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DIRECTORATE-GENERAL
TAXATION AND CUSTOMS UNION
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VALUE ADDED TAX COMMITTEE
(ARTICLE 398 OF DIRECTIVE 2006/112/EC)
WORKING PAPER NO 922

QUESTION
CONCERNING THE APPLICATION OF EU VAT PROVISIONS

ORIGIN:	**Poland**
REFERENCES:	**Articles 167, 168, 173, 174, 184, 185 and 187**
SUBJECT:	**Adjustment of input VAT deduction where a taxable person is carrying out both economic activities and non-economic activities**

1. INTRODUCTION

Poland has asked the Commission to put on the agenda of the VAT Committee a question concerning the possibility for a taxable person to adjust initially deducted input VAT on capital goods used both for economic activities and for non-economic activities in the case where there is a change in the proportion of use of the capital goods for these two types of activities.

The question and the analysis submitted by Poland are annexed to this document.

2. SUBJECT MATTER

In relation to the system of adjustments to deductions set out in Articles 184 to 192 of the VAT Directive[1], Poland seeks to clarify whether a taxable person has the right to perform a positive adjustment in his favour in respect of input VAT incurred on capital goods used in part for economic activities and in part for non-economic activities which fall outside the scope of the VAT, such as activities performed in the capacity of a public authority or the activities of associations and foundations which are not performed for consideration, in case of an increase in the business use of the capital goods.

In this regard, Poland has no doubts concerning the obligation of a taxable person to perform a negative adjustment of the initially deducted input tax in case of a decrease in the initial use of the capital goods for business purposes.

However, Poland has serious doubts whether a taxable person can effect a positive adjustment in case of an increase in use for business purposes beyond the initial use.

Poland refers in this respect to the settled case-law of the Court of Justice of the European Union (CJEU) on the allocation of mixed-use capital goods[2]. It follows from this case-law that where capital goods are used both for business and for private purposes the taxpayer has the *choice*, for the purposes of VAT, of *(i)* allocating those capital goods wholly to the assets of his business and deducting, in principle, the whole amount of input VAT immediately and in full; *(ii)* retaining them wholly within his private assets, thereby excluding them entirely from the system of VAT; or *(iii)* integrating them into his business only to the extent to which they are actually used for business purposes.

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1 Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax (OJ L 347, 11.12.2006, p. 1).

2 Judgment of 4 October 1995, *Armbrecht*, C-291/92, EU:C:1995:304, paragraph 20; judgment of 8 March 2001, *Bakcsi*, C-415/98, EU:C:2001:136, paragraphs 24 to 34; judgment of 8 May 2003, *Seeling*, C-269/00, EU:C:2003:254, paragraphs 40 and 41; judgment of 21 April 2005, *HE*, C-25/03, EU:C:2005:241, paragraph 46; judgment of 14 July 2005, *P. Charles and T. S. Charles-Tijmens*, C-434/03, EU:C:2005:463, paragraph 23; judgment of 30 March 2006, *Uudenkaupungin kaupunki*, C-184/04, EU:C:2006:214, paragraph 34; judgment of 14 September 2006, *Wollny*, C-72/05, EU:C:2006:573, paragraph 21; judgment of 16 February 2012, *van Laarhoven*, C-594/10, EU:C:2012:92, paragraph 25; judgment of 23 April 2009, *Puffer*, C-460/07, EU:C:2009:254, paragraph 39; judgment of 16 February 2012, *Eon Aset Menidjmunt*, C-118/11, EU:C:2012:97, paragraph 53.

3. THE COMMISSION SERVICES' OPINION

It is settled case-law that the deduction scheme established by the VAT Directive relates to all economic activities, whatever their purpose or results, provided that they are themselves subject in principle to VAT[3].

Therefore, as non-economic activities do not fall within the scope of the VAT Directive[4], to the extent that input VAT is incurred by a taxable person on expenditure relating to non-economic activities, it cannot give rise to a right to deduct[5].

In addition, where a taxable person simultaneously carries out economic activities, taxed or exempt, and non-economic activities falling outside the scope of the VAT Directive, deduction of the VAT relating to expenditure is allowed only to the extent that the expenditure in question is attributable to the taxable person's economic activity within the meaning of Article 2(1) of that Directive[6].

The system of adjustment of deductions is an essential element of the system introduced by the VAT Directive in that its purpose is to ensure the accuracy of deductions and hence the neutrality of the tax burden. The period laid down in Article 187 of the VAT Directive for adjustment of deductions in regard to capital goods, including services which may be treated as such under Article 190 of the VAT Directive, makes it possible to avoid inaccuracies in the calculation of deductions and unjustified advantages or disadvantages for a taxable person where, in particular, changes occur in the factors initially taken into consideration when determining the amount of deductions after the declaration has been made[7].

The application of the adjustment mechanism depends on the existence of a right to deduct based on Article 167 of the VAT Directive[8]. It follows from that Article that the right to deduct VAT arises at the time when the deductible tax becomes chargeable, which is the time when the goods (or services) are delivered, pursuant to Article 63 of the VAT Directive.

Consequently, only the capacity in which a person is acting at the time when the capital goods are delivered to him can determine the existence of the right to deduct. In this respect, it follows from the provisions of Articles 2, 167 and 168 of the VAT Directive that only a person who is a taxable person and who is acting as such at the time of the purchase of goods, has a right to deduct in respect of those goods and may deduct the

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3 See, *inter alia*, judgment of 21 March 2000, *Gabalfrisa and Others*, joined cases C‑110/98 to C‑147/98, EU:C:2000:145, paragraph 44; judgment of 8 June 2000, *Midland Bank*, C‑98/98, EU:C:2000:300, paragraph 19; judgment of 22 February 2001, *Abbey National*, C‑408/98, EU:C:2001:110, paragraph 24; judgment of 13 March 2008, *Securenta*, C-437/06, EU:C:2008:166, paragraph 28; judgment of 12 February 2009, *Vereniging Noordelijke Land- en Tuinbouw Organisatie*, C‑515/07, EU:C:2009:88, paragraphs 26-28.

4 See in that respect *Securenta*, paragraphs 30 and 31; *Vereniging Noordelijke Land- en Tuinbouw Organisatie*, paragraphs 36 and 37; judgment of 15 September 2016, *Landkreis Potsdam-Mittelmark*, C-400/15, EU:C:2016:687, paragraph 30.

5 See, *inter alia*, *Landkreis*, paragraph 20, and *Securenta*, paragraph 30.

6 See *Securenta*.

7 See, *inter alia*, *Uudenkaupungin kaupunki*, paragraphs 25 and 26; judgment of 5 June 2014, *Gmina Międzyzdroje*, C-500/13, EU:C:2014:1750, paragraphs 20 and 24.

8 See *Uudenkaupungin kaupunki*, paragraph 37.

VAT due or paid in respect of those goods if he uses them for the purposes of his taxable transactions giving rise to a right to deduct.[9].

By contrast, a non-taxable person does not have a right to deduct the VAT he has paid on the purchase of goods. That person's activities – his supplies of goods or services – do not fall within the scope of VAT pursuant to Article 2 of the VAT Directive.

Under Article 13(1) of the VAT Directive, states, regional and local government authorities and other bodies governed by public law are not to be regarded as taxable persons in respect of the activities or transactions in which they engage as public authorities. It follows that, when those bodies act as public authorities at the time of the purchase of capital goods, they do not, as a rule, have any right to deduct in respect of those goods and thus no right to adjust deductions can arise.

Article 184 of the VAT Directive contains no provision concerning the conferral of entitlement to deduct. As the CJEU held in *Lennartz*[10], Article 184 does no more than establish the procedure for calculating adjustments to the initial deduction and cannot, therefore, give rise to any right to deduct or convert the tax paid by a taxable person in respect of his non-taxable transactions into a tax that is deductible within the meaning of Article 168 of the VAT Directive.

In *Waterschap Zeeuws Vlaanderen*[11] the CJEU applied that argument to a body governed by public law which acted as a public authority at the time when it purchased capital goods. The CJEU reasoned that since that body did not at that time act as a taxable person it did not have any right to deduct the VAT paid by it in respect of those capital goods. The fact that that body subsequently acted as a taxable person could not, under Article 184 of the VAT Directive, result in the deductibility, within the meaning of Article 168 of that Directive, of the tax paid by that same body in respect of transactions effected as a public authority.

As regards the use to which capital goods are put, in *Uudenkaupungin kaupunki*, at paragraph 39, the CJEU stated that the use to which capital goods are put merely determines the extent of the initial deduction to which the taxable person is entitled under Article 168 of the VAT Directive and the extent of any adjustments in the course of the following periods, but does not affect whether a right to deduct arises.

In view of the above considerations and in the situation referred to by Poland, the Commission services are of the opinion, like Poland, that if the taxable person has decided at the time of the acquisition of capital goods to allocate them wholly to his assets as a non-taxable person, or to allocate them only to some extent to his assets as a taxable person, then no right to deduct may arise upon acquisition or at a later stage in respect of the whole or the part allocated to the assets as a non-taxable person.

Pursuant to the case-law on mixed-use of capital goods[12], where capital goods are used both for economic activities subject to VAT and for either private purposes or for

[9] Judgment of 11 July 1991, *Lennartz*, C-97/90, EU:C:1991:315, paragraphs 8 and 9.
[10] *Lennarz*, paragraphs 11 and 12.
[11] See, *inter alia*, judgment of 2 June 2005, *Waterschap Zeeuws Vlaanderen*, C-378/02, EU:C:2005:335, paragraphs, 39 to 41.
[12] See footnote 2 above.

purposes "other than those of his business", the taxable person may, for VAT purposes, allocate those goods wholly to the assets of his business and deduct the whole amount of VAT immediately and in full, but only in so far as the private use or the use for purposes "other than those of the business" is subsequently taxed under Article 26(1) of the VAT Directive.

However, the CJEU has held that the option of allocation of mixed-use capital goods wholly to the assets used as a taxable person, which in principle allows the input VAT to be deducted immediately and in full, cannot be transposed to a situation where a taxable person carries out both economic activities (whether taxed or exempt) and non-economic activities which fall outside the scope of VAT without however being alien to the purposes of his business[13].

Therefore non-economic activities, such as activities of bodies governed by public law which they perform in their capacity as public authorities and activities of associations and foundations for the promotion of the general interest of their members which are not performed for consideration, cannot be considered as activities made "for purposes other than those of his business" within the meaning of Article 26 of the VAT Directive, given that these non-economic activities constitute the main corporate purpose of these entities.

Further, in relation to Article 26 of the VAT Directive, the CJEU also held that Article 26 is not intended to establish a rule by which transactions that fall outside the scope of the VAT system may be considered to have been carried out "for purposes other than those of a taxable person's business" within the meaning of that provision. This is because such an interpretation would have the effect of rendering Article 2(1) of the VAT Directive meaningless[14].

Finally, in *Uudenkaupungin kaupunki*[15], the CJEU stated that Article 26 of the VAT Directive applies only where the goods concerned are put to private use, not where the goods are put to another use as part of a non-taxable activity.

In view of the above, in the circumstances referred to by Poland, a taxable person is not entitled to exercise the option of allocating mixed-use capital goods to his assets as a taxable person, allowing him to deduct immediately and in full the input VAT incurred on their acquisition and then to treat under Article 26 of the VAT Directive the use of the capital goods for non-economic activities in which he engages as a public authority, as a taxable supply of services for consideration.

Therefore, in so far as the capital goods concerned are used both for taxable transactions and for non-taxable transactions, such as activities in which he engages in the capacity of a public authority, the taxable person is, in principle, authorised to deduct the input VAT due or paid by him to the extent of the use of the capital goods for the purposes of his taxable transactions giving rise to a right to deduct. In proportion to which those capital

[13] See, *inter alia*, *Uudenkaupungin kaupunki*, paragraph 33; *Vereniging Noordelijke Land- en Tuinbouw Organisatie*,, paragraphs 37 and 38; judgment of 10 September 2014, *Gemeente 's-Hertogenbosch*, C-92/13, EU:C:2014:2188, paragraphs 25 and 26; and *Landkreis Potsdam-Mittelmark*, paragraph 31.

[14] See *Vereniging Noordelijke Land- en Tuinbouw Organisatie*,, paragraph 38; *Landkreis Potsdam-Mittelmark*, paragraph 31.

[15] See *Uudenkaupungin kaupunki*, paragraph 33.

goods are used for the transactions which are exempt or which do not fall within the scope of VAT, the deduction of VAT will not be permitted.

Since the use of capital goods for non-economic activities cannot be treated as a supply of services for consideration under Article 26, such use would fall outside the scope of VAT and, accordingly, of the rules on proportional deduction contained in Articles 173 and 174 of the VAT Directive, which, as the CJEU has pointed out, relate only to the apportionment of input VAT on expenditure connected exclusively with economic activities.

As the CJEU held in *Securenta*, the VAT Directive provides no mechanism for apportioning amounts of input VAT which is paid in relation both to economic transactions and non-economic transactions carried out by a taxable person. Although it is thus for the Member States to determine the methods and criteria for that apportionment, the CJEU has nevertheless pointed out that, having regard to the aims and broad logic of the VAT Directive, they must exercise their discretion in such a way as to ensure that deduction is made only for that part of the VAT proportional to the amount relating to transactions giving rise to a right to deduct.

If business use increases beyond the initial business use where goods are used partly for business purposes and partly for non-economic activities outside the scope of VAT, there is no adjustment mechanism under the VAT Directive for adjustments in favour of the taxable person. Only a taxable person who is acting as such at the time of the purchase of goods has a right to deduct the VAT due or paid in respect of those goods and can subsequently perform an adjustment where appropriate, if he uses them for the purposes of his taxable transactions giving rise to a right to deduct.

4. DELEGATIONS' OPINION

The delegations are invited to express their views on the question raised by Poland and the observations made by the Commission services.

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Annex

Question from Poland

According to Article 398 of Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax (OJ L 347, 11.12.2006, p. 1, with subsequent amendments), hereinafter "the Directive", the Ministry of Finance of the Republic of Poland is kindly requesting to discuss the following issues with the VAT Committee (if possible within the next meeting).

From 2016 Poland has clarified its legal regulations concerning the deduction of VAT in a situation where a taxable person conducts a business activity and an activity remaining beyond the scope of the VAT system (Article 86 section 2a-2h of the Polish VAT Act), in the case where it is not possible to directly allocate a given expenditure to the economic activity. In accordance with the case-law of the Court of Justice of the European Union[1] the clarification of these issues remains outside the scope of Directive 2006/112/EC.

In accordance with the clarified regulations (before 2016 the rules of deduction in such cases were based on national practice[2]) in order to determine the correct amount for the tax deduction Polish taxable persons are required to select and apply the method that is the most suited to the characteristics of the activity conducted by the taxable persons and the acquisitions carried out by them. This method is intended to objectively reflect the proportion of the expenditures attributable, respectively, to the business activity and to purposes other than the business activity (but other than those referred to in Articles 16 and 26 of the Directive). For public finance sector entities the revenue-turnover method was proposed as the most optimal choice (modeled on the turnover method, referred to in Article 174 of the Directive), however these entities are not obliged to apply it, if according to their assessment there is another method more relevant to their situation. If they apply this method, however, they have a guarantee that such deductions will not be questioned by the tax administration.

However, from 2016 a new institution has been introduced (for the adjustment of deductions in time) associated with these deductions – a system of annual and multi-annual adjustments, based on the system of adjustments provided for in Articles 184-192 of the Directive. In relation to goods and services which are non-capital goods, a one-year adjustment period applies, in relation to real estate – a 10-year adjustment period applies, and in relation to the remaining capital goods – a 5-year adjustment period applies. While Poland has no doubts concerning the obligation to perform a "negative" adjustment of the initially deducted input tax, when it turns out after the end of the tax year that the initial deduction was overstated, it has some doubts as to the legitimacy of performing a "positive" adjustment.

[1] For example, the judgment in Case C-437/06 *Securenta*, paragraphs 33-35.

[2] What is not in contradiction with the Directive – see: opinion of P. Mengozzi in joined Cases C-108/14 and C-109/14, *Marenave Schiffahrts AG*, paragraphs 19-23.

These doubts arise from the analysis of the case-law of the Court of Justice of the European Union concerning the principle of immediate deduction[3], from which it follows directly, that if the taxable person has decided at the time of acquisition of capital goods to allocate them wholly to their personal assets, or to allocate them only to some extent to their business activity, then no right to deduction may arise in respect of the whole or the part allocated to the personal assets. That is because a taxable person carrying out certain activities in private capacity does not act as a taxable person within the meaning of the Directive[4]. The status of a taxable person is crucial in this case and its possession is assessed at the time of acquisition of the given goods by that entity. Similarly, in such a case the subsequent use of a part of the goods allocated to personal assets for business purposes cannot give rise to a right to deduct, since this right arises at the moment when the tax obligation arises. European Union law does not provide for any adjustment mechanism in such a situation (apart from Article 168a of the Directive, applicable from 2011, which will be discussed below). It is mainly for this reason[5] that the Court took the position that a taxable person must have the option of allocating mixed-use goods to business assets, while at the same time recognizing the obligation of subsequent taxation of the private use of these goods[6].

Such a principle – devised on the grounds of the taxable person's use of the given goods for private purposes – cannot, however, apply in a situation where the taxable person uses the given goods for business purposes and other non-business purposes (e.g. activity in the capacity of a public authority)[7]. If the taxation of private use is not possible, then no deduction of input tax can be granted in that respect, even if the capital item has been wholly assigned for business purposes. Such a situation may occur if the hypothesis of Article 26 is not fulfilled[8]. The provision of Article 26 of Directive 2006/112/EC will not apply in a situation where the given entity allocates the goods both for business purposes and also for the purposes of (non-private) activities remaining outside the scope of the VAT system, which cannot be regarded as not related to their business activity, in a situation where such (non-taxable) activities constitute the principal business of that entity[9].

Therefore the principles governing the option to allocate capital goods to business assets or personal assets cannot be transposed to a situation in which a taxable person carries out both economic activities subject to VAT (whether taxable or exempt) and non-economic

3 For example, the judgments in Case C-25/03 *HE*, paragraph 46; in Case C-434/03 *P. Charles and T.S. Charles-Tijmens*, paragraph 23; in Case C-72/05 *Wollny*, paragraph 21; in Case C-594/10 *Laarhoven*, paragraph 25; in Case C-460/07 *Puffer*, paragraph 39; in Case C-118/11 *Eon Aset Menidjmunt OOD*, paragraph 53.

4 For example, the judgments in Case C-291/92 *Armbrecht*, paragraph 17 and 18; in Case C-415/98 *Bakcsi*, paragraph 24.

5 In such a case a taxable person using goods acquired in a private capacity for business purposes cannot free themselves of the incurred tax, which burdens their business activity in a manner incompatible with the requirement of VAT neutrality for taxable persons, which places them at a disadvantage vis-à-vis other competing taxable persons.

6 Opinion of E. Sharpston in Case C-460/07 *Puffer*, paragraph 61.

7 For example, in the opinion of F. G. Jacobs in Case C-434/03, paragraph 59; the opinion of P. Mengozzi in Case C-515/07 *VNLTO*, paragraphs 49, 54, 57; in the judgments: in case C-515/07 *VNLTO*, paragraph 38; in case C- 92/13 *Gemeente's Hertogenbosch*, paragraphs 25-26.

8 Opinion of J. Kokott in Case C-334/10, paragraph 27.

9 Judgment in Case C-515/07 *VNLTO*, paragraphs 37-39.

activities which remain outside the scope of VAT, but fall within the main object of their operations[10].

Consequently, the tax deduction in the acquisition of such goods will be allowed only to the extent that the expenditures associated with that acquisition can be attributed to the taxable person's business activity. This will apply in particular to public authorities[11], associations and foundations, whose main objective is carrying out non-taxable activities. In their case, the business activity is usually carried out incidentally.

The principle of immediate deduction developed through the case law of the Court of Justice of the European Union became obsolete in relation to real estate at the end of 2010, due to the addition of Article 168a to the Directive[12]. This article removed the obligation of taxing the unpaid provision of services in relation to real estate **(Article 168a(1) second paragraph)**. At the same time, the provision establishes a system of adjustments, which allows for the reflection of changes in the business-related and non-business use of the immovable property, wherein that system covers both increased as well as decreased business use (Article 168a(1) second paragraph). This system has therefore, on the one hand, replaced the taxation of non-business use (Article 26 of the Directive) during the adjustment period, and on the other hand, introduced the possibility of adjustments in favour of the taxable person in the case of increased professional use of the immovable property concerning transactions which give the right to deduction. The adoption of such a structure of accounts in relation to real estate eliminated a major flaw of the previous approach concerning a situation where at the moment of purchase a taxable person allocated only a part of the goods to the business activity (the one that served the business activity), and in the case of subsequent use of the goods for business purposes exceeding the initial deduction it was impossible to increase the original deduction[13]. In its functionality, this system is similar to the already existing system of adjustment of deductions in relation to capital goods, which for the proportion used for business purposes introduces a percentage of taxable transactions (and other transactions giving the right to deduction) and exempted transactions (without the right to deduction) during the adjustment period (Articles 184-192 of the Directive).

If the above considerations were to be applied to a situation where the given capital goods are used for business purposes and for purposes other than business, such as activities in the capacity of a public authority (i.e. other than for private purposes, in the case of which there is an option of taxation of private use pursuant to Article 26 of the Directive), in Poland's assessment there are serious doubts as to whether, in such a case, the increased

[10] Opinion of E. Sharpston in Case C-92/13 *Gemeente's Hertogenbosch*, paragraphs 17, 51, 56. These theses were confirmed by the CJ in its judgment on the case, paragraph 25.

[11] The case *Gemeente's-Hertogenbosch* concerned a local public authority, which was not considered to be a taxable person in respect of the activities or transactions undertaken in the capacity of a local public authority, as a result of which these activities were not covered by the scope of VAT. They constituted the main object of its operations. In addition, it provided both taxable services and services exempt from taxation, but falling within the scope of VAT and in this respect it should be deemed to be a taxable person.

[12] Council Directive 2009/162/EU of 22 December 2009 amending various provisions of Directive 2006/112/EC on the common system of value added tax.

[13] It should be pointed out, however, that the principle of immediate deduction, along with the indicated flaws, still applies in respect of capital goods other than the estate (of course, to the extent to which the given Member State did not take advantage of the possibility provided by paragraph 2 of Article 168a of the Directive).

business use of the capital goods should authorize the performance of a "positive" adjustment, that is, one made in favour of the taxable person.

Poland would like to kindly request the European Commission and the VAT Committee to present their views in this matter.