to pass and treated the supplies made under the leasing agreements as supplies of services. Because the supplier, RBSD, was established in Germany, the Commissioners treated those services as supplied in Germany in accordance with Article 9(1) of the Sixth VAT Directive.

However, under German law, the same transactions were regarded as supplies of goods. Therefore, pursuant to Article 8(1)(b) of the Sixth VAT Directive, the place of supply was regarded as being "the place where the goods are when the supply takes place." In the present case, this was the United Kingdom where the relevant cars remained at all times. The result was that RBSD claimed that its leasing of cars to Vinci was to be categorised as a supply of goods under German VAT law and thus no output tax was due in Germany – and at the same time, it was to be classified as a supply of services under United Kingdom VAT law and thus no output tax was due in the United Kingdom either. Therefore, RBSD claimed that no output tax was due in either the United Kingdom or Germany, even though the leasing of cars was a taxable supply at the relevant time (and remains taxable) in both Member States.

The reason why RBSD wished to ensure that no output tax was due on its leasing of cars to Vinci was that the United Kingdom would not allow a lessee of cars to recover 50% of any input tax on cars which were used for both business and personal use (see paragraphs 7(1) and 7(2H) of the VAT (Place of Supply of Goods) Order 1992 [SI 1992/3283]). Therefore, it was advantageous for Vinci to incur no VAT and recover none. Indeed, Vinci was prepared to pay RBSD a higher lease charge than it would otherwise have been prepared to pay a UK-established lessor, since the total charges imposed by RBSD were lower than they would have been if VAT had been added to them. The only output tax which RBSD accounted for in relation to the transactions was the VAT which it charged on the ultimate sale of the cars to Vinci Fleet Services Ltd.

Nevertheless, RBSD had to pay VAT on its purchase of the cars and it sought to claim credit for that input tax from HMRC. The Commissioners refused on two grounds. First, they contended that the provisions laying down the right to deduct input tax in Article 17(3)(a) of the Sixth VAT Directive did not permit deduction of input tax paid in respect of the acquisition of goods which were used for transactions which were not chargeable to VAT. Secondly, the Commissioners decided that RBSD had engaged in an abusive practice which was contrary to the purposes of the Sixth VAT Directive, insofar as it had engaged in leasing transactions which were designed to exploit the differences in transposition of the Directive in the UK and Germany.

ISSUE 1: DEDUCTIBILITY OF INPUT TAX

Article 17(3)(a) of the Sixth VAT Directive permitted deduction of input tax relating to economic activities carried out in another country "which would be deductible if they had been performed within the territory of the country".

The question for the ECJ was whether that meant that the output supply (here, the leasing of the cars to Vinci) would hypothetically have been taxable if it had been made in the Member State of claim (here, the United Kingdom), or whether the output supply was in fact taxable in the Member State of supply (here, Germany) and thus the relevant input tax would have been deductible if the supply had been performed in the Member State of claim (here, the UK).

The UK (supported by Denmark, Ireland and Italy) argued that the Court of Justice should adopt the latter interpretation because allowing recovery of input tax in respect of goods and services used to make supplies on which no output tax was due would be contrary to the principle of fiscal neutrality, which forms one of the cornerstones of the Community VAT system. In particular, the Member States in question relied on paragraph 20 of the Court's judgment in Case C-72/05 *Wollny* [2006] ECR I 8297, in which it had indicated that a taxable person cannot deduct input tax if the relevant goods or services are used for the purposes of transactions on which no output tax is due, regardless of whether this is because the transactions are exempt or because they are outside of the scope of VAT.

However, at paragraph 36 of its judgment in *RBS Deutschland*, the Court distinguished *Wollny* on the basis that the transactions entered into by RBSD were in principle taxable, even though no output tax had been accounted for on them, and were not exempt or outside

of the scope of the tax. They were therefore capable of giving rise to a right to deduct. The Court went on to hold in paragraph 41 that "the right to deduct VAT cannot depend on whether the output transaction has in fact given rise to the payment of VAT in the Member State concerned." Both the Advocate General and the Court reached this conclusion even though the Advocate General accepted at paragraph 40 of his Opinion that the outcome was "admittedly, unsatisfactory, and contrary to the scheme of the VAT legislation and the principle of fiscal neutrality". Similarly, the Court indicated at paragraph 44 of its judgment that the result was "inconsistent in some respects" with fiscal neutrality. Both the Advocate General and the Court of Justice came to this conclusion on the basis that the Sixth Directive allowed for derogations from strict application of the principle of fiscal neutrality and that the wording of Article 17(3)(a) indicated that this was just such a derogation.

In reaching this conclusion, the Court of Justice distinguished its previous judgment in Case C-302/93 *Debouche* [1996] ECR I-4495. In that case, Mr Debouche was a lawyer established in Belgium, who hired a car from a leasing company in the Netherlands. He used the car exclusively for his professional activities in Belgium, which were treated by that Member State as exempt. Mr Debouche then submitted an application to the Dutch authorities for the refund of the VAT which had been charged by the Dutch lessor on the cost of hiring the vehicle, on the basis that his legal services would have been taxable if carried out in the Netherlands. The Court held in that case that Mr Debouche could not obtain a refund of VAT under the Eighth VAT Directive in the Netherlands in circumstances where he was not entitled to deduct input tax in Belgium.

In *RBSD*, the Court distinguished *Debouche* at paragraph 43 on the narrow grounds that Mr Debouche was not entitled to a refund on the basis that he did not have a certificate proving that he was a taxable person in Belgium because his activities were treated as exempt in that Member State. However, as the UK and the other Member States submitted in *RBSD, Debouche* was in point since the Court had stated in paragraph 11 of its judgment in that case that the national Court's question involved consideration of, inter alia, both Articles 17(2) and 17(3)(a) of the Sixth VAT Directive.

Indeed, the Court of Justice made it absolutely clear in paragraphs 16 and 18 of *Debouche* that its interpretation was "in keeping with that given by the Court on Article 17 of the Sixth Directive" and it was "not the purpose of the Eighth Directive to undermine the scheme introduced by the Sixth Directive."

ISSUE 2: ABUSE OF RIGHTS

The United Kingdom argued in the alternative that RBSD should be refused input tax deduction on the basis of the principle of abuse of rights. The UK argued that both of the conditions for the application of that principle, laid down in Case C-255/02 *Halifax and others* [2006] ECR I 1609 at paragraphs 74 and 75, were satisfied.

As to the condition that the essential aim of the transaction be to obtain a tax advantage, the UK pointed out that the referring Court in Scotland had made it plain in the Order for Reference that RBSD's parent, The Royal Bank of Scotland Group, not only selected RBSD as the lessor of the vehicles, but also determined the duration of the leasing arrangements, "with a view to obtaining the tax advantage of no VAT being payable on the rental payments."

However, despite that, the Court of Justice held at paragraph 50 of its judgment that "the various transactions took place between two parties which were legally unconnected" and "were not artificial in nature and … were carried out in the context of normal commercial operations."

Not only does this finding cut across the determinations of fact made by the national court, it also fails to properly apply the Court's previous decision in *Halifax*. It is clear from *Halifax* itself that it is not necessary to establish that the whole of the transaction has no commercial logic or economic reality to it for the doctrine of abuse of right to apply. It is only necessary to establish that the purpose of including a particular feature or features of the transactions is to obtain a wrongful tax advantage. In *Halifax*, the taxpayer had a genuine business need to construct the four call centres in issue (see paragraph 15 of the judgment) and its subsidiary, County, entered into arm's length contracts with builders and professionals for the construction of those centres (see paragraph 29 of the judgment).

However, the relevant question in that case was not whether the transactions had an overall commercial purpose, which was not in doubt, but whether particular features of them had been artificially inserted in order to obtain a tax advantage – in that case, the insertion of County and Leeds Development into the arrangements to enable Halifax to recover input tax on the construction of the call centres even though it would normally have been able to recover less than 5% of its input VAT.

Indeed, the fact that it is necessary to look at the aim of each feature of the transactions and not the transactions as a whole was made clear by the Court of Justice in *Halifax* in dealing with redefinition of the transactions once an abusive practice had been found to exist. The Court held at paragraph 94 that the transactions in question should be redefined so as to ignore the artificial features of the overall transaction or series of transactions, thus allowing any non-abusive features of the transactions to survive the redefinition process. The fact that any non-abusive features of the transactions can survive the redefinition process must mean that it is necessary to assess whether each feature of the transaction or transactions in question has the essential aim of obtaining a tax advantage. Accordingly, in the light of *Halifax*, it is difficult to understand on what basis the Court failed to apply the doctrine of abuse to the artificial features of the transactions entered into by RBSD, even though those features form part of otherwise commercial transactions between parties operating at arm's length. As to the other condition that the granting of the tax advantage be contrary to the purpose of the relevant provisions of the VAT Directives, the Court simply observed at paragraph 54 that where a trader has a choice from among a number of transactions, he may choose to structure his business in such a way as to limit his tax liability.

Again, this conclusion appears inconsistent with certain aspects of the *Halifax* judgment, in which the Court of Justice explained in paragraphs 78 to 80 that the whole purpose of the deduction system under the Sixth Directive was to ensure neutrality relieving the trader of the burden of VAT payable or paid in the course of all his economic activities, provided that those economic activities are themselves subject in principle to VAT. In those paragraphs, the Court of Justice emphasised that both Articles 17(2) and 17(3) had to be interpreted as meaning that, in principle, there had to be a direct and immediate link between a particular input transaction and a particular output transaction before the taxable person was entitled to deduct input tax.

Accordingly, for RBSD to be able to deduct the whole of the input tax on the relevant cars in the UK whilst accounting for no output tax on the leases in either Germany or the UK would seem to be directly contrary to the purpose of the deduction mechanism.

CONCLUSION

The judgment of the Court in *RBS* is chiefly of interest for the limitations it has placed on the application of two of the general principles of EU law: the principle of fiscal neutrality

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and the principle of abuse of rights. In restricting the availability of those principles to combat arbitrage, the Court seems to be leaving it to the Member States to prevent arbitrage by ensuring that their respective national VAT legislation is compatible with that of the other Member States. Realistically though, given that there are now 27 Member States and given the complexity of VAT legislation, it will never be possible to rely on legislation alone to iron out discrepancies between the VAT systems of the Member States. The Court may yet have to revisit *RBS Deutschland.*

For more information on Raymond Hill please contact the Clerks on +44 (0)207 405 7211or consult the 'Find a Barrister' section at www.monckton.com.

Monckton Chambers
1 & 2 Raymond Buildings
Grays Inn
London, WC1R 5NR

Tel: +44 (0)20 7405 7211
Fax: +44 (0)20 7405 2084
Email: chambers@monckton.com
www.monckton.com