# EU Perspective on VAT Exemptions

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## I. Introduction

As early as 1967, the Member States of the European Community – six at that time – agreed to harmonize their national systems of turnover taxes, based on what is now Art. 113 TFEU[2] (ex-Art. 93 EC). As a model they chose the French system of value added tax[3] that had also been deliberated in other Member States like Germany, establishing a general, multi-stage but non-cumulative turnover tax in the First and Second VAT Directives[4]. These first two VAT Directives laid down only the general structures of the system so as to ensure neutrality of competition regarding both, intra-Community and intra-State trade. Member States were still almost entirely free to provide for exemptions in their national VAT systems[5]. But in its 1973 proposal for a Sixth VAT Directive, the EC Commission envisaged a far greater degree of harmonisation including, inter alia, rules on a limited number[6] of uniform and compulsory tax exemptions[7]. This list of exemptions had been drawn up having regard to the exemptions already existing in the Member States[8]; the Commission obviously was not willing to engage into disputes as to whether all of these exemptions were really well-founded[9]. Likewise, the

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[1] *Joachim Englisch*, University of Muenster. I am deeply grateful for the comments made by my discussant *Richard Lyal*. I would also like to express my gratitude for the suggestions and comments made by two anonymous referees. Any eventual errors are all mine.

[2] Treaty on the Functioning of the European Union, entry into force on 1 November 2009.

[3] Cf. *Celorico Palma*, O IVA e o marcado interno, Lisbon 1998, pp. 53 et seq.

[4] Directives 67/227/EEC, OJ 1967, p. 1301, and 67/228/EEC, OJ 1967, p. 1303, respectively.

[5] Cf. Art. 10 of the Second VAT Directive. However, the Commission had stressed in the explanatory memorandum of the preceding proposal of the Second VAT Directive that "it is highly desirable to limit the number of exemptions as far as possible.", cf. "Proposition d'une Deuxieme Directive du conseil en matiere d'harmonisation des legislations des etats members relatives aux taxes sur le chiffre d'affaires concernant la structure et les modalites d'application du systeme commun de taxe sur la valeur ajoutee" of 13 april 1965, IV/COM(65) 144 (final), p. 15.

[6] Cf. ECJ 12 November 1998, Case C-149/97, Institute of the Motor Industry [1998] ECR I-7053, para. 18; ECJ 20 November 2003, Case C-307/01, d'Ambrumenil [2003] ECR I-13989, para. 54; ECJ 14 June 2007, Case C-445/05, Haderer [2007] ECR I-4841, para. 16: the provisions of the Sixth VAT Directive (now Recast VAT Directive) on tax exemptions are exhaustive.

[7] The harmonisation of VAT exemptions was chiefly motivated by the desire to make VAT a suitable source of Community revenue by ensuring a uniform basis of assessment and thus a uniform collection in all Member States, cf. *Amand*, International VAT Monitor 2010, p. 409 (pp. 410 et seq.), with further references to preparatory documents for the VAT directives; *de la Feria*, The EU VAT System and the Internal Market, 2009, pp. 54 et seq.; see also recital 11 of the Preamble to the Sixth Directive.

[8] Cf. Explanatory Memorandum to the Proposal for a sixth Council Directive on the harmonization of Member States concerning turnover taxes, submitted to the Council by the Commission on 29 June 1973, COM(73) 950, p. 15. For further references, see *Amand*, International VAT Monitor 2010, p. 409 (p. 411 and p. 413), who points to the traditional exemptions of the German turnover tax preceding the European harmonization of VAT in particular.

[9] See also *Cnossen*, International Tax and Public Finance 10 (2003), p. 625 (p. 627): "The rationale for most exemptions must be found in the history of their adoption, not in their underlying economic or administrative logic." See furthermore *Krever*, in Krever (ed.), VAT in Africa, Pretoria 2008, p. 9 (p. 16), who points out that a

Commission maintained the principle that input VAT on goods and services used for the purpose of exempt transactions should not be deductible, without any further explanation[10]. When the Sixth VAT Directive was finally adopted in 1977 after only minor amendments, these concepts became binding for the Member States.

Since then, over 30 years have passed. The Sixth VAT Directive has been replaced by the Recast VAT Directive (RVD), and the harmonized system of VAT is now being implemented in 27 Member States. Over the course of time, the rules related to exemptions have proven to be a major source for legal dispute[11], they have been associated with distortions of competition, and most VAT planning activities revolve around the system of exemptions. Like in other VAT jurisdictions, this provokes the question whether exemptions are really a necessary evil, or whether they are rather unnecessarily evil so that the system should be amended, or no evil at all? However, there are some peculiarities inherent to the harmonized system of VAT that make it worthwhile to dedicate a paper specifically to the EU perspective on exemptions: First, the EU constitutes a supranational institution founded on the rule of law (cf. Art. 2 EU) that recognises fundamental rights, freedoms, equality and other constitutional principles. As a consequence, the entire body of harmonized VAT law including the provisions relating to exemptions is subject to quasi-constitutional review. Second, the relevant Directives have always clearly stated that harmonized VAT is an indirect tax on consumption expenditure[12] designed to burden the final consumer even though collected by economic operators as taxable persons[13]. As a consequence, the assessment of exemptions from a legal perspective must bear in mind this presumption when analyzing possible repercussions for business and for final consumers. Finally, the fact that VAT is harmonized at EU level but mostly implemented through national VAT Acts constitutes a particular challenge with regard to its uniform and principle-based interpretation[14].

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expansive list of exemptions was adopted so as to win the support of the business sector in the (formerly: six) Member States, by making the shift from traditional turnover taxes to a VAT appear a rather minor one.

[10] Cf. Explanatory Memorandum (note 8), p. 18.

[11] Cf. *Amand*, International VAT Monitor 2010, p. 409: "The VAT exemptions are probably the most complex aspect of the European VAT system."

[12] As regards the present version of the common system of VAT, cf. Art. 1 (2) RVD; see also, in greater detail, *Englisch*, in Lang/Melz/Kristofferson (eds.), Value Added Tax and Direct Taxation, Amsterdam 2009, p. 1 (25 et seq.); *Henkow*, Finanical Activities in European VAT, Alphen aan den Rijn 2008, p. 67; *Terra/Kajus*, Introduction to European VAT, Amsterdam 2010, pp. 249 et seq.

[13] ECJ 20 October 1993, Case C-10/92, Balocci [1993] ECR I-5105, para. 25; ECJ 21 February 2008, Case C-271/06, Netto Supermarkt [2008] ECR I-771, para. 21; *Alonso González*, Fraude y delito fiscal en el IVA, Madrid 2008, pp. 19 et seq.; *Reiß*, in Tipke/Lang (eds.), Steuerrecht, 20. ed. Köln 2010, § 14 para. 1; *Stadie*, Umsatzsteuerrecht, Köln 2005, paras. 1.15 and 1.18.

[14] See also *Amand*, International VAT Monitor 2010, p. 409 (p. 410): The occasional "lack of obedience [with respect to ECJ judgments] leads to serious distortions of competition and legal uncertainty..."

This paper will focus on exemptions available for intra-State transactions only. These exemptions are characterized, in principle, by the non-deductibility of input VAT for any supplies that become cost elements of the exempt transactions. This kind of exemptions needs to be distinguished from the exemptions that do not preclude the right to deduct input VAT. As a general rule, the latter type of exemptions are exclusively available for cross-border transactions so as to ensure taxation in conformity with the destination principle[15]; they are equivalent to zero-rating exports.

The paper is organised as follows: It sets out with a short overview of both, the harmonized and the non-harmonized aspects of the EU system of exemptions, and a brief analysis of the way they are interpreted by the European Court of Justice (ECJ). Having thus sketched the legal framework, the paper then discusses the constitutional standards as well as some economic and tax policy benchmarks by which the different types of exemptions provided for in the EU VAT system should be assessed. Based on these findings, the subsequent section carries out a critical analysis of seven possible rationales for those exemptions. Finally, the exclusion of input VAT deduction will be scrutinized.

As a caveat, it should be mentioned that this paper is not primarily intended to provide a tax policy analysis of VAT exemptions in general. Instead, it is mainly dedicated to the legal issues associated with exempt supplies, with special emphasis on the constitutional and institutional framework of the present EU VAT system. Nevertheless, due consideration will also be given to economic insights, in particular when analyzing the EU system of exemptions in the light of the primary Union law requirements of neutrality, proportionality and consistency. As the reader will notice, there is a considerable degree of congruence between the constitutional and the economic standards of assessment, even in so far as the latter are now influenced by optimal taxation theory. The main differences seem to be that a constitutional review can only ask for a reasonable rather than for an optimal degree of compliance with the aforementioned and other benchmarks[16]; and moreover it will accept a welfare decrease resulting from particular features of the tax system more readily, in so far as the former constitutes a corollary of the protection of individual human rights[17].

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[15] Cf. *Genser/Winker*, Finanzarchiv 54 (1997), p. 563.

[16] For further explanation, see below at III.2.b.(4).

[17] As regards the preference for utilitarianism under optimal taxation theory, see *Kaplow*, National Tax Journal 48 (1995), pp. 497 et seq.; *Tiley*, Revenue Law, 6th ed. 2008, p. 14. See also *Bird/Gendron*, The VAT in Developing and Transitional Countries, Cambridge 2007, pp. 70 et seq., who distinguish between tax-specific equity (the traditional legal approach) and overall equity, or welfare effect, of the tax and budgetary system (the approach of most modern economists).

## II. Overview of the system of exemptions in EU VAT

Different from what might be expected, not all aspects of VAT are harmonized in the common system of EU VAT. As regards exemptions in particular, some key aspects still remain at the discretion of Member States. Furthermore, the responsibility for interpreting the VAT exemptions is shared by national Courts and the European Court of Justice (ECJ), although the latter may usually claim ultimate authority in this regard.

### 1. Harmonized aspects of exempt transactions

#### *a) The exemption list of Art. 132 to 136 RVD*

The Art. 132 to 136 RVD provide an enumerative list with more than 30 compulsory exemptions. Most of these exemptions concern the supply of services. They have been subdivided into two categories by the Community legislator: Exemptions for certain activities in the public interest, on the one hand, and exemptions for other activities, on the other hand. The first category encompasses, *inter alia*, certain postal services, the supply of medical care, the supply of services and of goods closely linked to welfare and social security work by public entities or charitable organizations, and certain educational and cultural services. Among the transaction that fall into the second category are insurance transactions, certain financial services, the leasing or letting of immovable property, and supplies of land or buildings that meet certain conditions. As a general rule, the exemptions listed in the aforementioned provisions of the VAT Directive are *objective* ones that refer to certain features of the exempt supply[18], rather than *subjective* ones reserved exclusively to suppliers with certain personal characteristics[19]. However, with respect to some objective exemptions only taxable persons who meet certain subjective criteria as well, such as being non-profit organisations, will be eligible for the exemption at issue[20].

#### *b) Exclusion from the input VAT deduction scheme*

Pursuant to Art. 168 RVD, all of the exemptions contemplated in Art. 132 to 136 RVD imply a denial of input tax deduction for any VAT charged in the price for supplies used for the purpose of carrying out the exempt transaction. The exclusion from the substantial scope of

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[18] Cf. ECJ 26 June 2003, Case C-305/01, MKG-Kraftfahrzeuge-Factoring [2003] ECR I-6729, para. 64.

[19] *Frink*, Der Ausschluss des Vorsteuerabzugs bei der Ausführung steuerfreier Umsätze im Umsatzsteuerrecht, Regensburg 2002, p. 85; *Poblet*, Manual del IVA, 3. ed., Madrid 2006, p. 392. The French VAT terminology is more precise in this regard, because it distinguishes between an objective "exoneration" and a subjective "exemption", cf. *Mollard*, Archiv für schweizerisches Abgaberecht 1994, p. 443 (p. 448).

[20] See also ECJ 11 July 1985, Case 107/84, Commission/Germany [1985] ECR 2655, para. 13.

the input VAT deduction will only exceptionally be reversed for certain cross-border transactions where the state of destination is a third country. If input supplies are only partially used for exempt transactions, there will be granted a pro-rata deduction of input VAT, as specified in Art. 173 et seq. RVD.

### *c) The mandatory character of the Directive's provisions*

Member States may not deviate from the above system of compulsory exemptions without a right to deduct input VAT unless expressly authorized to do so. Such authorization can be granted either by the Directive itself, or by a decision of the Council that is in itself empowered to grant a waiver with respect to mandatory provisions under certain conditions, especially based on Art. 395 RVD[21]. By contrast, Art. 131 RVD which stipulates that Member States are to lay down the conditions for exemptions in order to ensure the correct and straightforward application of the exemptions and to prevent any possible evasion, avoidance or abuse, does not authorize Member States to modify the subject-matter of the exemptions envisaged by the Directive[22].

If a Member State does not (properly) transpose an exemption that is provided for by the Directive into its national VAT laws, then the taxable person might be entitled to rely directly on the Directive to claim the exemption if this turns out to be favourable for him. According to settled case-law, such direct effect only presupposes that the provisions of a directive appear, as far as their subject-matter is concerned, to be unconditional and sufficiently precise[23]. In a similar vein, if a Member State does provide for an exemption that is neither contemplated in nor authorized by the Directive, then the taxable person may rely directly on the Directive to claim an input tax credit if this turns out to be more favourable for him than the exemption[24]. In any event, the EU Commission can initiate infringement proceedings against a Member State that deviates from the Directive without proper authorization.

## 2. Non-harmonized aspects of exempt transactions

### *a) Option for taxation*

Pursuant to Art. 137 RVD, Member States may grant taxable persons a right of option for taxation in respect of a limited number of exempt transactions: certain financial transactions,

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[21] Cf. Art. 395 (1) RVD: "The Council, acting unanimously on a proposal from the Commission, may authorise any Member State to introduce special measures for derogation from the provisions of this Directive, in order to simplify the procedure for collecting VAT or to prevent certain forms of tax evasion or avoidance."
[22] Cf. ECJ 18 October 2007, Case C-97/06, Navicon [2007] ECR I-8755, para. 27.
[23] See, for instance, ECJ 25 May 1993, Case C-193/91, Mohsche [1993] ECR I-2615, para. 17.
[24] See also ECJ 14 September 2006, Case C-228/05, Stradasfalti [2006] ECR I-8391, para. 66.

the supply of buildings or land, and the leasing and letting of immovable property. The predominant purpose of this authorization consists in providing Member States with a mechanism to counter VAT cascading in B2B transactions that might occur due to the denial of a right to deduct input VAT on supplies used for exempt transactions. Even when they decide to provide that right of option, Member States are, in principle, free to restrict its scope or set forth certain prerequisites as they deem fit. At present, only very few Member States have altogether excluded that feature from their national VAT system. On the other hand, hardly any Member State grants an option to taxation for the entire range of supplies that could qualify for it by virtue of Art. 137 RVD, and most of them have established additional requirements[25].

***b) Special scheme for small enterprises***

The VAT Directive authorizes Member States to exempt taxable persons whose annual turnover is below a certain threshold. The threshold is determined on an individual basis for each Member State, as laid down in Art. 284 to 288 RVD. This special scheme for small enterprises constitutes a personal or subjective exemption[26]; in particular, any enterprise covered by its substantive scope that does not opt out is not entitled to deduct any input VAT. With the notable exception of Spain, all Member States currently provide for a registration threshold; however, the latter differs considerably depending on the respective country[27].

***c) Deductible portion of input VAT regarding mixed-use purchases***

In the case of goods or services used by a taxable person both for exempt and for taxed transactions only such proportion of the input VAT as is attributable to the taxed transactions shall be deductible[28]. By default, the deductible portion is calculated as a pro rata by putting the entire taxable turnover in proportion to the taxed turnover, as specified in Art. 174 et seq. RVD. However, Member States may have resort to alternative, more precise measures to calculate the deductible portion, which are stipulated in Art. 173 (2) RVD.

***d) Aspects of minor importance***

Finally, there are some aspects of minor importance that are not fully harmonized within the EU: Member States are authorized to make certain exemptions subject to certain conditions or

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[25] See, in greater detail, *van der Corput / Annacondia*, EU VAT Compass, IBFD 2009/2010, pp. 481 et seq.
[26] Likewise *Crawford/Keen/Smith*, in Mirrlees et al. (eds.), Dimensions of Tax Design: the Mirrlees review, 2010, p. 275 (p. 309); *Stadie*, Das Recht des Vorsteuerabzugs, Köln 1989, p. 152.
[27] For further details, consult *van der Corput / Annacondia*, EU VAT Compass, IBFD 2009/2010, pp. 413 et seq.
[28] Cf. Art. 173 (1) RVD.

to restrict their scope, by virtue of Art. 133, 135 (2) 2 RVD. Some Member States may also abstain from implementing certain exemptions which are, in principle, compulsory (cf. Art. 370, 375 et seq. RVD), and conversely, some may exempt certain transactions which constitute, in principle, taxed transactions (cf. Art. 371, 375 et seq. RVD). Finally, some Member States have negotiated as part of their transition to the common system of VAT the authorization to zero-rate certain transactions which constitute, in principle, taxed or exempt transactions (cf. Art. 375 et seq. RVD).

## 3. Interpretation of Exemptions within the EU VAT system

### *a) General observations*

The interpretation of the provisions relating to VAT exemptions is initially a task to be mastered by the Member State's national tax administrations and courts, but it is the European Court of Justice (ECJ) that has ultimate jurisdiction in this regard in so far as the disputed provision constitutes a fully harmonized element of the common system of VAT. The ECJ comprises some of Europe's brightest judges. But it is not a court that is specialized in tax law, nor has any of its chambers been designated to deal specifically with disputes concerning taxes, or VAT in particular. For that reason, the Court faces peculiar challenges in developing a coherent body of case-law, especially since the sheer number of judgments on VAT issues well exceeds 500 by now and has thus expanded considerably since the first cases were decided in the 1970s. Regarding the interpretation of VAT exemptions in particular, the problem is aggravated by the lack of a clear and consistently implemented rationale for many of the exemptions[29].

According to settled case-law of the ECJ, the exemptions provided for in the Directive have, as a general rule, their own independent meaning in Community law and must therefore be given a Community definition[30]. This will only exceptionally be different when the exemption, as contemplated in the VAT Directive, makes express reference to the law of the

[29] For extensive analysis, see below at IV.

[30] Cf. ECJ 5 June 1997, Case C-2/95, SDC [1997] ECR I-3017, para. 21; ECJ 4 October 2001, Case C-326/99, Goed Wonen [2001] ECR I-6831, paras. 47 et seq.; ECJ 11 June 2009, Case C-572/07, Tellmer Property [2009] ECR I-7501, para. 15; ECJ 28 January 2010, Case C-473/08, Ingenieurbüro Eulitz, n.y.r., para. 25; ECJ 3 June 2010, Case C-237/09, De Fruytier, para. 21; and the case-law cited there. For critical comments regarding the exemption for the letting of real estate, see Opinion Statement of the CFE on the distinction between taxable and VAT exempt letting of immovable property, submitted in Nov. 2009. However, the statement ignores the international distortions of competition that might arise in case of a national interpretation due to a possible denial of a credit also in B2B transactions.

Member States for the purposes of determining its meaning and scope[31]. Furthermore, the ECJ has consistently held that exemptions from VAT should be interpreted „strictly", because they constitute exceptions. This restrictive stance was never explained further by the Court; it could be regarded as an implicit acknowledgement of the aforementioned difficulties of rational interpretation, or as carried by the desire to pursue as far as possible the fundamental concept of VAT as a *general* tax on consumption expenditure, as laid down in what is now Art. 1 (2) RVD.

However, the Court's approach has repeatedly been criticized as too simplistic by prominent scholars. A distinguished Advocate General observed that the provisions on exemptions "should not be whittled away by interpretation… As a corollary, limitations on exemptions should not be interpreted narrowly, but nor should they be construed so as to go beyond their terms. Both the exemptions and any limitations on them must be interpreted in such a way that the exemption applies to that to which it was intended to apply and no more."[32] This criticism had its impact on the Court's jurisprudence[33], and in recent times the ECJ has made express reference also to the need of systematic interpretation and purposive construction[34]. It should be noted, though, that the ECJ still relies heavily on a literal interpretation of exemptions. The Court is very reluctant to interpret them beyond their wording, i.e. to apply them by analogy, even when their purpose and objective would suggest such an approach[35]. Along the same lines, the ECJ has also refused to construe an exemption narrower than its seemingly clear and unambiguous wording would suggest[36].

In order to identify the principles or public policy goals underlying an exemption, the ECJ has frequently referred to the directive's preamble[37], but it has also drawn inspiration from the

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[31] ECJ 3 December 2009, Case C-433/08, Yaesu Europe [2009] ECR I-11487, para. 18.

[32] AG Jacobs, Opinion of 13 December 2001, Case C-267/00, Zoological Society of London [2002] ECR I-3353, paras. 18 et seq. Likewise *Terra/Kajus*, Introduction to European VAT, Amsterdam 2010, p. 697; *Stadie*, UStG,, Köln 2009, pp. 479 et seq.

[33] For further details, see *Schulyok*, International VAT Monitor 2010, p. 266 (pp. 267 et seq.). It should be noted, though, that the Court has *de facto* never relied on the "strict interpretation" formula alone when it handed down its judgements on VAT exemptions, also in its early judgements.

[34] See, for example, ECJ 14 June 2007, Case C-434/05, Horizon College [2007] ECR I-4793, para. 16; ECJ 18 November 2004, Case C-284/03, Temco Europe [2004] ECR I-11237, para. 17; ECJ 18 November 2010, Case C-156/09, Verigen Transplantation Service International, n.y.r., paras. 23 et seq. For further references, see *Terra/Kajus*, Introduction to European VAT, Amsterdam 2010, pp. 234 et seq., and the case-law cited there.

[35] A negative example in this regard is the case *Seeling*, cf. ECJ 8 May 2003, Case C-269/00, Seeling [2003] ECR I-4101; for critical comments, see *Reiß*, in Tipke/Lang (eds.) Steuerrecht, 20. ed., Köln 2010, § 14 para. 89.

[36] Cf. ECJ 29 October 2009, Case C-29/08, AB SKF [2009] ECR I-10413., paras. 46 et seq.

[37] See, for example, ECJ 26 September 1996, Case C-327/94, Dudda [1996] ECR I-4595, para. 22; ECJ 23 April 2009, Case C-357/07, TNT Post UK [2009] ECR I-3025, para. 48.

normative context and overall system of the directive[38]. The ECJ has also resorted to somewhat more formal contextual arguments relying on the positioning of the exemption at issue within the Directive's sections or sub-sections[39]. Furthermore, the Court has occasionally referred to the legal history of the provision at issue in so far as the relevant considerations are published and thus accessible to the taxpayer[40]. Therefore, the explanatory memoranda accompanying the respective legislative proposal made by Commission are also relevant[41]. Another valuable source of interpretation is provided by comparing the various language versions of the Directive[42]. By contrast, the interpretation of exemptions need not necessarily be reconciled with similar definitions or concepts in other sources of secondary EU law that deal with the subject matter of the exemption. However, it must be carefully examined on a case by case basis if contextual, historical, or teleological arguments support the consideration of other legal provisions beyond the ones contained in the VAT Directives[43].

Finally, the ECJ has repeatedly held that whenever the wording of secondary Community law is ambiguous, preference should be given to the interpretation which renders the provision consistent with the EU treaties, and with the fundamental rights protected by the EU legal order "or with the other general principles of Community law". In the area of VAT, this convincing approach has materialized in an accentuated role of the principle of fiscal neutrality in the interpretation of exemptions[44]. In particular, the scope of an exemption must

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[38] See, for example, ECJ 24 May 1988, Case 122/87, Commission/Italy [1988] ECR I-2685, para. 10; ECJ 4 October 2001, Case C-326/99, Goed Wonen [2001] ECR I-6831, para. 53; ECJ 8 December 2005, Case C-280/04, Jyske Finans [2005] ECR I-10683, para. 34 et seq.

[39] See, for example, ECJ 12 November 1998, Case C-149/97, Institute of the Motor Industry [1998] ECR I-7053, paras. 18 and 21.

[40] Cf. ECJ, 27 March1990, Case C-372/88, Cricket St. Thomas [1990] ECR I-1345, para. 19; ECJ 5 June 1997, case C-2/95, SDC [1997] ECR I-3017, para. 22; ECJ 14 September 2010, Case C-384/98, "D" [2000] ECR I-6795, para. 16; see also *Terra/Kajus*, Introduction to European VAT, Amsterdam 2010, pp. 237 et seq., and the case-law cited there.

[41] Cf. ECJ 6 March 2008, Case C-98/07, Nordania Finans [2008] ECR I-1281, para. 22; ECJ 29 October 2009, case C-174/08, NCC Construction [2009] ECR I-10567, para. 30. By contrast, declarations recorded in Council minutes in the course of preparatory work leading to the adoption of a directive cannot be used for the purpose of interpreting that directive where no reference is made to the content of the declaration in the wording of the provision in question, cf. ECJ 8 June 2000, Case C-375/98, Epson Europe [2000] ECR I-4243, para. 26.

[42] Cf. ECJ 2 April 1998, Case C-296/95, EMU Tabac [1998] ECR I-1605, para. 36; ECJ 12 November 1998, Case C-149/97, Institute of the Motor Industry [1998] ECR I-7053, para. 16; ECJ 26 June 2003, Case C-305/01, MKG-Kraftfahrzeuge-Factoring [2003] ECR I-6729, paras. 67 et seq.; ECJ 26 May 2005, Case C-498/03 Kingscrest [2005] ECR I-4427, para. 26. See also *Terra/Kajus*, Introduction to European VAT, Amsterdam 2010, pp. 226 et seq., and the case-law cited there.

[43] Cf. ECJ 25 February 1999, Case C-349/96, Card Protection Plan [1999] ECR I-973, paras. 17 et seq.; ECJ 28 June 2007, Case C-363/05, JP Morgan Fleming Claverhouse [2007] ECR I-5517; ECJ 23 April 2009, Case C-357/07, TNT Post UK [2009] ECR I-3025.

[44] See, for example, ECJ 12 January 2006, Case C-264/04, Turn- und Sportunion Waldburg [2006] ECR I-589, para. 34; ECJ 17 February 2005, Joined Cases C-453/02 and C-462/02, Linneweber and Akritidis [2005] ECR

be construed, at least within the limits set by its wording[45], so as to ensure that similar goods and supplies of services, which are thus in competition with each other, are treated equally[46]. Thus, unless specified otherwise, the status of the entity providing the supply (public body, charity, profit-oriented entity, etc.) should not be relevant[47].

By virtue of the provisions on Community loyalty[48], national tax administrations and courts must interpret the exemptions enshrined in their respective national VAT statutes in a manner consistent with the corresponding provision of the RVD, taking into account the rules of interpretation discussed above. Arguably, this obligation can now also be derived from the more specific provision of Art. 291 (1) TFEU. The authorities and courts of the Member States must also make sure that they do not rely on an interpretation of them which would be in conflict with the various fundamental rights protected by the Community legal order or with the other general principles of Community law[49]. In so far as the Directive grants – exceptionally – discretion to the Member States regarding the scope or conditions of an exemption, it must not be construed so as to impair fiscal neutrality[50].

***b) Specific topics of general interest***

(1) Complex transactions

When a taxable transaction comprises a bundle of elements and acts, only some of which would qualify for an exemption if each element was viewed in isolation, the question arises as to whether the remaining elements nevertheless fall under the scope of the exemption, too, because they form part of a single transaction for VAT purposes. A similar problem surfaces in the context of the place of supply rules that differentiate between supplies of goods and

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I-1131, para. 24 et seq. See also *Martínez Muñoz*, Revista española de Derecho Financiero 2010, p. 145 (p. 184).

[45] This limit is emphasized by *Schulyok*, International VAT Monitor 2010, p. 266 (pp. 269 et seq.); however, an application by analogy should also be allowed for to ensure conformity with primary union law requirements, so long as it can be defended as *interpretatio praetor legem* rather than *interpretatio contra legem*.

[46] See, for example, ECJ 7 September 1999, Case C-216/97, Gregg [1999] ECR I-4947, para. 20; ECJ 4 May 2006, Case C-169/04, Abbey National [2006] ECR I-4027, para. 68; ECJ 10 March 2011, Case C-540/09, Skandinaviska Enskilda Banken, n.y.r., paras. 20 and 36. See also *Martínez Muñoz*, Revista española de Derecho Financiero 2010, p. 145 (184). The Court's case law is not entirely consistent in this regard, though, as can e.g. be seen in ECJ 18 November 2010, Case C-156/09, Verigen Transplantation Service International, n.y.r., paras. 30 et seq.

[47] See, in this regard, also *Tait*, Value-Added Tax, Washington 1988, p. 69.

[48] Cf. ECJ 10 April 1984, Case 14/83, Colson [1984] ECR 1891, para. 26.

[49] Cf. ECJ 6 November 2003, Case C-101/01, Lindqvist [2003], ECR I-12971, para. 87; ECJ 26 June 2007, Case C-305/05, Ordre des barreaux francophones et germanophone [2007]ECR I-5305, para. 28.

[50] Cf. ECJ 28 June 2007, Case C-363/05, JP Morgan Fleming Claverhouse Investment Trust [2007]ECR I-5517, paras. 22 and 43; ECJ 10 June 2010, Case C-58/09, Leo-Libera, n.y.r., paras. 34 et seq.

supplies of services, and furthermore require more specific classifications, based on the objective characteristics of the transaction, within each category of supply.

By and large, the Court has developed identical criteria in the context of either of the aforementioned scenarios in order to decide whether a composite or complex transaction really constitutes one single supply, and if so, which element(s) should be regarded as the characteristic ones. According to settled case-law, every transaction must normally be regarded as distinct and independent. However, a transaction which comprises a single supply from an economic point of view should not be artificially split[51]. This can be confirmed where two or more elements or acts supplied by the taxable person to the customer are so closely linked that they form, objectively, a single, indivisible economic supply[52]. Such is also the case where one or more elements are to be regarded as constituting the principal service, whilst one or more elements are to be regarded, by contrast, as ancillary services which share the tax treatment of the principal service. In particular, a service must be regarded as ancillary to a principal service if it does not constitute for customers an aim in itself, but a means of better enjoying the principal service supplied[53].

However, it must not go unnoticed that there is also a fundamental difference between the delimitation of the scope of an exemption, on the one hand, and of a place of supply rule, on the other hand: In the latter case, the question at issue will tend to focus on which proxy for the destination principle should apply in B2B transactions, and in B2C trade the analysis will usually determine whether the destination principle applies at all[54]. As a general rule, considerations of a tax-technical nature are dominating this assessment. By contrast, the application of an exemption usually implies the conferral of a tax privilege upon the final consumer or, exceptionally, upon the taxable person, which must be justified by overriding reasons of public interest[55]. Therefore, two additional aspects come into play, both of which have occasionally already been relied on by the Court: First, it is appropriate to take into account of the objective pursued by the exemption – provided that it is discernible – in order

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[51] Cf. ECJ 2 December 2010, Case C-276/09, Everything Everywhere, n.y.r., paras. 21 et seq. and the (settled) case-law cited there.

[52] Cf. ECJ 27 October 2005, Case C-41/04, Levob Verzekeringen [2005] ECR I-9433, paras. 20 and 22; ECJ 29 March 2007, Case C-111/05, Aktiebolaget NN [2007] ECR I-2697, paras. 22 et seq.; ECJ 21 February 2008, case C-425/06, Part Service [2008] ECR I-897, para. 53; ECJ 11 February 2010, Case C-88/09, Graphic Procédé, n.y.r., para. 19.

[53] ECJ 29 March 2007, Case C-111/05, Aktiebolaget NN [2007] ECR I-2697, para. 28; ECJ 21 February 2008, Case C-425/06, Part Service [2008] ECR I-897, paras. 51 et seq.; ECJ 11 June 2009, Case C-572/07, Tellmer Property [2009] ECR I-7501, para. 18; ECJ 11 February 2010, Case C-88/09, Graphic Procédé, n.y.r., para. 24.

[54] For further details, see *Terra/Kajus*, Introduction to European VAT, Amsterdam 2010, pp. 485 et seq.

[55] See, in this regard, below at III.2.

to determine whether those elements of the composite transaction at issue that would not by themselves qualify for the exemption are indeed closely linked or of a merely ancillary nature to the qualifying elements[56]. Second, the extension of the exemption must not lead to serious distortions of competition that would infringe the fundamental principle of fiscal neutrality[57]. In general, this calls for a restrictive approach towards assessing complex transactions in the context of VAT exemptions.

(2) Outsourcing

The denial of input VAT deduction that corresponds with a VAT exemption[58] provides an incentive for vertical integration of business, contrary to the principle of fiscal neutrality. The outsourcing of constituent elements of an exempt transaction to a legally independent service provider will imply an additional and irrecoverable VAT burden for the supplier of the exempt goods or services[59], if his subcontractor does not benefit from the exemption himself. To alleviate these negative effects, the ECJ has developed a set of criteria whose fulfilment will permit to include the activities realized by the subcontractor in the scope of the exemption. According to settled case-law, they must, viewed broadly, form a distinct whole, fulfilling in effect the specific, essential functions of a transaction described in the exemption at issue[60]. By contrast, mere material or technical supplies which do not share the characteristic features that distinguish the exempt transaction from other supplies, such as the making available of a system of information technology, are not covered by the respective exemption[61].

The jurisprudence of the Court thus requires that the outsourced supply forms a well-matched and clearly definable composition of goods and / or services ("distinct whole") which, having

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[56] Cf. ECJ 1 December 2005, Joined Cases C-394/04 and C-395/04, Diagnostiko & Therapeftiko Kentro Athinon-Ygeia, para. 22 and 25; Bundesfinanzhof, 10 December 2009, Case V R 18/08, BFHE 227, 528.

[57] Cf. ECJ 1 December 2005, Joined Cases C-394/04 and C-395/04, Diagnostiko & Therapeftiko Kentro Athinon-Ygeia, para. 32 et seq.; see also ECJ 11 June 2009, Case C-572/07, Tellmer Property [2009] ECR I-7501, para. 22. However, see also ECJ 2 December 2010, Case C-276/09, Everything Everywhere, n.y.r., para. 31, regarding the reverse situation of an ancillary element of a supply that would be exempt if assessed in isolation. Here, the Court did not esteem the neutrality principle very highly, probably well aware of the serious and indeed disproportionate complications that the exemption of a minor part of an integrated supply and the ensuing need to determine and apply a pro rata for the calculation of the deductible input VAT would imply.

[58] For further details, see below at V.

[59] See also – with respect to public sector entities that carry out non-taxable or exempt transactions – *Copenhagen Economics / KPMG*, VAT in the public sector and exemptions in the public interest, Final Report for TAXUD/2009/DE/316, 2011, pp. 10 et seq., p. 13.

[60] Cf. ECJ 5 June 1997, Case C-2/95, SDC [1997] ECR I-3017, para. 66, ECJ 13 December 2001, Case C-235/00, CSC Financial Services [2001] ECR I-10237, para. 25; ECJ 4 May 2006, Case C-169/04, Abbey National [2006] ECR I-4027, para. 70.

[61] Cf. ECJ 5 June 1997, Case C-2/95, SDC [1997] ECR I-3017, para. 66; ECJ 4 May 2006, Case C-169/04, Abbey National [2006] ECR I-4027, para. 71.

regard to its inherent and objective characteristics[62], features core elements of the exempt transaction that characterize and distinguish the latter ("specific functions") and contributes significantly to the performance of the exempt transaction as contemplated in relevant provision ("essential functions"). For the sake of fiscal neutrality, the latter criterion in particular should not be applied overly strict. However, it is not sufficient, all by itself, that the supply by the subcontractor constitutes an indispensable element of the exempt transactions[63].

## III. Benchmarks for the analysis of exemptions

Pursuant to the preamble and to Art. 1 RVD, the common system of EU VAT intends to establish a VAT that is harmonized as between Member States, neutral with respect to competition between economic operators, and designed as a general tax on expenditure for consumption exactly proportional to the price of the goods and services. Just like in other jurisdictions with a comprehensive VAT or GST, exemptions constitute an "alien matter" within the tax system[64]. They raise concerns regarding both, optimal tax policy and constitutional requirements of the tax system. In the following, the paper will elaborate on the respective benchmarks in so far as they are relevant, before applying them to the specific rules to be examined. Tax policy aspects will only be discussed rather briefly, though, since the paper intends to contribute to the debate mainly from a legal perspective.

### 1. Tax policy considerations

#### *a) Neutrality*

According to modern theory of public finance, a key requirement for a good tax system is that it should ideally not interfere with the efficient allocation of resources[65]. As a general rule, a tax system should therefore be neutral with respect to the decisions of market agents (the supply and the demand side) in the absence of market failure[66]. There is a common belief among economists that considering information asymmetries and the reality of political decision making, "… best practice… strongly indicates that the consumption base of the VAT should be defined as broadly as possible and that all goods and services should be taxed at a

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[62] Special reference to the objective characteristics is also made by *Heidemann*, Die Umsatzsteuerbefreiungen von Finanzdienstleistungen, Berlin 2008, p. 216.
[63] Cf. ECJ 13 December 2001, Case C-235/00, CSC Financial Services [2001] ECR I-10237, para. 32.
[64] Likewise *Guía del Impuesto sobre el Valor Añadido*, 8. ed., Valencia 2006, p. 289; *Ruppe*, in Lang (ed.), Die Steuerrechtsordnung in der Diskussion, Festschrift für Klaus Tipke, Köln 1995, p. 457 (p. 461).
[65] Pars pro toto *Stieglitz*, Economics of the Public Sector, 3rd ed. 2000, pp. 458 et seq.
[66] Pars pro toto *Tiley*, Revenue Law, 6th ed. 2008, p. 11.

uniform rate" in order to promote fiscal neutrality[67]. One of the main arguments brought forward in favour of a comprehensive VAT in this context is that it leaves relative factor prices unchanged[68]. By contrast, exemptions are hardly ever fully neutral with respect to competing goods or services. Moreover, the neutrality requirement extends also to the organization of business activities. Finally, any national tax system – or in case of the EU VAT, the European tax system – should also not cause distortions in international commerce[69]. With respect to both aspects, the "input taxation" effect inherent to the "standard" EU VAT exemption causes problems[70].

In so far as an incentive or disincentive for certain behaviour not following market rationale is desired by the legislator contrary to the neutrality principle, or a correction of market outcome is intended, it should be achieved in the most efficient way (and therefore possibly not as a tax measure). However, unlike direct personal taxes, VAT as an indirect tax is often ill-suited to pursue extra-fiscal policy goals through tax concessions. VAT laws only address the taxable person in his function as a tax collector, rather than the final consumer who is supposed to be the final taxpayer and who is therefore normally intended to ultimately benefit from most objective exemptions[71]. Exemptions therefore often cannot be tailored to their objective without producing free-rider effects, due to the impossibility to make their grant dependent upon the fulfilment of certain personal criteria by the recipient of the supply at issue.

It is finally worth mentioning that VAT exemptions may diminish or aggravate the distortions caused by the respective system of direct personal taxes[72].

***b) Simplicity and administrative efficiency***

A tax system should not cause disproportionate or even excessive costs for those affected, taking into account both, compliance costs of the taxpayer and administrative costs of the tax

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[67] Cf. *Cnossen*, in Mirrlees et al. (eds.), Dimensions of Tax Design: the Mirrlees review, Oxford 2010, p. 370; *the same*, International Tax and Public Finance 5 (1998), p. 399. See also *Crawford/Keen/Smith*, in Mirrlees et al. (eds.), Dimensions of Tax Design: the Mirrlees review, Oxford 2010, p. 275 (pp. 286 et seq.): uniform taxation of all commodities tends to be the best guarantee for neutrality of taxation; likewise *van Brederode*, Systems of General Sales Taxation, Alphen aan den Rijn 2009, p. 46.

[68] Cf. *Bhatia*, Journal of Public Economics, Vol. 19 (1982), p. 203 (pp. 209 et seq.).

[69] Cf. *van Brederode*, Systems of General Sales Taxation, Alphen aan den Rijn 2009, p. 47; *Meade*, The Structure and Reform of Direct Taxation, 1978, p. 20.

[70] To be discussed below at V.1.c.

[71] Cf. *Tonner*, Umsatzsteuerbefreiung heilberuflicher Leistungen, Berlin 2005, p. 30; for an in-depth analysis, see below at III.2.b.(2).

[72] See the different examples given by *Gottfried/Wiegard*, Journal of Public Economics 46 (1991), p. 307 (pp. 325 et seq.), on the one hand; and by *ab Iorwerth/Whalley*, The Canadian Journal of Economics 35 (2002), p. 166 (pp. 173 et seq.).

authorities[73]. This requires, first, to implement its fundamental principles as consistently as possible so as to maintain structural simplicity and enhance legal certainty. This aspect, too, calls for a comprehensive design of VAT[74]. Since exemptions are by definition exceptions[75] they add complexity to the tax system. In particular, they tend to give rise to difficult interpretive questions regarding the delimitation of their scope[76]. The resulting increase in compliance costs and risks for business will also tend to reduce the benefits of the exemption for the taxpayer[77]. Moreover, in the EU context these drawbacks are particularly severe, because exemptions are supposed to be interpreted uniformly in all Member States[78], which has proven to be an almost insurmountable task for national tax administrations and courts[79]. Second, a balanced trade-off may be required between the individual assessment of all the circumstances that should matter for the scope of an exemption pursuant to its underlying objective, on the one hand, and the lower administrative costs corresponding to a higher degree of standardization[80].

***c) Transparency***

Considerations of public choice and political accountability call for transparency of the tax system[81]. In the context of VAT exemptions, this implies that it should be clear who is the intended beneficiary, and these intentions should not be incongruous with economic reality. Moreover, the extent of the tax concession ensuing from an "exemption" should not be left in the shadows of tax technicalities and market mechanisms hard to grasp by ordinary citizens (and voters); it can already be stated here that with respect to exemptions without credit, the Australian term "input-taxation" would therefore be clearly preferable.

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[73] Cf. *Gale/Holtzblatt*, in Zodrow/Mieszkowski (eds.), US Tax Reform in the 21st Century, Cambridge 2002, pp. 179 and 185.

[74] Cf. *Cnossen*, in Mirrlees et al. (eds.), Dimensions of Tax Design: the Mirrlees review, Oxford 2010, p. 370.

[75] Cf. *Hoffsümmer*, Steuerbefreiungen für Inlandsumsätze, Frankfurt a.M. 2009, p. 3; *Martínez Muñoz*, Revista española de Derecho Financiero 2010, p. 145 (p. 183).

[76] Cf. *Camenzind/Honauer/Vallender*, Handbuch zum MwSt-Gesetz, 2. ed., Bern 2003, p. 235 (para. 652); *Heidemann*, Die Umsatzsteuerbefreiungen von Finanzdienstleistungen, Berlin 2008, pp. 38 et seq.; *Raboy*, in Weidenbaum et al. (eds.), The Value Added Tax: Orthodoxy and New Thinking, Boston 1989, p. 87 (pp. 92 et seq.). For some very nice examples, see *Tait*, Value-Added Tax, Washington 1988, pp. 70 et seq.

[77] Cf. *van Brederode*, Systems of General Sales Taxation, Alphen aan den Rijn 2009, p. 132; *Camenzind/Honauer/Vallender*, Handbuch zum MwSt-Gesetz, 2. ed., Bern 2003, p. 236 (para. 654); *Krever*, in Krever (ed.), VAT in Africa, Pretoria 2008, p. 9 (p. 17).

[78] See above at II.3.a.

[79] The latter, supranational problem could be alleviated by implementing measures at the EU level – in particular, Council Regulations based on Art. 397 RVD – but the Commission and the Council have so far been reluctant to enact such measures.

[80] For instance, an exemption for books that is intended to promote the consumption of a seemingly meritorious good might refrain from making further distinctions, thus also covering "profane" books such as train timetables. For further examples, see *Tait*, Value-Added Tax, Washington 1988, p. 74.

[81] Pars pro toto *Stiglitz*, Finanzwissenschaft, München 2000, pp. 416. et seq.

***d) Flexibility***

The fact that within the EU the exemptions listed in the VAT Directive are supposed to be uniformly granted has additional drawbacks. Such a harmonized system of mandatory exemptions may force certain social, economic etc. policy priorities upon individual Member States even though the respective national government would not, by itself, want to pursue such politics (any more). Member States may thus be forced to forgo revenue and raise it otherwise by increasing the regular VAT rate or other taxes[82]. This is a particularly harsh consequence for new Member States who must, as a general rule, accept the catalogue of "standard" exemptions without ever having influenced it. By contrast, a restrictive approach to exemptions in the European VAT Directives would not hinder Member States to pursue their eventual non-tax policies, either by resorting to direct subsidies or through concessions in other, non-harmonized taxes. These considerations call for a strict limitation of exemptions.

**2. Constitutional requirements**

It is suggested that within the EU, exemptions and the distortions caused by them do have an additional, (quasi-)constitutional dimension:

***a) General observations***

Pursuant to Art. 2 EU, the European Union is founded on, inter alia, freedom, equality, and the rule of law, and it is based on a society in which justice prevails. Art. 6 (1) EU specifies further that "the Union recognises the rights, freedoms and principles set out in the Charter of Fundamental Rights of the European Union, which shall have the same legal value as the Treaties". Moreover, Art. 6 (3) EU adds that "fundamental rights, as guaranteed by the European Convention for the Protection of Human Rights and Fundamental Freedoms and as they result from the constitutional traditions common to the Member States, shall constitute general principles of the Union's law". All Community institutions are bound to respect these superior principles of EU law, in particular when enacting rules of secondary EU law. The enactment of VAT legislation constitutes no exception in this regard, as the ECJ has demonstrated on various occasions[83]. For that reason, exemptions need to be justified in so far

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[82] Admittedly, these taxes could be fine-tuned so as to correlate closely to a certain exemption, e.g. by imposing an insurance tax at the standard VAT rate so as to compensate for the exemption of insurance services. However, it is suggested here that such specific excise duties may not wholly undermine the exemption stipulated by the Directive, hence distortions or shortcomings will (have to) remain, even apart from the denial of a right to deduct input tax which will be discussed later on.

[83] It should be noted, though, that so far the ECJ has never declared void any provision of the VAT Directives on grounds of a presumed incompatibility with superior principles of EU law.

as they constitute a *prima facie* infringement of the equality principle, a freedom right, or any other general principle referred to in Art. 2 and 6 EU.

According to Art. 3 (3) 1 EU, the EU shall establish an internal market. Pursuant to Art. 26 (2) TFEU, the internal market shall comprise an area without internal frontiers in which the free movement of, inter alia, goods and services is ensured. Precisely in order to ensure the establishment and the functioning of the internal market, the competence to adopt provisions for the harmonisation of legislation concerning turnover taxes has been conferred upon the Union in Art. 113 EU. Consequently, exemptions also need to be justified in so far as they constitute a *prima facie* infringement of the guarantees of free movement of goods (Art. 34 et seq. TFEU and Art. 110 TFEU) or of the freedom to provide services (Art. 56 TFEU). It should be noted, though, that such an infringement will only exceptionally occur; usually with regard to those aspects of the exemption regime that have not as yet been fully harmonized[84]. For example, Art. 135 (1) (g) exempts the management of special investment funds "as defined by Member States". If a Member State proceeds to define as beneficiaries only investment funds established under national law, as Germany did until a few years ago, this constitutes an obstacle to the freedom to provide services within the meaning of Art. 56 TFEU.

As a general rule, the provisions on prohibited State aid stipulated in Art. 107 TFEU are not applicable to VAT exemptions; this has also been acknowledged by the Commission[85]. Under Article 107 (1) TFEU, "any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the common market". The ECJ has convincingly pointed out that those parts of the VAT system which are set up by Community legislation and must be uniformly implemented by all Member States do not meet the condition of intervention by the State and therefore do not constitute State aid within the meaning of Art. 107 (1) TFEU[86].

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[84] Cf. *Hoffsümmer*, Steuerbefreiungen für Inlandsumsätze, Frankfurt a.M. 2009, pp. 29 et seq.

[85] Cf *EU Commission*, Report on the implementation of the Commission notice on the application of the state aid rules to measures relating to direct business taxation, 9 February 2004, C(2004)434, http://ec.europa.eu/competition/state_aid/studies_reports/rapportaidesfiscales_en.pdf, para. 72.

[86] Cf. ECJ 23 April 2009, Case C-460/07,Puffer [2009] ECR I-3251, paras. 67 to 71; CFI (Court of first instance) 5 April 2006, Case T-351/02, Deutsche Bahn / Commission [2006] ECR II-1047, para. 100 u. 103. See also Opinion of GA *Jacobs* 13 December 2001, Case C-482/99, France / Commission [2002] ECR I-4397, para. 54, who convincingly pointed out that "the second alternative in Article 87(1) [now Art. 107 (1)] of the Treaty (aid granted through State resources) … serves only to preclude circumvention of the State aid rules through

***b) Relevant Constitutional principles***

For the reasons given above, the main standard of quasi-constitutional review of any VAT exemptions in the context of the common system of EU VAT are the fundamental rights and general principles which are binding upon the Union legislator. In the context of VAT, and with regard to exemptions in particular, the following rights and principles are specifically relevant:

(1) Fiscal neutrality for business as a corollary of the equality principle

It is settled case law that the equality principle has to be considered a fundamental right[87] and thus constitutes one of the fundamental and general principles of Union law[88]. Its character as a superior principle of EU law has recently been enhanced when Art. 20 of the Charter of Fundamental Rights became legally binding for almost all Member States, pursuant to Art. 6 (1) EU Treaty as amended by the so-called Lisbon Treaty. Sometimes also denominated as general principle of non-discrimination, equal treatment requires, according to the ECJ, that similar situations be not treated differently and different situations be not treated alike unless such treatment is objectively justified[89]. In recent years, the ECJ has even repeatedly held that in the field of VAT, the principle of fiscal neutrality is "the" reflection of the fundamental principle of equal treatment[90].

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decentralised or privatised distribution of aid. That means however that where aid is granted under the second alternative through State resources the measure must be the result of action of the Member State concerned."

[87] ECJ 13 April 2000, Case 292/97,Karlsson [2000] ECR I-2737, paras. 37 et seq.; ECJ 12 December 2002, Case C-442/00, Caballero [2002] ECR I-11915, paras. 31 et seq.; ECJ 13 December 2005, case C-177/05, Guerrero Pecino [2005], ECR I-10887, para. 26; ECJ 7 September 2006, Case C-81/05, Alonso [2006] ECR I-7569, para. 37. See also *Tridimas*, The General principles of EU Law, 2nd ed., Oxford 2006, p. 60.

[88] ECJ 12 February 2002, joined Cases C-27/00 and C-122/00, Omega Air a.o. [2002] ECR I-2569, para 79; ECJ 20 October 2005, Case C-334/03, Commission/Portugal [2005] ECR I-8911, para. 23 et seq.; ECJ 15 April 1997, Case C-27/95, Bakers of Nailsea [1997] ECR I-1847, para 17; ECJ 16 December 2008, Case C-127/07, Arcelor [2008] ECR I-9895, para. 23.

[89] See, to that effect, ECJ 17 July 1997, joined Cases C-248/95 and C-249/95, SAM Schiffahrt and Stapf [1997] ECR I-4475, para. 50; ECJ 13 April 2000, Case C-292/97, Karlsson [2000] ECR I-2737, para. 39.

[90] Cf. ECJ 26 May 2005, Case C-498/03, Kingscrest Associates [2005] ECR I-4427, paras. 54 et seq.; ECJ 27 April 2006, joined Cases C-443/04 and C-444/04, H.A. Solleveld a.o. [2006] ECR I-3617, para. 35; ECJ 8 June 2006, case C-106/05, L.u.P. [2006] ECR I-5123, para. 48; ECJ 7 December 2006, case C-240/05, Eurodental [2006] ECR I-11479, para. 55; ECJ 10 April 2008, Case C-309/06, Marks & Spencer [2008] ECR I-2283, paras. 47 and 49; ECJ 10 July 2008, Case C-484/06, Fiscale eenheid Koninklijke Ahold [2008] ECR I-5097, para. 36; ECJ 23 April 2009, Case C-460/07, Puffer [2009] ECR I-3251, para. 53. Hence, fiscal neutrality should properly be regarded as a VAT-specific sub-principle of the more fundamental principle of equal treatment, instead of the reverse. For an in-depth discussion, see *Englisch*, in Schön/Beck (eds.), Zukunftsfragen des deutschen Steuerrechts, Heidelberg 2009, pp. 39 et seq.; for a different opinion, see *de la Feria*, The EU VAT System and the Internal Market, Amsterdam 2009, pp. 262 et seq.

Fiscal neutrality as interpreted by the Court of Justice[91] precludes, as already mentioned, treating similar goods or similar economic transactions, which are in competition with each other, differently for VAT purposes[92]. Occasionally, the ECJ has also stressed the requirement of organizational neutrality of VAT[93]. Moreover, the principle of fiscal neutrality is also conceived by the ECJ to require, as a general rule, a full relief of the taxable person with respect to VAT burden payable or paid in the course of all her taxable economic activities[94]. This latter aspect is closely related to the conception of VAT as a tax on consumer expenditure, rather than business expenses[95]. The constitutional status that must be attributed to the neutrality principle as a presumed reflection of the equality principle implies that any infringement must serve legitimate conflicting interests or policies and do so in a proportionate manner[96].

It should be noted, though, that the ECJ has recently decided that different from the equality principle, the principle of fiscal neutrality would be merely a "fundamental principle underlying the common system of VAT established by the relevant Community legislation" and therefore "subject of detailed rules" that may deviate from it without need for justification"[97]. Against the background of the above conclusions, it is respectfully submitted that the ECJ's reasoning is inconsistent or at least misleading and should not establish a model for future case-law. If fiscal neutrality is presumed to be a or even "the" reflection of equality in the area of VAT, then any VAT regime that does not comply with requirements of fiscal neutrality must by definition also constitute, ultimately, an infringement of the equality principle, to be justified according to the standards developed for such infringements.

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[91] For a thorough analysis of the Court's case-law on fiscal neutrality, see also *Martínez Muñoz*, Revista española de Derecho Financiero 2010, p. 145 (pp. 149 et seq.).

[92] Cf. ECJ 11 June 1998, Case C-283/95, Fischer [1998] ECR I-3369, paras. 21 and 27; ECJ 13 May 2001, Case C-481/98, Commission v France, [2001] ECR I-3369, para. 22; ECJ 23 October 2003, Case C-109/02, Commission v Germany [2003] ECR I-12691, para 20; ECJ 16 September 2004, Case C-382/02, Cimber Air [2004] ECR I-8379, para. 24; ECJ 7 December 2006, Case C-240/05, Eurodental [2006] ECR I-11479, para. 46; ECJ 18 October 2007, Case C-97/06, Navicon [2007] ECR I-8755, para. 21; ECJ 22 May 2008, Case C-162/07, Ampliscientifica and Amplifin [2008] ECR I-4019, paras. 25 et seq.

[93] Cf. ECJ 21 June 2007, Case C-453/05, Ludwig [2007] ECR I-5083, para. 35.

[94] Cf. ECJ 8 June 2000, Case C-400/98, Breitsohl [2000] ECR I-4321, para. 37; ECJ, 23 April 2009, Case C-460/07, Puffer [2009] ECR I-3251, para. 47.

[95] See, for instance, ECJ 10 July 2008, Case C-484/06, Fiscale eenheid Koninklijke Ahold [2008] ECR I-5097, para. 36. See also *Frink*, Der Ausschluss des Vorsteuerabzugs bei der Ausführung steuerfreier Umsätze im Umsatzsteuerrecht, Regensburg 2002, pp. 63 et seq.; *Heidemann*, Die Umsatzsteuerbefreiungen von Finanzdienstleistungen, Berlin 2008, p. 30; *Reiß*, in Lang (ed.) Die Steuerrechtsordnung in der Diskussion, Festschrift für Klaus Tipke, Köln 1995, p. 433 (p. 440).

[96] As regards the specific requirements of the proportionality principle, see below at (3).

[97] Cf. ECJ 29 October 2009, Case C-174/08, NCC Construction [2009] ECR I-10567, paras. 41-43.

(2) Fair taxation of final consumers as a corollary of the equality principle

It is the common constitutional tradition of (almost) all Member States of the EU to inseparably link tax equality with the notions of tax equity and tax fairness[98]. The legislator is thus constitutionally required, in the field of taxation, to plausibly pursue a reasonable concept of tax fairness in a consistent manner, in principle without privileging or discriminating against any individual taxpayer. This should therefore also be the standard of review to be derived from the right to equal treatment enshrined in Art. 20 of the Charter of Fundamental rights, even though the ECJ has not as yet pronounced itself accordingly[99].

Obviously, the requirement of tax fairness has to be observed with respect to the – final – taxpayer, rather than to the tax collector[100]. Considering the conceptual basis of the EU system of VAT, this calls for equal tax burdens on comparable consumption expenditure: As a general rule that can be inferred from Art. 2 and 9 RVD, only a business carrying out taxable supplies for consideration is liable to VAT. By virtue of Art. 1 (2) RVD, though, the EU system of harmonized VAT has to be conceived, for the purposes of legal analysis, as a "general tax on consumption". Hence, the EU VAT has been designed as an indirect tax (as opposed to a direct, personal expenditure tax) on consumption expenditure. The incidence of the tax is therefore presumed and intended to rest with final consumers[101].

Admittedly, this statutory incidence need not coincide with the effective division of the tax burden between suppliers and consumers that depends, predominantly, on demand and supply elasticities[102]. It does also not take into account second order effects of a possible decrease in trade volume, resulting welfare losses, eventual production inefficiencies, etc.

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[98] Cf. the country reports in Meussen (ed.), The Principle of Equality in European Taxation, London 1999; *Tipke*, in Kirchhof (ed.), Staaten und Steuern, Festschrift für Klaus Vogel, Heidelberg 2000, p. 561 (pp. 567 et seq.).

[99] In addition, the Union legislator is also bound by the non-discrimination standard enshrined in Art. 14 of the European Convention on Human Rights (ECHR), which in combination with the right to a peaceful enjoyment of possessions laid down in Art. 1 of Protocol No. 1 also offers protection against discriminatory taxation, cf. the landmark judgment of the European Court of Human Rights (ECR) 23 October 1990, App. No. 11581/85, Darby v Sweden, §§ 30 et seq.; see also ECR 19 July 2005, App. No. 6638/03, P.M. v United Kingdom, § 28; ECR 29 April 2008, App. No. 13378/05, Burden v. United Kingdom, §§ 59 et seq. However, the Court has so far only objected to arbitrary imposition of tax burdens and has not as yet specified on any further requirements regarding the justification of a deviation from a consistent implementation of the respective tax fairness standard.

[100] Cf. *Tipke*, Steuer und Wirtschaft 1992, p. 102 (p. 105); for a more detailed discussion, see also *Englisch*, in Weber (ed.), Traditional and Alternative Routes to European Tax Integration, Amsterdam 2010, p. 231 (p. 257).

[101] See also *Krever*, in Krever (ed.), VAT in Africa, Pretoria 2008, p. 9 (p. 10), regarding the typical contemporanean VAT in general.

[102] Cf. *Bird/Gendron*, The VAT in Developing and Transitional Countries, Cambridge 2007, p. 71; *van Brederode*, Systems of General Sales Taxation, Alphen aan den Rijn 2009, pp. 29 et seq.; as regards demand elasticities in particular, see also *Raboy / Massa*, in Weidenbaum et al. (eds.), The Value Added Tax: Orthodoxy and New Thinking, 1989, p. 39 (pp. 56 et seq.).

Notwithstanding these acknowledgements, the principle of equal treatment will have to be applied, in the field of VAT, based on the *intended* (first order) effects of taxation: From the perspective of constitutional law, the legislator enjoys a margin of appreciation regarding the actual effects of statutory provisions – including tax laws – as long as its assumptions are not manifestly erroneous or the envisaged effects have been demonstrated not to occur on a regular basis[103]. Furthermore, the legislator cannot be held accountable for merely indirect repercussions of its tax legislation on the economy and social welfare if the incidence of such second order effects cannot be clearly assessed on a general basis. However, the legislator must at least ensure that its own conception (and perception) of the tax at issue is in compliance with the aforementioned standards of tax equality.

This calls for equal and fair taxation of the final consumers who are intended to be the final taxpayers, under the presumption – or, if preferred: legal fiction – that the VAT burden is shifted forward onto them[104]. In economic terms, this requirement tends to be equivalent to demanding that, in principle, relative prices remain unchanged after VAT is imposed. It is important to note, though, that from a constitutional perspective what ultimately matters with respect to the equality principle is not that consumer preferences remain undistorted[105], but rather that the distribution of the tax burden is evenly oriented according to an equitable indicator of taxpaying capacity, i.e. consumption expenditure[106].

Remarkably, some scholars argue that equality in VAT should be restricted to the principle of paying the same tax for *similar* goods[107]. This stance indeed comes close to reducing the impact of the equality principle regarding both, the interpretation and (quasi-)constitutional review of VAT, to the principle of fiscal neutrality. Under such a premise, no justification is needed under the equality principle in so far as the exemption is neutral in itself, i.e. if it

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[103] Cf. ECJ 17 July 1997, Joined Cases C-248/95 and C-249/95, SAM Schiffahrt und Stapf [1997] ECR I-4475, para. 25; ECJ 12 March 2002, Joined Cases C-27/00 and C-122/00, Omega Air [2002] ECR I-2569, para. 65; see also German Constitutional Court 9 July 1969, Case 2 BvL 20/65, BVerfGE 26, p. 302 (p. 312); German Constitutional Court 7 July 1969, Case 2 BvL 3/66, BVerfGE 27, p. 111 (p. 127).

[104] As regards the plausibility of this presumption, cf. *Carbonnier*, Journal of Public Economics 91 (2007), pp. 1219 et seq.; *Christian*, in Weidenbaum et al. (eds.), The Value Added Tax: Orthodoxy and New Thinking, Boston 1989, p. 17 (26 et seq.); *Raboy / Massa*, in Weidenbaum et al. (eds.), op. cit., pp. 39 et seq.; *Raboy*, in Weidenbaum et al. (eds.), op. cit., p. 69 (pp. 73 et seq.).

[105] This might be a concern under a freedom right analysis, cf. *Wernsmann*, Verhaltenslenkung in einem rationale Steuersystem, Tübingen 2005, pp. 345 et seq.

[106] Some prefer to denominate this „the legal neutrality" of VAT, cf. *van Brederode*, Systems of General Sales Taxation, Alphen aan den Rijn 2009, p. 46; however, in the context of the harmonized EU VAT system this term is slightly confusing, because the ECJ uses a legal concept of neutrality that refers exclusively to effects of VAT on taxable business.

[107] Cf. *Hemels*, in Lang et al. (eds.), Value Added Tax and Direct Taxation, Amsterdam 2009, p. 35 (pp. 40 and 47); in a similar vein *Stadie*, in Seer (ed.) Umsatzsteuer im Europäischen Binnenmarkt, Köln 2009, p. 275.

covers an encompassing group of competing goods or services[108]. An exemption for certain goods and services could not be constitutionally objected to regardless of whether a convincing rationale could be brought forward in its defence, and independent of an eventual lack of proportional and coherent implementation, as long as all similar – directly competing – goods and services benefit from the exemption.

It is suggested here, though, that such a narrow approach falls short of the concept of VAT as a *general* tax on consumption expenditure. Under such a premise, set forth by the Union legislator itself, an equal amount of expenditure must also be taxed equal, regardless of whether it is incurred for similar or for different goods or services[109]. One could also argue that only such a broader perspective complies with the fundamental principle of tax fairness as the most significant reflection of the equality principle in the field of taxation, in a European Union committed to the achievement of justice in the exercise of its competences. Quite a few scholars will even equate fairness regarding the taxation of consumption expenditure as a particular expression of the ability to pay-principle even if it does not take the form of a personal expenditure tax[110]. However, this assessment and the opalescent notion of ability to pay in the various tax jurisdictions need not be discussed in the present context in order to assert that exemptions must be justified *per se* because they constitute an infringement of the principle of equal taxation of consumption expenditure.

(3) The proportionality principle

The scope and extent of an exemption must furthermore respect the general principles of proportionality[111] and consistency.

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[108] Obviously, distortions might then still arise due to the ensuing denial of input VAT taxation, which is an aspect to be assessed separately, though.

[109] Likewise *Frink*, Der Ausschluss des Vorsteuerabzugs bei der Ausführung steuerfreier Umsätze im Umsatzsteuerrecht, Regensburg 2002, pp. 65 et seq.

[110] Cf. *Abella Poblet*, Manual del IVA, Madrid 2006, p. 112; *Alonso González*, Fraude y delito fiscal en el IVA, Madrid 2008, pp. 19 et seq; *Amatucci*, L'Ordinamento Giuridico Della Finanza Pubblica, Napoli 2007, p. 82; *Break*, The Value-added Tax, in Pechman (ed.) The Promise of Tax Reform, Englewood Cliffs 1985, p. 128 (p. 139); *Casalta Nabais*, O Dever Fundamental de Pagar Impuestos, Coimbra 2004, pp. 480 et seq.; *Coimbra Silva*, in Silva/Bernades/Fonseca (eds.) Tributação sobre o Consumo, São Paulo 2008, p. 321 (p. 331); *Comelli*, IVA comunitaria e IVA nazionale, Padova 2000, pp. 998 et seq.; *Herrera Molina*, Capacidad Económica y sistema fiscal, Madrid 1998 p. 456; *Lobo Torres*, Tratado de Direito Constitucional Financeiro e Tributário II, Rio de Janeiro 2005, p. 310; *Mollard*, Archiv für schweizerisches Abgaberecht 1994, p. 443 (p. 463); *Ruppe*, Umsatzsteuergesetz, 3. ed., Wien 2005, Einf para. 32; *Sullivan*, The Tax on Value Added, New York 1965, pp. 4 and 20; See also *Englisch* in Lang et al. (eds.), Value Added Tax and Direct Taxation, Amsterdam 2009, p. 1 (22 et seq.) with further references.

[111] Cf. landmark ruling ECJ 17 December 1970, Case 11/70, Internationale Handelsgesellschaft [1970], ECR 1125, para. 15; *Emiliou*, The Principle of Proportionality in European Law, London 1996, pp. 134 et seq.; *Jacobs*, in Ellis (ed.), The principle of Proportionality in the Laws of Europe, Oxford 1999, p. 1.

Even if there exists – as can usually be expected – a legitimate objective underlying the exemption at issue, which serves important policies relating to the public interest, a restriction on the general principles and freedoms guaranteed by the EU Treaties – and of the equality principle in particular – may be justified only if the relevant measure is appropriate to ensure the attainment of the objective in question and does not go beyond what is necessary to attain that objective[112]. The necessity requirement is a modified standard of Pareto efficiency firmly established in the case-law of the Court as the second leg of the proportionality principle. In addition, the legitimate interest must also be an overriding one, which implies a weighing and balancing of the breach of the principle of equal taxation, on the one hand, and the policies underlying the exemption[113]. It should be noted, though, that the application of the principle of proportionality is disputed in the context of the equality principle, and the Court's case-law is inconsistent in this regard[114]. However, if one assumes that tax fairness as an expression of equality of taxation constitutes a (quasi-)constitutional value and individual right, then the legislator should not be permitted to compromise it any further than necessary and appropriate[115].

Furthermore, the ECJ has repeatedly held in the context of an infringement of the fundamental freedoms enshrined in the TFEU that legislation is appropriate to ensuring attainment of the objective pursued only if it genuinely reflects a concern to attain it in a consistent and systematic manner[116]. The same should apply, by analogy, in case of a breach of a general principle of EU law. It is suggested here that legal inconsistency implies arbitrary measuring

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[112] See, for example, ECJ 12 September 2006, Case C-479/04, Laserdisken, [2006] ECR I-8089, para. 53; for further references, consult *Groussot*, General Principles of Community Law, Groningen 2006, p. 153; *Jacobs*, in Ellis (ed.), The principle of Proportionality in the Laws of Europe, Oxford 1999, p. 2.

[113] Cf. ECJ 24 September 1985, Case 181/84, Man [1985] ECR 2889, para. 20; ECJ 11 July 1989, Case 265/87, Schräder [1989] ECR 2237, para. 4; ECJ 13 November 1990, Case C-331/88, Fedesa [1990] ECR I-4023, paras. 6 and 13; ECJ 16 October 1991, Case C-26/90, Wünsche [1991] ECR 4961, paras. 12 et seq.; CFI 10 July 1991, Case T-76/890, ITP / Kommission [1991] ECR II-575, paras. 78 et seq.; *de Búrca*, Yearbook of European Law 1993, p. 105 (p. 113).

[114] See, for instance, ECJ 21 February 1990, Case 267/88 a.o., Wuidart a.o. [1990] ECR I-435, paras. 27 et seq.; ECJ 13 January 2005, Case C-126/04, Heinecken [2005] ECR I-331, paras. 21 et seq., on the one hand (mere review of the legitimacy of a possible justification for unequal treatment); ECJ 26 October 1999, Case C-273/97, Sirdar [1999] ECR I-7403, para. 26; ECJ 13 April 2000, Case C-292/97, Karlsson [2000] ECR I-2737, paras. 44 et seq.; ECJ 18 December 2008, Case C-127/07, Arcelor [2008] ECR I-9895, paras. 47 and 59, on the other hand (strict scrutiny, also regarding necessity and proportionality *strictu sensu*). See also *Kingreen*, in Ehlers (ed.), European Fundamental Rights and Freedoms, Berlin 2007, § 18 para. 8 et seq.; *Manolkidis*, in: Dashwood/O'Leary (eds.), The Principle of Equal Treatment in EC Law, London 1997, para. 5.37.

[115] See also *Hoffsümmer*, Steuerbefreiungen für Inlandsumsätze, Frankfurt a.M. 2009, p. 127.

[116] See, for example, ECJ 10 March 2009, Case C-169/07, Hartlauer [2009] ECR I-1721, para. 55; ECJ 6 October 2009, Case C-153/08, Commission / Spain [2009] ECR I-9735, para. 38; ECJ 17 November 2009, Case C-169/08, Regione Sardegna, [2009] ECR I-10821, para. 42; ECJ 16 December 2010, case C-137/09, Josemans, n.y.r., para. 70; ECJ 3 March 2011, Case C-161/09, Kakavetsos-Fragkopoulos, n.y.r., para. 42.

by a double standard contrary to the principle that all parties should stand equal before the law.

(4) Judicial restrain

With respect to all the above principles, judicial review must not be overly strict, because the ECJ must not – and indeed shows no inclination to – usurp the power of political decision-making reserved to the legislating institutions of the EU, i.e. to the Commission, the Council, and Parliament. Judicial restrain is required so as to avoid undermining 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[117]. Therefore, as already mentioned, a margin of appreciation must be conceded to the Union legislator; only obvious violations of the aforementioned principles can – and must – lead to the invalidity of the respective exemption or related provision. Moreover, generalizing assumptions must be accepted unless they are unrealistic or if the subject matter is too diverse for too broadly standardized rules.

It should be noted, though, that judicial restrain should not be mistaken for giving the legislator a *carte blanche* in the area of European tax law, and with respect to VAT exemptions in particular[118]. And while it seems appropriate to acknowledge a prerogative of the legislator with respect to a prognostic assessment of the impact of an exemption upon its introduction, the proportionality principle implies that the legislator must also monitor its effects and any subsequent developments carefully. If an exemption that could originally be justified turns out to be ineffective or if it has outlived its purpose, the legislator is under a duty to amend or repeal it. It is indeed somewhat astonishing that in over 30 years of judicial review of the Sixth VAT Directive and its successor directive, the Court has never declared void any provision contained in the directives itself on grounds of a presumed violation of general principles of EU law[119].

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[117] Cf. ECJ 22 May 1999, case C-70/88, Parliament v Council [1990] ECR I-2041, para. 22; ECJ 6 May 2008, Case C-133/06, Parliament v Council [2008] ECR I-3189, para. 57.

[118] Likewise *Hoffsümmer*, Steuerbefreiungen für Inlandsumsätze, Frankfurt a.M. 2009, pp. 10 et seq.

[119] It is pointed out by *de la Feria*, The EU VAT System and the Internal Market, 2009, pp. 279 et seq., that "a more radical attempt by the Court to resolve the problems of the EU VAT system could ultimately lead to a legal vacuum." While this assessment certainly highlights the need for judicial restrain (cf. *Hoffsümmer*, Steuerbefreiungen für Inlandsumsätze, Frankfurt a.M. 2009, p. 47), it cannot relieve the Court of its duty to assert the supremacy of general principles and fundamental rights in harmonized areas of tax law, as it already does in other, non-tax areas of legislation where the Court can also only annul but not reform legislation. It is suggested here that by doing so, the ECJ would probably sharpen the legislator's awareness of these supreme guidelines for VAT law design and thus contribute significantly to a better system of VAT.

## IV. Critical analysis of the rationale for the exemptions of the EU system

There are various rationales given for the exemptions that are currently enshrined in the VAT Directive. Some are broadly indicated by the title that chapter 2 of Title IX of the Directive carries: "activities in the public interest". More detailed reasons for exempting certain supplies are laid down in the explanatory memorandum to the Commission's proposal for the Sixth Directive; however, those explanations cover only a fraction of all exemptions contemplated in Art. 132 et seq. RVD. Therefore, most justifications must be inferred from the substantive scope and the prerequisites of the exemption at issue; this is also the approach chosen by the ECJ when the Court elaborates on the objective for an exemption. In the following, the paper will analyze seven possible rationales for the "standard" VAT exemptions of the harmonized EU system, preceded by some general remarks on the perspective to be adopted when assessing VAT exemptions.

### 1. General observations

As an indirect tax on consumption, VAT has a twofold impact: with respect to economic operators who are taxable persons and therefore liable to pay VAT, on the one hand, and regarding final consumers from whom the tax is supposed to be collected and who are thus intended final taxpayers, on the other hand. This peculiarity, which distinguishes VAT from a direct tax on income or a personal expenditure tax, implies that there exist two potential beneficiaries of a tax exemption: either the taxable person, i.e. business, or the final taxpayer, i.e. the final consumer[120]. In so far as exemptions are intended to have a subsidizing effect, their justification will therefore also depend on a correct identification of the intended beneficiary[121].

Personal (subjective) exemptions will tend to subsidize the taxable person himself, as long as most competitors are not eligible for the exemption. The equilibrium price in the market should then not be significantly affected by the exemption[122], hence the privileged operators

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[120] See also *Mollard*, Archiv für schweizerisches Abgaberecht 1994, p. 443 (p. 453).

[121] Likewise *Weidenbaum / Christian*, in Weidenbaum et al. (eds.), The Value Added Tax: Orthodoxy and New Thinking, Boston 1989, p. 1 (p. 10). For a different opinion, cf. *Hoffsümmer*, Steuerbefreiungen für Inlandsumsätze, Frankfurt a.M. 2009, p. 73: In the context of a VAT type consumption tax, exemptions can only be justified if they provide relief for (final) consumers. However, this stance seems too rigid; since tax exemptions do not fit into the system of a general tax on consumption (expenditure) and therefore need to be justified, anyways, it is not conceivable why possible justifications should *a priori* be limited to effects concerning the final taxpayer rather than the taxable person. But as *Hoffsümmer*, op. cit., p. 74, correctly points out, also under the latter premise exemptions aimed at the taxable person usually cannot be justified as proportional, as shall be demonstrated below.

[122] See also the caveat provided for in Annex X Part B (5) to the RVD regarding the exemption for transactions carried out by blind persons or by workshops for the blind.

can charge gross prices as if they were liable for VAT and can thus make greater profits or compensate for extra-fiscal competitive disadvantages. A good example is the exemption for transactions carried out by blind persons[123] that some Member States have maintained by virtue of the authorization granted in Art. 371 RVD[124].

Objective exemptions will usually have the primary effect and aim to lower the tax burden of the final consumers who are recipients of the exempt supply, at least if they cover all directly competing goods or services[125]. As explained above, the European-style VAT is based on the theory that under conditions of competition the tax for which the economic operator is liable will be wholly shifted forward onto his customer and, ultimately, onto the final consumer. It should already be noted, though, and will be discussed in greater detail below[126], that exemptions generally do not provide complete relief from VAT due to a corresponding denial to credit input VAT corresponding to the exempt supply, but rather only relieve the value added by the exempt trader from tax[127].

At least in B2C transactions, an exemption should thus lead to a decrease of marginal costs equivalent to the VAT on the value added by the taxable person[128]. This implies a reduction of the tax wedge between demand and supply prices corresponding to the reduced VAT burden (i.e. the arithmetic product of the VAT rate and the value added by the exempt trader), even though the ensuing new equilibrium price need not fully reflect this due to second order effects. Therefore, according to the inherent logic of VAT, it is the final consumer who under a legal analysis must normally be held to directly benefit from objective exemptions[129]. In so far as the exempt traders also benefit due to the second order effects – e.g. an increased turnover volume – these indirect and rather remote effects could hardly justify an exemption as a proportionate measure, because direct subsidies would obviously be much more efficient instruments for that purpose.

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[123] See also *Frink*, Der Ausschluss des Vorsteuerabzugs bei der Ausführung steuerfreier Umsätze im Umsatzsteuerrecht, Regensburg 2002, pp. 114 et seq.; *Kirchhof*, Umsatzsteuer Gesetzbuch, Heidelberg 2008, § 11 para. 104; *Stadie*, UStG, Köln 2009, p. 607.

[124] Cf. *Ruppe*, Umsatzsteuergesetz, 3. ed., Wien 2005, § 6 para. 291.

[125] See also *Frink*, Der Ausschluß des Vorsteuerabzugs bei der Ausführung steuerfreier Umsätze im Umsatzsteuerrecht, Regensburg 2002, p. 141.

[126] See below at V.

[127] Cf. *van Brederode*, Systems of General Sales Taxation, Alphen aan den Rijn 2009, p. 127; *Genser/Winker*, Finanzarchiv 54 (1997), pp. 563 et seq.; *Raboy*, in Weidenbaum et al. (eds.), The Value Added Tax: Orthodoxy and New Thinking, Boston 1989, p. 87 (p. 97); *Tait*, Value-Added Tax, Washington 1988, p. 50.

[128] See also *Guía del Impuesto sobre el Valor Añadido*, 8. ed., Valencia 2006, p. 289; *Pérez Herrero*, La Sexta Directiva Comunitaria del IVA, Barcelona 1997, p. 202; *Löhr*, Das umsatzsteuerrechtliche Optionsrecht für Vermietungsumsätze, Berlin 2003, pp. 105 et seq.

[129] Cf. *Kirchhof*, Umsatzsteuer Gesetzbuch, Heidelberg 2008, § 11 para. 5.

Exceptionally, objective exemptions may be assumed to subsidize primarily the taxable person, if the latter operates in a market which is typically characterized by little price flexibility due to political or other constraints. In certain sectors of the economy such as, for example, the educational sector or the sector of cultural activities like opera, theatre and other artistic performances, the majority of economic operators are state-controlled and will sustain costs that exceed the turnover they generate. Therefore, they depend on subsidies to carry out their activities. Since the prices they charge are already below uncontrolled market prices, a decrease in the VAT burden will not result in a price reduction but only in a reduced need for direct subsidies[130].

In the following paragraphs, the most relevant of possible justifications for the exemptions contemplated in the VAT Directive will be discussed.

**2. Expenditure not indicating any taxpaying capacity**

Some of the compulsory exemptions contemplated in Art. 132 RVD and granted "for certain activities in the public interest" can by defended, in principle, by considerations of tax equity or tax fairness because the expenditure incurred for the exempt supplies should arguably not be deemed to indicate taxpaying capacity. One may reasonably assume that the obligation to pay taxes without receiving any directly related or equivalent consideration in return can (only) be regarded as equitable because according to contemporary concepts of tax fairness, every person who is integrated into society or has to a certain degree become connected with society should be under a solidary obligation to contribute to that society's common good. However, such a solidary responsibility presupposes that the taxpayer has certain funds – as indicated by income, wealth or expenditure, i.e. funds that he or she earns, owns, or spends – at his or her *free disposal*[131]. In so far that he or she depends on these funds to pay for essential personal needs or those of dependent family members, though, this person should not be assumed to be under a social responsibility to nevertheless contribute to cover the costs of public welfare and public goods; hence the corresponding income, wealth or expenditure does not indicate chargeable financial resources.

Even though transfer payments (social assistance) to the poor and higher income tax allowances for households that pay income tax are often considered a viable alternative to a

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[130] Cf. explanatory memorandum to the German VAT Act implementing the former Sixth VAT Directive, Bundestags-Drucksache V/1581, p. 5.

[131] Cf. *Lehner*, Einkommensteuerrecht und Sozialhilferecht, Tübingen 1993, pp. 41 et seq.; *Lang*, in Tipke/Lang, Steuerrecht, 20. Aufl., Köln 2010, § 4 para. 113; *Schemmel*, Entlastung lebensnotwendiger Ausgaben von der Mehrwertsteuer, Berlin 2009, p. 48.

direct tax relief[132], they are not fully equivalent from a constitutional perspective. They are an inferior choice when expenditure for essential goods or services can (exceptionally) be relieved from VAT sufficiently targeted even though VAT is levied as an indirect, impersonal tax, for the following reasons: On the one hand, respect for human dignity requires that taxation must not push individuals who could otherwise sustain themselves (in particular, low-income workers) into relative poverty and social assistance programs, even though this could be avoided by a tax concession without significant "spillover" to non-essential expenditure. On the other hand, the increase of lump-sum income tax allowances for VAT on expenditure for essential needs will not guarantee vertical tax equity at least with respect to those items where individual spending differs (e.g. medicine). And even if allowances were personalised, their compensatory effect would differ under a progressive income tax, diametrically opposed to requirements of vertical tax equity.

Exemptions that are potentially justified partially or primarily on grounds of this kind of tax equity considerations are, *inter alia*, the supply of hospital care and closely related activities[133], the provision of (other) medical care[134], the supply of services by dental technicians[135], and the supply of transport services for sick or injured persons[136]. Expenditure for medicine and pharmaceuticals could also be considered to qualify for a tax concession based on the above consideration, at least if only available by prescription; however, the EU VAT Directive does not allow for an exemption of such supplies[137]. Moreover, the exemptions stipulated for the supply of services and of goods closely linked to welfare and social security work[138], or to the protection of children and young persons[139], probably fall into this category as well. According to the ECJ and also the German Constitutional Court, this is also true for the supply of basic postal services[140]. Some scholars would also consider

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[132] Not the least by the European Commission, cf. EC Commission, cf. Report from the Commission to the Concil, COM(82) 885 final, 17 January 1983, reproduced in Intertax 1983, 137 (139).
[133] Cf. Art. 132 (1) b RVD.
[134] Cf. Art. 132 (1) c RVD.
[135] Cf. Art. 132 (1) e RVD.
[136] Cf. Art. 132 (1) p RVD.
[137] Instead, Member States may apply a reduced rate by virtue of Art. 98 RVD. Only very few Member States such as Ireland and Malta have been granted a derogation from the general rule and may exempt medicine (with credit, i.e. by way of zero-rating).
[138] Cf. Art. 132 (1) g RVD.
[139] Cf. Art. 132 (1) h RVD.
[140] Cf. ECJ 23 April 2009, Case C-357/07, TNT Post UK [2009] ECR I-3025, para. 33: „essential needs"; German Constitutional Court, 9 February 2010, case 1 BvL 1/09, Neue Juristische Wochenschrift 2010, p. 505.

the exemption for the leasing and letting of residential housing to be justified on grounds that it spares expenditure for essential personal needs from taxation[141].

In the context of VAT as an indirect tax, it is unavoidable that wealthy or high-income consumers can avail themselves of the relevant tax exemptions, too, just like poor members of society[142]. However, this does not *per se* put into question the legitimacy of the aforementioned kind of exemptions. Contrary to commonly held beliefs[143] shared by the EU Commission[144], exemptions granted wholly or primarily on grounds of tax equity considerations of the kind discussed so far do not focus on a redistribution of wealth, nor do they derive their justification from the objective to mitigate the seemingly[145] regressive effects of VAT. Instead, they merely acknowledge that certain expenditure does not indicate individual taxpaying capacity[146], regardless of the personal circumstances of the consumer.

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[141] Cf. *Kirchhof*, Umsatzsteuergesetzbuch, Heidelberg 2008, pp. 141 et seq.; *Reiß* in Seer (ed.), Umsatzsteuer im Europäischen Binnenmarkt, Köln 2009, p. 9 (p. 46).; By contrast, the ECJ refers only to reasons of social policy, cf. ECJ 4 October 2001, case C-326/99, Goed Wonen [2001] ECR I-6831, para. 52; likewise *Stadie*, UStG, Köln 2009, p. 530

[142] This effect has been pointed out by, e.g., *Frink*, Der Ausschluss des Vorsteuerabzugs bei der Ausführung steuerfreier Umsätze im Umsatzsteuerrecht, Regensburg 2002, p. 147; *Reiß*, in Tipke/Lang (eds.) Steuerrecht, 20. ed., Köln 2010, § 14 para. 88.

[143] See, i.a., *Gottfried/Wiegard*, Journal of Public Economics 46 (1991), p. 307 (p. 308); *Krever*, in Krever (ed.), VAT in Africa, Pretoria 2008, p. 9 (pp. 18 et seq.); *Raboy*, in Weidenbaum et al. (eds.), The Value Added Tax: Orthodoxy and New Thinking, Boston 1989, p. 87 (pp. 91 et seq.).

[144] Cf. Communication from the Commission to the Council and the European Parliament on VAT rates other than standard VAT rates, 5 July 2007, COM(2007) 380 final, p. 5: "... improving equity... In this respect, the study finds that for the improvement of income distribution in a Member State, reduced VAT rates are effective only when the share of consumption expenditure of goods/services subject to a reduced rate (out of the total consumption expenditure) differs sufficiently between low and high-income groups and is stable over time."

[145] From a life-cycle perspective, taking into account also inheritance taxation, it is probably more correct to consider VAT a proportional rather than a regressive tax, see also *van Brederode*, Systems of General Sales Taxation, Alphen aan den Rijn 2009, p. 44; *Crawford/Keen/Smith*, in Mirrlees et al. (eds.), Dimensions of Tax Design: the Mirrlees review, Oxford 2010, p. 275 (285). And even when income is chosen as the standard against which distributive effects are to be assessed, a VAT need not necessarily be regressive, or if so, only slightly, cf. the surveys provided by *Bird/Gendron*, The VAT in Developing and Transitional Countries, Cambridge 2007, pp. 72 et seq.

[146] This does not preclude the possibility that certain exemptions could be justified by either aspect. For example, a tax concession for the supply of food might be justified on grounds of a very generous generalization that expenditure for food is typically incurred to pay for the minimum subsistence. However, under a stricter approach, this might not seem an acceptable assumption because frequently the type, quality and / or quantity of food consumed exceeds what would be considered minimum standards in the respective society (to be assessed, e.g., in the light of legislation on social assistance). A tax concession might then nevertheless be introduced to add a certain element of progressivity into the VAT system (as discussed in the next section), because empirical data shows that low-income households use a comparatively higher portion of their income to buy food. In such a situation, a conscious choice on part of the legislator is required as to which justification should carry a VAT concession for the good or service at issue, because the decision predetermines the question whether the supply at issue should be zero-rated or could rather also be maintained or be replaced by a mere rate reduction; for further discussion, see below at V.2.b. In the EU VAT system, the supply of food is not exempt. But most foodstuff qualifies for a reduced rate; moreover, some Member States have retained a right to exempt it with credit (zero-rating).

Moreover, many times and with respect to health care services in particular, the corresponding expenditure is not roughly the same for every (final) taxpayer, but rather varies considerably. As already mentioned, the exemption of related supplies could therefore, in principle, also be justified by considerations of vertical tax equity: Even though the amount of expenditure of two individuals in a certain period of time may be the same – whether relatively high or relatively low – it does not indicate the same capacity and obligation to contribute to public sector activities if one of them has had to spend considerably more on essential goods or services than the other. The allegation that an exemption for essential expenditure must be regarded as highly inefficient, because the majority of consumption of "necessities" is attributable to families with incomes in excess of poverty level (i.e. to middle-class and upper-class households)[147], therefore misses the point with respect to the categories of exemptions discussed in this section.

It has to be acknowledged, though, that under VAT as an *indirect* and transaction-based tax on consumption, expenditure related to the subsistence minimum cannot be spared from taxation by applying the targeted approach of *personal* taxes on income that usually provide for a lump-sum allowance and special deductions for specific needs. Instead, the legislator has to resort to generalizing assumptions as to whether certain goods or services can be classified, by referring to their objective features and characteristics, as suited to cover the essentials of life. Moreover, in order to avoid spill-over effects that would run counter to the principle of tax equity, an exemption can be justified on these grounds only if expenditure incurred for such goods or services it typically limited to the costs of subsistence. Hence, both qualitative and quantitative criteria related to the subsistence minimum have to be met in order to reasonably defend an exemption for the supply of certain goods or services as a measure that promotes tax equity. Moreover, the exemption should also not cause excessive compliance or administrative costs. Otherwise, it is preferable to accept certain shortcomings with respect to this objective, which are inherent to the technical design of VAT, and refer the taxpayer to a (partial) compensation by way of higher income tax allowances or to social assistance.

Therefore, the attempt to justify the exemption concerning the leasing or letting of residential housing on the basis of tax equity considerations as the ones discussed above is highly questionable, because the exemption covers supplies ranging from public housing to the letting of luxury apartments. This can hardly be defended on grounds of vertical tax equity

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[147] Cf. *Raboy*, in Weidenbaum et al. (eds.), The Value Added Tax: Orthodoxy and New Thinking, Boston 1989, p. 87 (p. 92).

and is not sufficiently targeted in order to relief only expenditure incurred for essential human needs[148]. As regards the exemptions related to the health care sector, they require a particularly close analysis: The corresponding goods and services do cover essential needs, and expenses will usually be incurred only to the extent deemed necessary to restore health or alleviate suffering. However, in almost all EU Member States the prices for medical care are highly regulated and thus generally inflexible in order to contain costs. A full taxation of related transactions would often not impose an additional burden on insurance systems and – ultimately – patients as final consumers[149], but rather it would negatively affect the profits and income of hospitals and doctors, or lead to an increase of government subsidies. For these reasons, it is hard to justify that the VAT Directive stipulates a mandatory exemption for supplies of hospital and other medical care regardless of the regulatory context in the several Member States.

Moreover, even if an exemption justified on grounds of tax equity considerations can be regarded as proportional, especially considering the margin of discretion to be conceded to the legislator, it can still be open to challenge due to a lack of consistency as to scope and prerequisites. In Germany, for instance, the exemption for the provision of medical care had until recently been transposed into national law in a broad wording that was understood to cover also cosmetic surgery, regardless of its motivation[150]. Obviously, the inclusion of such services does not constitute a coherent alignment of the exemption to concerns of tax equity[151].

Another example is the exemption for "public" postal services laid down in Art. 132 (1) a RVD, which has been interpreted by the ECJ to be reserved to suppliers of universal postal services in the entire territory of a particular Member State (irrespective of the agent's status as public law or private law entity)[152]. As a consequence, not all basic postal services are exempt, but only those offered by suppliers with universal coverage. While both concepts were still congruent when the Sixth Directive was adopted, because all Member States had state monopolies in the postal sector at that time, the subsequent liberalization has led to an asymmetric impact of the exemption. Therefore, it would nowadays have to be regarded as inconsistent if its legitimacy were based – as pretended – on the intention to decrease the tax

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[148] Likewise *Hoffsümmer*, Steuerbefreiungen für Inlandsumsätze, Frankfurt a.M. 2009, pp. 145 et seq.
[149] See, in this regard, *Peffekoven*, Zur Reform der Mehrwertsteuer, Berlin 2010, p. 32.
[150] For further details see *Reiß*, in Tipke/Lang (eds.) Steuerrecht, 20th ed., Köln 2010, § 14 para. 90.
[151] Cf. ECJ 20 November 2003, Case C-307/01, d'Ambrumenil [2003] ECR I-13989, paras. 57 et seq. and case-law cited therein. See also the detailed restatement of relevant ECJ jurisprudence by *Terra/Kajus*, Introduction to European VAT, Amsterdam 2010, pp. 712 et seq.
[152] Cf. ECJ 23 April 2009, Case C-357/07, TNT Post UK [2009] ECR I-3025, para. 36.

burden on expenditure for essential needs. And if one were to consider that the exemption might then instead be justified as a subsidy to the economic agent itself, in order to compensate for the higher costs associated with the obligation to provide universal postal service[153], this would seem hardly appropriate: The same effect could be reached much more efficiently and transparently by direct subsidies.

However, the efforts undertaken by the Commission to reform the VAT treatment of postal services by abolishing the exemption[154] have so far been frustrated by the Council. Meanwhile, the ECJ has refused to enter a thorough proportionality analysis and has merely declared that suppliers of universal postal services operate in a different legal context than other suppliers of postal services, hence fiscal neutrality of VAT should not be assumed as being affected[155]. It is respectfully submitted that this kind of reasoning is highly unsatisfactory. It ignores economic reality; economic surveys show that the tax exemption is distorting competition significantly in European postal markets[156], even when taking into account the moderating effect of the denial of input VAT deduction[157]. From a normative perspective, the position of the ECJ fails to adequately reflect that fiscal neutrality as a VAT-specific expression of the equality principle focuses on equal conditions of competition for suppliers of goods and services that are considered similar – i.e. substitutable – by their consumers, and that the legal context of their supply matters in the comparability analysis only in so far as it has an impact on this particular similarity concept.

### 3. Social policy and redistributive effects

Some compulsory or transitional exemptions that are contemplated in the VAT Directive have been justified on grounds of social policy or tax impact distribution. Even though this kind of justification is also somewhat related to aspects of tax equity and tax fairness, the corresponding exemptions should be distinguished from the tax relief measures discussed above that address a presumed lack of relevant taxpaying capacity: In the latter case, the relief should not be at the discretion of the EU legislator, in so far as it is technically feasible to

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[153] See, in this regard, *Dietl/Jaag/Lang/Trinkner*, The B.E. Journal of Economic Analysis and Policy 11 (2011), p. 1 (p. 22). Since the exemption contemplated in Art. 132 (1) (a) RVD is granted for the provision of all universal postal services by the privileged supplier, it effectively enables qualifying companies to cross-subsidize costly services in rural areas by extra-profits made by the provision of services in urban areas.

[154] Cf. Proposal of the Commission for the amendment of the VAT treatment of services provided in the postal sector, COM (2003) 234, 5 May 2003, and the amended Proposal COM (2004) 468, 8 July 2004.

[155] Cf. ECJ 23 April 2009, Case C-357/07, TNT Post UK [2009] ECR I-3025, para. 37.

[156] Cf. *Dietl/Jaag/Lang/Trinkner*, The B.E. Journal of Economic Analysis and Policy 11 (2011), p. 1 (pp. 16 et seq.) with further references.

[157] For further details on this aspect, see below at V.1.c.

integrate it without significant spill-over or overcompensation effects into the design of VAT as an indirect and thus "impersonal" tax. Moreover, the final consumer should then be fully shielded from any tax burden. By contrast, the exemptions analyzed in the following sections can either be characterized as subsidies ("tax expenditure") that are motivated by aspects of social policy, or they serve to enhance the redistributive effects of VAT; both objectives will indeed often go hand in hand. Their introduction into the harmonized system and their extent can be regarded as a deliberate choice on part of the legislator that must however respect the requirements of proportionality and consistency.

Such social policy concerns have been brought forward as ancillary motives for the exemption related to the granting of consumer credit[158], and they have furthermore been identified as the main reason underlying the exemption of the management of special investment funds[159]. This is particularly striking since both of these exemptions are listed in Art. 135 (1) RVD under the heading "exemptions for other activities", rather than being included in the list of Art. 132 (1) RVD concering "exemptions for activities in the public interest". Furthermore, if one were to disagree with the attribution of any of the exemptions discussed above to the category of tax relief measures that reflect a lack of taxpaying capacity, one would at least have to consider whether they can be justified on grounds of tax policy reasons. In particular, this seems to be the position of the Commission and the ECJ with respect to the exemption provided for the letting and leasing of residential housing[160].

Different from exemptions justified on grounds of a lack of taxpaying capacity, exemptions that are motivated by "mere" objectives of social policy or redistributive effects can be regarded as consistent and legitimate only if either one of the following two scenarios applies: First, if it has been demonstrated or may at least reasonably be assumed that the exempt supplies benefit predominantly final consumers with relatively low income and relatively little wealth. This is arguably the case, for example, regarding social welfare services that specifically target the youth or elderly persons with few resources[161]. By contrast, even acknowledging a margin of appreciation to be conceded to the legislator, a sufficiently

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[158] Cf. ECJ 19 April 2007, Case C-455/05, Velvet & Steel [2007] ECR I-3225, para. 24; ECJ 10 March 2011, Case C-540/09, Skandinaviska Enskilda Banken, n.y.r., para. 21.

[159] Cf. ECJ 4 May 2006, case C-169/04, Abbey National [2006] ECR I-4027, para. 62; see also *Heidemann*, Die Umsatzsteuerbefreiungen von Finanzdienstleistungen, Berlin 2008, p. 123.

[160] Cf. ECJ 4 October 2001, Case C-326/99, Goed Wonen [2001] ECR I-6831, para. 52; see furthermore explanatory Memorandum to the Proposal for a sixth Council Directive on the harmonization of Member States concerning turnover taxes, submitted to the Council by the Commission on 29 June 1973, COM(73) 950, p. 15.

[161] See, for example, Art. 132 (1) (g) and (h) RVD.

focused impact can hardly be presumed regarding the granting of consumer credit[162]. For the reasons already discussed above, it is also highly questionable whether the exemption concerning the leasing or letting of immovable property could be defended as proportional and consistent on grounds of social policy considerations. Similar objections could be raised with regard to the exemption available for the management of investment funds[163]. Second, if the exemption is intended to enhance the redistributive effects of VAT by introducing an element of (indirect) tax progression[164], it must shown that low-income households typically spend a significantly higher portion of their income on the exempt items or services than households in the higher income deciles[165].

In economic literature, it is sometimes suggested that VAT concessions on grounds of social policy or income redistribution are unnecessary, at least in developed countries such as the EU Member States, because income tax and income-support measures would achieve the same objective equally well or even better with less distortions and at lower compliance and administrative costs[166]. If such a conclusion were indeed obvious, the respective VAT exemptions would have to be considered disproportionate also under a constitutional scrutiny based on primary Union law. However, some caution seems appropriate in this regard. In order to be equally targeted as a VAT exemption on social policy grounds, both additional social assistance programs and income tax allowances also require additional administrative resources and cause additional compliance costs, and they may also give rise to definitional problems and invite misclassification. By contrast, mere lump-sum payments or (in the tax context) lump-sum deductions are less precise; they risk under- or overcompensation, and in the case of social assistance, also the (ab)use for other than the intended consumption by the

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[162] As regards, for example, the situation in Germany, see *Schupp* et al., Repräsentative Analyse der Lebenslagen einkommensstarker Haushalte, Berlin 2003, pp. 81, 86 and 90.

[163] However, a tax concession for financial services of this kind could be defended as a measure to avoid distortions between a self-supply of portfolio management services and the investment through collective investment vehicles. Moreover, as shall be discussed below at (7), the cost of such management services does not constitute consumption expenditure and should therefore be relieved from VAT.

[164] See, in this regard, also *van Brederode*, Systems of General Sales Taxation, Alphen aan den Rijn 2009, p. 34.

[165] Under this premise the objective of reducing regressive effects of VAT or – more precisely – introducing an element of tax progression into VAT is not called into question by the fact that the expenditure of households in higher income deciles on the exempt items or services is higher in absolute amounts than the corresponding expenditure of low-income households; for a seemingly different opinion, see *Cnossen*, International Tax and Public Finance 5 (1998), p. 399 (pp. 409 et seq.).

[166] Cf. *Cnossen*, International Tax and Public Finance 10 (2003), p. 625 (p. 628). See also *Bird*, in Mirrlees et al. (eds.), Dimensions of Tax Design: the Mirrlees review, Oxford 2010, p. 363 (366); *Crawford/Keen/Smith*, in the same volume, p. 275 (p. 277 and p. 284). See furthermore *Bird/Gendron*, The VAT in Developing and Transitional Countries, Cambridge 2007, p. 76 and pp. 126 et seq., who point out the differences between developed and developing countries in this regard; likewise the special study by *Boccanfuso et al*, Can the removal of VAT Exemptions support the Poor? The Case of Niger, CERDI, Etudes et Documents, E 2011.6, pp. 5 et seq.,

recipients[167]. As regards exemptions granted due to concerns of tax impact distribution, they can be more easily replaced by direct transfers or income tax measures[168], but not without certain drawbacks, either[169].

Notwithstanding the above, it will in any event be necessary to scrutinize both kinds of exemptions with respect to their proportionality *strictu sensu*, hence it needs to be assessed for each VAT exemption whether it strikes a reasonable balance between its objective, on the one hand, and its negative implications for social welfare, on the other hand. This assessment must also take into account the combined superior and inferior aspects of alternative measures. Under such an approach, empirical evidence suggests that a VAT exemption of "basic" goods and services intended to smoothen the distributive impact of VAT is indeed disproportionate because it is much less efficient than income tax or income enhancing measures[170], but only – if at all – slightly superior with a view towards administrative and public acceptance issues.

Finally, it should be noted that even if a VAT concession of the aforementioned kind can be regarded as legitimate and proportionate, this does not automatically imply that the exemption *without credit* is the best or at least an acceptable instrument to implement such a VAT relief[171].

An exemption may exceptionally also be granted on grounds of social policy in order to benefit the taxable person rather than final consumers. The only straightforward example in the common system of VAT is the transactions carried out by blind persons or by workshops for the blind[172], which may be maintained by certain Member States by virtue of Art. 371 RVD. It seems questionable, though, whether such exemptions constitute an appropriate and coherent measure to ensure the attainment of their social objective[173]: The amount of aid

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[167] See, in this regard, *Hickel*, Wirtschaftsdienst 2010, p. 585 (p. 589).

[168] As regards the positive New Zealand experience in this context, see *Dickson/White*, in Mirrlees et al. (eds.), Dimensions of Tax Design: the Mirrlees review, Oxford 2010, p. 387 (pp. 399 et seq.; see also the comments made on p. 404).

[169] For an in-depth discussion of possible difficulties (in the similar context of reduced VAT rates), see *Ismer/Kaul/Reiß/Rath*, Analyse und Bewertung der Strukturen von Regel- und ermäßigten Sätzen bei der Umsatzbesteuerung unter sozial-, wirtschafts-, steuer- und haushaltspolitischen Gesichtspunkten, Berlin 2010, pp. 201 et seq. This issue will not be explored further here, because food as the most obvious contender for an exemption on grounds of redistributive policy is actually not exempt under the standard EU VAT rules; it merely qualifies for a reduced rate (that could, of course, also be questioned for the reasons given above).

[170] Cf. *Crawford/Keen/Smith*, in Mirrlees et al. (eds.), Dimensions of Tax Design: the Mirrlees review, Oxford 2010, p. 275 (300 et seq.) and the references cited there. See also *Krever*, in Krever (ed.), VAT in Africa, Pretoria 2008, p. 9 (p. 19); *Tait*, Value-Added Tax, Washington 1988, p. 70.

[171] For further discussion of this aspect, see below at V.

[172] See explanatory memorandum to the corresponding provision in the German VAT Act, Bundestags-Drucksache V/1581, p. 5.

[173] Likewise *Stadie*, UStG, Köln 2009, p. 608; very critical *Mollard*, Archiv für schweizerisches Abgaberecht 1994, p. 443 (p. 448, note 15).

conveyed through the exemption will increase with the volume of turnover of the taxable person, which is however unrelated – or even in inverse relation – to his or her need for social assistance.

**4. Reasons of cultural or educational policy / meritorious services**

Another set of mandatory exemptions contemplated in the common system of VAT pursues objectives of cultural and educational policy, including the promotion of sport or physical education. This can be assumed, in particular, with respect to the following exempt supplies: the provision of children's or young people's education, school or university education, vocational training or retraining, the supply of certain cultural services, the supply of certain services closely linked to sport or physical education, and the non-commercial activities carried out by public radio and television bodies. These exemptions concern activities which are arguably of societal value[174], so that the related supplies provide "meritorious" goods and services to the final consumer. The legislator can thus, in principle, promote their consumption through a tax concession. The policy considerations underlying such exemptions therefore constitute legitimate reasons to deviate from the principles of fiscal neutrality and tax fairness[175].

However, in so far as an exemption that pursues the aforementioned legitimate objectives is designed to benefit the final consumer, it should be considered proportional only if the legislator may reasonably assume that a significant number of potential consumers would abstain from having recourse to these services, or consume them to a significantly lower degree, if they were (fully) burdened with VAT. Economic surveys suggest that such an assessment can in general be accepted as reasonable for supplies related to physical education in sport clubs etc.[176] and probably also regarding higher education services[177], taking into account the margin of appreciation to be granted to the Union legislator.

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[174] As regards education in particular, see also *Ebrill* et al., The modern VAT, Washington 2001, pp. 93 et seq. For a different opinion regarding cultural services and services linked to sport or physical education see *Cnossen*, in Mirrlees et al. (eds.), Dimensions of Tax Design: the Mirrlees review, Oxford 2010, p. 370 (p. 382)

[175] Cf. *Hoffsümmer*, Steuerbefreiungen für Inlandsumsätze, Frankfurt a.M. 2009, p. 123.

[176] Cf. *Wicker*, Perspektiven und Grenzen der Beitragsfinanzierung von Sportvereinen, Köln 2009, pp. 197 et seq. (summary at pp. 314 et seq.).

[177] A comprehensive meta-study carried out in the US came to the conclusion that there is a certain degree of price responsiveness among college and university students, in particular among less selective public institutions, cf. *Leslie/ Brinkman*, Journal of Higher Education 58 (1987), p. 181 (pp. 198 et seq.), and the studies cited therein. These results are probably also true for EU Member States.

By contrast, economic research indicates that the price responsiveness of the demand for cultural services tends to be relatively low[178]. Hence, the present consumers of such services would not markedly change their consumption patterns if VAT were charged at the regular rate, while the exemption will not contribute significantly to attract consumers who are habitually alien to such activities. Moreover, exemptions that would promote such activities with the stated aim to incentivize consumer behaviour could often be objected because of their paternalistic approach[179]. For instance, it would seem little convincing that under the current rules of EU law, the acquisition of an opera ticket is exempt, whereas the purchase of a theme park ticket is not. Furthermore, such distortive effects would then infringe the neutrality principle without good reason[180]. Finally, very difficult borderline issues may arise when taxpayers and authorities have to classify certain services as either exempt cultural services or as taxed service of a different quality[181].

Against this background, the exemptions for cultural services should be regarded as disproportionate in so far as they are intended to benefit final consumers. However, some of those exemptions may also have been conceived to benefit the taxable person. Under such a premise, i.e. assuming that the exemption functions as a subsidy for the economic operator, the legislator enjoys a greater margin of appreciation as to which sectors and organizations should be eligible for the exemption. The corresponding exemptions therefore can withstand constitutional scrutiny, aside from their implications for the input VAT credit. Nevertheless, good tax policy, taking into account efficiency considerations and the transparency principle, would replace such exemptions with direct subsidies.

**5. Avoidance of double tax burdens**

Some exemptions have originally been granted by the Member States prior to VAT harmonization to mitigate an accumulation of turnover taxation, on the one hand, and the levy of special excise or stamp duties, on the other hand[182]. It is quite probable that they were incorporated into the Sixth VAT Directive not the least against this historical background, albeit sometimes also based on additional considerations. This can be assumed, in particular, for the supply of insurance services, for transactions relating to bets and lotteries, for certain

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[178] Cf. *Seaman*, in Ginsburgh/Throsby (eds.), Handbook of the Economics of Art and Culture, Amsterdam 2006, Chapter 14, pp. 424 et seq., and the references cited therein.

[179] See also *Hoffsümmer*, Steuerbefreiungen für Inlandsumsätze, Frankfurt a.M. 2009, p. 121: „arbitrary"; in a similar vein, *Mollard*, Archiv für schweizerisches Abgaberecht 1994, p. 443 (p. 463).

[180] Likewise *Cnossen*, International Tax and Public Finance 5 (1998), p. 399 (p. 404).

[181] Cf. *Tait*, Value-Added Tax, Washington 1988, p. 83.

[182] Cf. *Dziadkowski*, Umsatzsteuer-Rundschau 2006, p. 87 (p. 89); *Reiß*, in Tipke/Lang (eds.) Steuerrecht, 20. ed., Köln 2010, § 14 para. 92.

financial services like the supply of shares and other securities, and to some extent probably also for the supply of real estate[183]. All of these transactions are at least partially exempt under Art. 135 (1) RVD. With respect to the aforementioned financial services in particular, such an objective would also provide a consistent explanation for the exclusion of the management or safekeeping of shares from the scope of the exemption.

It should be noted, though, that over the course of the last decades and in the light of the modernization of many Member States' tax system, this originally legitimate justification[184] has become a rather weak one. It does not provide, by itself, a sound reason why the conceptually superior system of VAT as a general tax on consumer expenditure should partially yield to historically overcome excise taxes which can be levied or abolished by Member States at their discretion[185]. It is thus the Member States that should be held responsible for a double tax burden rather than the European system of harmonized VAT. Admittedly, some Member States with a strong emphasis on fiscal federalism may find it hard to integrate certain excise taxes and stamp duties into VAT and abolish them as independent taxes, because revenue allocation between the federal level and the sub-national level may be differing for the respective kind of tax. However, this problem could be solved by granting a generous transition period towards a more uniform commodities and service taxation.

To summarize, the Union legislator should not consider it necessary to exempt a transaction merely because it might be subject to national excise or stamp duties. Moreover, if the respective exemption is not matched by a corresponding excise or stamp duty within a certain Member State, its effects will go beyond what is necessary to attain its objective, hence the mandatory and uniform nature of the exemptions at issue seems ill-founded. It is therefore suggested that for proportionate justification, one should rather search for reasons that might justify levying a separate and often lower tax – instead of VAT – in the first place. These might be technical reasons, as could be brought forward, e.g., in the case of bets and lotteries or with a view towards certain financial services, or reasons of tax equity like in the case of certain insurance services.

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[183] Cf. *Peffekoven*, Zur Reform der Mehrwertsteuer, Berlin 2010, p. 32; *Stadie*, UStG, Köln 2009, p. 515 and p. 522. As regards insurance services in particular, see also *Swinkels*, International VAT Monitor 2007, p. 262; as regards real estate, see *Bird/Gendron*, The VAT in Developing and Transitional Countries, Cambridge 2007, pp. 84. However, the supply of real estate might also have been designated as exempt supply due to the difficulties of determining the consumption element inherent to the acquisition and use of this durable good, cf. *Ebrill* et al., The modern VAT, Washington 2001, p. 98.

[184] Cf. *Dziadkowski*, Umsatzsteuer-Rundschau 2006, p. 87 (p. 89).

[185] Cf. *Mollard*, Archiv für schweizerisches Abgaberecht 1994, p. 443 (pp. 463 et seq.).

**6. Hard to tax-supplies / avoidance of undue compliance burdens**

Some exemptions are based on considerations of administrative efficiency with respect to the assessment and collection of the tax, as well as on the desire to avoid undue compliance burdens.

The personal exemption for small enterprises – the so-called registration threshold provided for in all but one national VAT systems of EU Member States – can be justified by the objective to avoid excessive compliance burdens for these economic operators[186]. If no such personal exemption were available, the ensuing compliance burden might indeed be considered a disproportionate infringement of the fundamental right to conduct a business, cf. Art. 16 Charter of Fundamental Rights. Moreover, the registration threshold also reduces administrative costs, because the tax administration has to monitor a smaller number of taxable persons whose accounts tend to be better kept[187]. Arguably, the legislator has a wide margin of discretion in this regard, though, and the weighing and balancing of the conflicting aspects of a distortion of competition and / or unequal tax burdens of final consumers, on the one hand, and relief for business and administrative efficiency, on the other hand[188], will also depend on the broader regulatory context and level of development of each Member State[189]. It can therefore be defended that the Directive sets only maximum thresholds.

In a similar vein, the exemption for leasing and letting of immovable property is officially based on the avoidance of disproportionate compliance and administrative costs[190], besides the considerations of vertical tax equity or social policy that have already been discussed (and dismissed) above. According to the ECJ, leasing or letting of real estate is normally a relatively passive activity, not generating any significant added value[191], so that taxing it

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[186] Cf. *Bird/Gendron*, The VAT in Developing and Transitional Countries, Cambridge 2007, p. 120; *Crawford/Keen/Smith*, in Mirrlees et al. (eds.), Dimensions of Tax Design: the Mirrlees review, Oxford 2010, p. 275 (p. 309); *Ebrill* et al., The modern VAT, Washington 2001, p. 90; *Ruppe*, Umsatzsteuergesetz, 3. ed., Wien 2005, § 6 para. 12. See also *Stieglitz*, Economics of the Public Sector, 3rd ed. 2000, pp. 465 et seq. Empirical support for the above thesis is provided by *Dickson/White*, in Mirrlees et al. (eds.), Dimensions of Tax Design: the Mirrlees review, Oxford 2010, p. 387 (pp. 394 et seq.), who refer to two major New Zealand surveys showing that GST/VAT compliance costs are very regressive; this is affirmed by *Krever*, in Krever (ed.), VAT in Africa, Pretoria 2008, p. 9 (p. 19).

[187] Cf. *Cnossen*, International Tax and Public Finance 5 (1998), p. 399 (p. 402).

[188] See, in this regard, also *Dickson/White*, in Mirrlees et al. (eds.), Dimensions of Tax Design: the Mirrlees review, Oxford 2010, p. 387 (p. 402); *Massa*, in Weidenbaum et al. (eds.), The Value Added Tax: Orthodoxy and New Thinking, Boston 1989, p. 237 (pp. 247 et seq.)

[189] See also *van Brederode*, Systems of General Sales Taxation, Alphen aan den Rijn 2009, pp. 123 et seq., regarding the factors to be taken into account when fixing the relevant threshold.

[190] Cf. Explanatory Memorandum (note 8), p. 15: "… it should be noted that in the Member States the letting of immovable property is generally exempted on technical, economic and social grounds."

[191] Cf. ECJ 4 October 2001, Case C-326/99, *Goed Wonen* [2001] ECR I-6831, para. 52, with further references to legislative history; confirmed in ECJ 18 November 2004, Case C-284/03, Temco Europe [2004] ECR I-11237, para. 20.

would not yield much extra revenue (as compared to the present exemption without credit) but impose significant compliance burdens on a great number of landlords who are not otherwise liable for VAT[192].

Based on such reasoning an exemption for the leasing and letting of *residential* housing can be regarded as justified: The assumption that the letting of such property provides for only a relatively small contribution to value added, whereas the number of private landlords and thus potential taxpayers is large, seems defendable taking into account a margin of appreciation to be conceded to the Union legislator[193]. It can also be defended to provide for an objective exemption in addition to the subjective registration threshold (small business exemption)[194]. Such reasoning would neglect the presumed peculiarity of letting and leasing of residential housing, namely the relatively small amount of value added which can reasonably raise concerns of disproportionate administrative costs also beyond the standard threshold. By contrast, it is questionable whether this is equally true for commercial rents. It is therefore consistent, but insufficient, to exclude the supply of hotel accommodation and parking sites, and the letting of permanently installed equipment and machinery from the scope of the exemption[195]. In general, it does cause unnecessary and thus disproportionate complications that the exemption (without credit) is not limited to residential housing[196].

Closely related to exemptions intended to avoid excessive compliance and administrative costs are those for "hard to tax"-services. Traditionally, it has been assumed that it is impossible or at least overly complex to assess the taxable base for certain categories of services within the framework of a transaction-based multi-stage tax such as VAT. The exemption for betting, lotteries and other forms of gambling laid down in Art. 135 (1) (i)

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[192] For critical comments, see *Kirchhof*, Umsatzsteuer Gesetzbuch, Heidelberg 2008, § 11 para. 36, who objects that landlords have to file tax reports and keep tax records, anyways, because they are usually liable to income tax; hence, a VAT liability would not imply any significant additional compliance or administrative costs. However, in the author's view the Community legislator should have a margin of appreciation regarding the relative severity of the added VAT compliance and administrative burden; it should furthermore be acknowledged that VAT liability is also associated with additional compliance *risks* for both, the taxable person and the tax administration. This is also not fully reflected in the critical statement made by *Hoffsümmer*, Steuerbefreiungen für Inlandsumsätze, Frankfurt a.M. 2009, pp. 147 et seq.

[193] For instance, the gross added value by letting of dwellings excluding imputed rent of owner occupiers accounted for only approx. 3 % of overall value added in the UK in 2010 (estimate, based on a homeownership rate of approx. 70 % and the data provided by the UK Office for National Statistics, The Blue Book 2010, p. 104). By contrast, there are an estimated 1 million private landlords in the UK (according to a 2007 Mintel study), most of whom will not already be registered for VAT on grounds of other economic activities.

[194] For a different opinion, see *Hoffsümmer*, Steuerbefreiungen für Inlandsumsätze, Frankfurt a.M. 2009, p. 147.

[195] Cf. Art. 135 (2) (a) to (c) RVD.

[196] For a detailed discussion, see *Cnossen*, International Tax and Public Finance 5 (1998), p. 399 (pp. 405 et seq.).

RVD has been based "on practical considerations" of this kind[197]. In the view of the Commission, such activities are "ill-suited to taxation on a value-added basis and are better dealt with by means of special taxes."[198] It has furthermore been pointed out that the exemption for the letting of residential housing can also be defended as a reflection of the difficulties inherent to the taxation of the imputed rental value of owner-occupied property: If the latter cannot be properly assessed, the former should also not be taxed to maintain fiscal neutrality[199].

In a similar vein, it has frequently been stated that the financial services listed in 135 (1) (b) to (g) RVD have originally been exempted because the taxable base was presumed to be difficult to calculate[200]. In particular, the cost of the service is often included in a margin and thus cannot be determined easily[201]. This argument has been advanced in literature, for example, with respect to transactions concerning the supply or exchange of currency, bank notes and coins used as legal tender[202]. Similar reasons have been put forward to justify the exemption available for depositing and account-keeping services[203], for the granting of credit[204], and for

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[197] Cf. ECJ 10 June 2010, Case C-58/09, Leo-Libera, n.y.r., para. 24.

[198] Cf. Explanatory Memorandum (note 8), p. 16; likewise *Terra/Wattel*, European Tax Law, 5th ed., Alphen aan den Rijn 2008, p. 308. See also *Schenk*, in Krever (ed.), VAT in Africa, Pretoria 2008, p. 47 (pp. 53 et seq.), who proposes to tax casinos and other operators of games of chance based on gross margins rather than on a transaction basis, albeit as an integral part of the VAT.

[199] Cf. *Bird/Gendron*, The VAT in Developing and Transitional Countries, Cambridge 2007, pp. 82 et seq.; *Cnossen*, International Tax and Public Finance 5 (1998), p. 399 (p. 405); *Krever*, in Krever (ed.), VAT in Africa, Pretoria 2008, p. 9 (pp. 24 et seq.). See also *van Brederode*, Systems of General Sales Taxation, Alphen aan den Rijn 2009, p. 191.

[200] Cf. ECJ 19 April 2007, Case C-455/05, Velvet & Steel [2007] ECR I-3225, para. 24; *Crawford/Keen/Smith*, in Mirrlees et al. (eds.), Dimensions of Tax Design: the Mirrlees review, Oxford 2010, p. 275 (p. 306); *Ebrill* et al., The modern VAT, Washington 2001, pp. 90 et seq.; *Henkow*, Finanical Activities in European VAT, Alphen aan den Rijn 2008, pp. 88 et seq. with further references. This view is questioned by *Amand*, International VAT Monitor 2010, p. 409 (p. 414), who refers to some statements made by *Maurice Lauré* about the motivation of the French legislator for the exemption of financial services implemented in France in 1954.

[201] For further details, see *Ebrill* et al., The modern VAT, Washington 2001, pp. 94 et seq.; *Grubert / Krever*, VAT and Financial Supplies: What should be taxed?, Oxford University Centre for Business Taxation Working Paper 10/18, 2010, pp. 12 et seq.; *Heidemann*, Die Umsatzsteuerbefreiungen von Finanzdienstleistungen, Berlin 2008, pp. 111 et seq. and pp. 116 et seq.

[202] Cf. *Reiß*, in Tipke/Lang (eds.), Steuerrecht, 20. ed., Köln 2010, § 14 para. 91. For a different opinion, see *Friedrich-Vache* Verbrauchsteuerkonforme Umsatzbesteuerung von Finanzdienstleistungen, Köln 2005, p. 248: the availment of the exchange service does not constitute consumption on part of the recipient of the service and should therefore not be subject to tax in the first place. However, in the author's view this could only be assumed if the exchange service were intrinsically linked to a savings / investment activity rather than a corollary to consumption, which is arguably not the case, though, cf. *Heidemann*, Die Umsatzsteuerbefreiungen von Finanzdienstleistungen, Berlin 2008, p. 72.

[203] Cf. *Hoffsümmer*, Steuerbefreiungen für Inlandsumsätze, Frankfurt a.M. 2009, p. 151.

[204] Cf. *Henkow*, Finanical Activities in European VAT, Alphen aan den Rijn 2008, pp. 6 et seq. with further references. It should be noted, though, that the main argument in this regard is an economic one which is based on the view that a bank, by offering the possibility of interest-bearing deposits, on the one hand, and by lending money to other economic agents, on the other hand, essentially provides intermediation services for its depositors and borrowers, hence the taxable base should be the value added by this intermediation activity, i.e. the difference between the respective interest rates for depositors and borrowers (after subtraction of an implicit fee for depositing services), which is hard to determine under a transaction based tax such as VAT, cf.

insurance services[205]. The Commission pointed out in 2006 that "the decision of the Council [in 1977 upon the adoption of the Sixth VAT Directive] was to exempt financial services and insurances, mainly for pragmatic reasons since the technical difficulties could not be readily overcome. These consisted mainly in the impossibility of establishing taxable amounts and the amounts of deductible VAT without generating unacceptable administrative charges and without creating legal and accounting complexity for both economic operators and Member States' fiscal authorities."[206]

Even though the Commission also referred to "the perceived political sensitivities associated with imposing VAT on consumers" as an additional motive for the exemption of financial services, the latter was probably only an ancillary concern[207]. It also goes a step too far to demand that all financial services "charged for in form of a fee... can and should be fully taxed"[208], even though the calculation of the taxable base indeed does not raise any conceptual difficulties in such cases. Their exemption can nevertheless be defended on grounds of the neutrality principle, in so far as the service at issue could also be charged implicitly in a margin, which will usually be the case.

However, it is appropriate to emphasise that exemptions for technical reasons imply a particular duty of the legislator to monitor technical developments, especially in the affected sector of the economy. An exemption is not necessary any more – and thus becomes a disproportionate interference with the principle of tax equality – once technical or economic changes or new developments in economic theory would make it feasible to tax the transactions at issue[209]. Furthermore, and from the provision's inception, the disadvantages associated with the exemption (less legal certainty due to the need to determine its scope; eventual infringements of the neutrality principle and of the principle of equality of taxation) must not outweigh the technical difficulties of taxing the transactions at issue. As regards financial services in particular, it seems that their exemption is still tenable despite the

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*Grubert / Krever*, VAT and Financial Supplies: What should be taxed?, Oxford University Centre for Business Taxation Working Paper 10/18, 2010, pp. 12 et seq.

[205] Cf. *Swinkels*, International VAT Monitor 2007, p. 262.

[206] European Commission, Consultation paper on modernising the Value Added Tax obligations for financial services and insurance, 2006, p. 2. For critical comments, see *Friedrich-Vache*, Verbrauchsteuerkonforme Umsatzbesteuerung von Finanzdienstleistungen, Köln 2005, pp. 213 et seq.

[207] As *Henkow*, Finanical Activities in European VAT, Alphen aan den Rijn 2008, p. 90, remarks, the exemptions would otherwise have been included in Art. 132 RVD (ex-Art. 13A Sixth Directive) titled "Exemptions… in the public interest". For a different opinion, see *Friedrich-Vache*, Verbrauchsteuerkonforme Umsatzbesteuerung von Finanzdienstleistungen, Köln 2005, pp. 212 et seq.

[208] Cf. *Crawford/Keen/Smith*, in Mirrlees et al. (eds.), Dimensions of Tax Design: the Mirrlees review, Oxford 2010, p. 275 (p. 306).

[209] Likewise *Mollard*, Archiv für schweizerisches Abgaberecht 1994, p. 443 (462).

taxation techniques that have meanwhile been proposed and discussed as possible alternatives[210].

**7. Non-consumptive nature of related expenditure**

It has already been demonstrated in the context of the above discussion of tax equity objectives that exceptionally, an exemption will promote rather than contradict essential principles underlying VAT as a tax that intends to allocate the fiscal burden in proportion to individual taxpaying capacity as indicated by consumption expenditure. This will arguably also be the case when the expenses incurred for the exempt supply cannot be considered expenditure made for the purpose of *consumption* even though they are not incurred in the course of taxable business. In a recent judgement, the ECJ has acknowledged that there exists a sphere of activities which constitute neither an economic activity relating to transactions that are taxable under the common system of VAT, nor an activity related to private consumption of goods or services[211].

This could in particular be assumed for private financial investments that do not yield any direct utility for the investor, such as the acquisition of bonds, shares, and other securities, but rather constitute a mere transformation of money into another form of monetary asset representing the potential for future consumption[212]. The same applies for (cash value) life insurance premiums or pension insurance premiums, in so far as the respective premium consists of a savings element[213]. Since the European-style VAT has explicitly been conceived

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[210] For a more extensive discussion, see *van Brederode*, Systems of General Sales Taxation, Alphen aan den Rijn 2009, pp. 146 et seq.; *Cnossen*, International Tax and Public Finance 5 (1998), p. 399 (pp. 407 et seq.); *Crawford/Keen/Smith*, in Mirrlees et al. (eds.), Dimensions of Tax Design: the Mirrlees review, Oxford 2010, p. 275 (pp. 306 et seq.). Since opinions of economic scholars on the issue are divided and there is no clear "best practice" as yet established, the continuation of the present system cannot be regarded as obviously disproportionate. Likewise *Bird/Gendron*, The VAT in Developing and Transitional Countries, Cambridge 2007, p. 97.

[211] Cf. ECJ 12 February 2009, Case C-515/07, Vereniging Noordelijke Land- en Tuinbouw Organisatie (VNLTO) [2009] ECR I-839.

[212] Cf. *Frink*, Der Ausschluss des Vorsteuerabzugs bei der Ausführung steuerfreier Umsätze im Umsatzsteuerrecht, Regensburg 2002, p. 145; *Heidemann*, Die Umsatzsteuerbefreiungen von Finanzdienstleistungen, Berlin 2008, pp. 57 et seq.; *Heidner*, in Bunjes/Geist (eds.), Umsatzsteuergesetz, 9. Auflage, München 2009, § 4 Nr. 8 para. 2; *Hoffsümmer*, Steuerbefreiungen für Inlandsumsätze, Frankfurt a.M. 2009, p. 151; *Kraeusel*, in Reiß/Kraeusel/Langer, Umsatzsteuergesetz, loose-leaf commentary, March 2010, Bonn, § 4 Nr. 8 para. 27; *Ruppe*, in Lang (ed.), Die Steuerrechtsordnung in der Diskussion, Festschrift für Klaus Tipke, Köln 1995, p. 457 (p. 464); *Ruppe*, Umsatzsteuergesetz, 3. ed., Wien 2005, § 6 para. 98. For a different opinion, see *Stadie*, in Seer (ed.) Umsatzsteuer im Europäischen Binnenmarkt, Köln 2009, p. 143 (pp. 149 et seq.).

[213] See also *Hoffsümmer*, Steuerbefreiungen für Inlandsumsätze, Frankfurt a.M. 2009, p. 137; *Kirchhof*, Umsatzsteuer Gesetzbuch, Heidelberg 2008, § 11 para. 24. However, *Kirchhof* ignores that part of the insurance premium constitutes a premium for the coverage of biometric risks and thus, arguably, consumption expenditure. The exemption also of this element of the premium can thus only be justified on grounds of

as a general tax on *consumption* (expenditure), one might therefore assume that any such transaction should not be burdened with VAT[214]. In the same vein, directly related services such as financial investment advisory services should also be spared from taxation[215], because they constitute expenses caused by private saving activities rather than consumption expenditure. This would be consistent with the usual deductibility of any such costs under a Haig-Simons income tax or a personal expenditure tax[216]. Since a VAT refund might be considered to be technically unfeasible, because it would seemingly require private individuals to register for VAT, the second-best solution might then be an exemption of the corresponding supplies. By contrast, the granting of a consumer credit that is now exempt pursuant to Art. 135 (1) (b) RVD should rather constitute a taxed transaction – were it technically feasible – because it is directly related to private consumption[217].

In a similar vein, many scholars contend that the expenditure for the acquisition of raw land, the supply of which might be exempt pursuant to Art. 135 (1) (k) RVD[218], does not relate to consumption but rather to an investment and savings activity[219]. It could also be argued that expenditure for (higher) education and vocational training is an investment rather than a consumption activity. It has long been accepted in economic and legal literature that education is a consumption good as well as an investment good[220], and it would not be

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administrative efficiency, because tax authorities can hardly be expected to verify the pertinent information that would have to be furnished by the insurance companies, cf. *Hoffsümmer*, at pp. 137 et seq.

[214] This is suggested by *Camenzind/Honauer/Vallender*, Handbuch zum MwSt-Gesetz, 2. ed., Bern 2003, pp. 235 et seq. (para. 653); *Ruppe*, Umsatzsteuergesetz, 3. ed., Wien 2005, § 6 para. 12.

[215] For a different opinion regarding related services, cf. *Frink*, Der Ausschluss des Vorsteuerabzugs bei der Ausführung steuerfreier Umsätze im Umsatzsteuerrecht, Regensburg 2002, p. 145; *Heidemann*, Die Umsatzsteuerbefreiungen von Finanzdienstleistungen, Berlin 2008, pp. 91 et seq. and pp. 101 et seq.

[216] See, in this regard, also the references to economic debate on financial intermediation and VAT provided by *Grubert / Krever*, VAT and Financial Supplies: What should be taxed?, Oxford University Centre for Business Taxation Working Paper 10/18, 2010, pp. 5 et seq.; *Henkow*, Finanical Activities in European VAT, Alphen aan den Rijn 2008, pp. 80 et seq.

[217] Likewise *Heidemann*, Die Umsatzsteuerbefreiungen von Finanzdienstleistungen, Berlin 2008, p. 93; *Kirchhof*, Umsatzsteuer Gesetzbuch, Heidelberg 2008, § 11 para. 46; for a different opinion see *Friedrich-Vache*, Verbrauchsteuerkonforme Umsatzbesteuerung von Finanzdienstleistungen, Köln 2005, pp. 220 et seq.; *Reiß*, in Tipke/Lang (eds.), Steuerrecht, 20. ed., Köln 2010, § 14 para. 91; *Reiß*, Cahiers de droit fiscal international, Vol. 88b, p. 351 (372).

[218] Art. 135 (1) (k) RVD exempts the supply of land which has not been built on other than the supply of building land.

[219] Cf. *Hoffsümmer*, Steuerbefreiungen für Inlandsumsätze, Frankfurt a.M. 2009, p. 131; *Ruppe*, Umsatzsteuergesetz, 3. ed., Wien 2005, § 6 para. 192; *Tait*, Value-Added Tax, Washington 1988, pp. 80 et seq. (albeit with some qualifications). For a different opinion, see *Söhn*, Steuer und Wirtschaft 1976, p. 1 (7 et seq.). See also *Henkow*, Finanical Activities in European VAT, Alphen aan den Rijn 2008, p. 69 and pp. 78 et seq.

[220] See, for instance, *Gross*, University of Chicago Law Review 55 (1988), p. 916 (pp. 930 et seq.); *McNulty*, California Law Review 61 (1973), p. 1 (pp. 18 et seq.); *Schaafsma*, The Journal of Human Resources 11 (1976), p. 233 and pp. 240 et seq.; *Schultz*, The Journal of Political Economy 76 (1968), p. 327 (p. 330); *Vila*, European Journal of Education 35 (2000), p. 21 (pp. 22 et seq.).

obviously unreasonable to argue that in today's modern labour markets, the investment aspect is clearly the dominating one[221].

Now admittedly, the present system of the harmonized European VAT does not distinguish between expenditure for private use and enjoyment of goods and services, on the one hand, and the use of goods or services for personal savings, or other non-taxable activities which arguably do not constitute private consumption, on the other hand. As a general rule, there is no tax relief available for the latter kind of activities, either. From the final taxpayer's perspective, the scope of the tax is thus not strictly limited to expenditure for private consumption. Hence, it would seemingly be inconsistent to single out financial services related to the acquisition of shares, educational services, etc., on grounds of a presumed non-consumptive nature of related expenditure. But one could also come to a different assessment, concluding that it is indeed the standard denial of VAT relief for supplies used for other activities than individual private consumption which is *prima facie* inconsistent and in need of justification, whereas the exemption for goods and services which are typically acquired only in order to carry out such activities would, in principle, correspond to the specific principles of tax fairness underlying the VAT system and to its inherent economic rationale. Such has been the conclusion of some prominent scholars, and this position is also shared by the author of this paper.

Obviously, an assessment of the consistency of the exemptions for financial services, as required by the equality principle, depends on whether the above explanation for them should be accepted, or whether the justifications that have originally been brought forward for those exemptions can still be regarded as relevant and convincing. For instance, based on the above premise, it would seem inconsistent to exclude the management or safekeeping of shares from the scope of the exemption under Art. 135 (1) (f) RVD.

Along the same lines, some other exemptions that certain Member States are authorized to maintain by virtue of Art. 371 RVD and Annex X Part B could be regarded as compliant with the concept of VAT as a general and equitable tax on consumption. In particular, public expenditure for the supply, modification, repair, maintenance, chartering and hiring of fighting ships or aircraft used by State institutions need arguably not be burdened with VAT.

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[221] Cf. *Argrett*, Syracuse Law Review 41 (1990), p. 621 (pp. 638 et seq.: consumption element is "insignificant"); *Ismer*, Bildungsaufwand im Steuerrecht, 2006, pp. 15 et seq. This has also been the position adopted by the German Federal Tax Court in the context of personal income taxation, cf. Federal Tax Court 28 August 2008, Case VI R 35/05, BStBl II 2009, p. 108 (p. 110); Federal Tex Court 27. Mai 2003, Case VI R 33/01, BStBl II 2004, p. 884 (p. 885).

These inputs for the provision of public goods and services do not imply identifiable supply transactions to individual consumers or other individual customers[222]. Moreover, in so far as they are funded through taxation they cannot be linked to individual (consumption) expenditure[223]. And even if one were to characterize the use of such input supplies as "collective" consumption that is realized by a public entity[224], such consumption would not indicate individual taxpaying capacity. However, the latter aspect is precisely what the equality principle is concerned with, because a fair and equitable tax is one that distributes the overall tax burden fairly among individuals. It is neither inherent to such a concept nor does it make much sense to have the state contribute its "fair share" to its own funding needs[225].

However, if one were to follow this reasoning, then obviously the fragmentary and non-compulsory nature of the corresponding exemptions must be objected to as inconsistent implementation of the underlying rationale. For instance, supplies related to military equipment in general would then have to be exempt. Adopting an even broader perspective, it also becomes obvious that itemized exemptions cannot be relied on as a comprehensive remedy for unjustified VAT burdens of public sector entities, even if they were granted with credit, i.e. in the form of zero-rating: Most supplies made to such entities will also be demanded by private customers, and to make the exemption dependent on customer status would inject considerable complexity into the system. Therefore, the superior approach would be the extension of the taxable sphere of public sector entities to all activities for which they receive a consideration from the private sector, and the implementation of refund schemes –

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[222] As regards this requirement under the RVD as interpreted by the ECJ, see ECJ 18 December 1997, Case C-384/95, Landboden Agrardienste [1997] ECR I-7387, para. 23. From a conceptual viewpoint, this requirement is debatable, cf. *Aujean/Jenkins/Poddar*, VAT Monitor 1999, p. 144 (pp. 146 et seq.).

[223] See also *Aujean/Jenkins/Poddar*, VAT Monitor 1999, p. 144 (p. 147): "the link is too remote". However, fees charged for public services should in any event be taxable and, as a general rule, taxed; likewise (but with preference for full taxation of the public sector) *Bird/Gendron*, The VAT in Developing and Transitional Countries, Cambridge 2007, p. 93.

[224] This "traditional thinking" is mentioned – and rejected – by *Aujean/Jenkins/Poddar*, VAT Monitor 1999, p. 144 (p. 146).

[225] Cf. *Kirchhof*, Umsatzsteuergesetzbuch, Heidelberg 2008, § 4 para. 4; *Pohmer*, in Aaron (ed.), The value-added tax. Lessons from Europe, 1981, p. 91 (p. 94). *Cnossen*, International Tax and Public Finance 5 (1998), p. 399 (403), argues that "application of the VAT… has the advantage of confronting policymakers more directly with the full cost of public intervention." However, this reasoning comes close to a *petitio principii*; VAT should be a cost factor only if the recipients of public goods and services – or private sector entities subsidizing the recipients – do have to make payments that can be sufficiently linked to these public sector supplies

such as currently operated in some EU Member States and in Canada[226] – for the remainder of (in particular: redistribution) activities[227].

**8. International tax competition**

For a Member State of the EU, there is little need to implement exemptions in order to match similar exemptions in other Member States that could undermine the competitiveness of taxable persons established in the former. As a general rule, exemptions are uniform within the entire EU, so that the phenomenon of international tax competition is essentially reserved to the application of a reduced tax rate, with respect to which Member States enjoy a wide margin of discretion. However, it cannot be excluded that certain service providers compete, to a significant degree, with suppliers from third countries who benefit from traditional tax exemptions. In particular, certain financial services may fall into this category[228].

Of course, under a model VAT where the taxation of all international trade is firmly and wholly based on the destination principle, there should be hardly any room for international tax competition and thus hardly any need to match exemptions in foreign jurisdictions in order to prevent competitive disadvantages for domestic business. Foreign suppliers who offer their goods and services to customers in the domestic market would then have to calculate with the same VAT burden as their domestic competitors. Under this premise, the level of taxation in other jurisdictions could, at most, influence a citizen's choice of habitual abode or domicile. But considering the relative (lack of) importance of this aspect in comparison with other factors that determine a person's place of residence, this would be a rather hypothetical and negligible effect.

It would only exceptionally be otherwise with respect to products and services which are typically consumed immediately when they are supplied, which moreover provide the same degree of utility to an average consumer regardless of where they are consumed, and which are so expensive that an average consumer would be willing to travel to another jurisdiction in order to acquire the supply there. For example, a family pondering a theme park vacation in Europe might be attracted to a certain jurisdiction through lower prices due to a VAT exemption. Moreover, with a view to the indirect effect that a VAT exemption usually has on

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[226] Cf. *Copenhagen Economics / KPMG*, VAT in the public sector and exemptions in the public interest, Final Report for TAXUD/2009/DE/316, 2011, pp. 80 et seq.

[227] See also *Aujean/Jenkins/Poddar*, VAT Monitor 1999, p. 144 (pp. 145 et seq.). As regards some of the possible shortcomings and trade-offs that have to be addressed when implementing a refund scheme, see *Bird/Gendron*, The VAT in Developing and Transitional Countries, Cambridge 2007, pp. 92 et seq.

[228] This is also suggested by *Kirchhof*, Umsatzsteuer Gesetzbuch, Heidelberg 2008, § 11 para. 47 and 51, with respect to the granting of credit and regarding account-keeping services.

the volume of turnover, economic agents, too, could make the choice where to offer their supplies dependent upon the existence of an exemption in such a scenario. This could be the case, for instance, for the organizers of huge sporting events such as world soccer championships. It is noticeable in this regard that some Member States are indeed authorized to still exempt admission to sporting events by virtue of Art. 371 RVD.

However, the reality of European VAT is a different one. For B2C transactions, with respect to which asymmetrical exemptions could convey a competitive advantage, the default rule in the harmonized system of VAT used to determine the place of supply for services and thus the relevant tax jurisdiction is still the *supplier's* place of management or fixed establishment, cf. Art. 45 RVD. Thus, the origin principle still prevails for B2C services, and services in turn make up for the great majority of exempt transactions. Therefore, the maintenance of certain exemptions (not necessarily the ensuing denial of input VAT deduction[229]) can possibly also be justified by the intention to fend off distortions of competition to the detriment of service suppliers established within the EU. For example, should the Union legislator decide to abolish the exemptions currently provided for the management of investment funds or the granting of credit, third-country financial services providers who are domiciled in a jurisdiction where these services are still exempt or not subject to VAT would enjoy a competitive edge over companies that offer similar services from within the EU[230].

At first sight, one could object that it is unnecessary and thus disproportionate to keep exemptions merely based on the above considerations, because a superior alternative would be to change the place of supply rules. Pursuant to the "switch-over" clause of Art. 59a RVD, Member States may already consider the place of supply of a service, if situated outside the Community, as being situated within their territory if the effective use and enjoyment of the service takes place within their territory, in order to prevent distortion of competition. If that rule were enhanced to become a compulsory one, the destination principle would prevail over the origin principle whenever a service is taxed under the EU harmonized system but usually exempt under the VAT/GST rules of third countries. However, a closer look reveals that such an approach cannot be considered a feasible alternative unless proper tax assessment and tax collection in the Member State of destination could be ensured even though the taxable person cannot be audited by that Member State, and the recipient of the supply has neither an incentive nor an obligation to report to the tax authorities. Considering the present degree of

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[229] See the discussion below at V.2.d.
[230] Cf. *Heidner*, in Bunjes/Geist, UStG, 9 Auflage, München 2009, § 4 Nr. 8 para. 39.

international cooperation in VAT matters, the Community legislator may in general reasonably assume that the maintenance of an exemption is the better solution.

It should be noted that under the premise that serious international tax competition is really the motive underlying an exemption, the latter does not constitute a tax privilege for the taxable person. To the opposite, such an exemption is necessary in order to avoid that the taxable person who cannot shift the asymmetrical VAT burden contrary to its concept as a tax to be borne by the final consumer suffers from distortions of competition that would infringe the neutrality principle. The exemption also does not have to be justified as a breach of the principle of equality of consumer taxation, because the latter is not primarily caused by the exemption as such, but rather by the fact that consumers could avoid a VAT burden anyways by substituting the taxed domestic services with exempt or untaxed services provided by third-country suppliers. Notwithstanding these considerations, the pressures of international tax competition provide a legitimate and proportional justification for a VAT concession only as long as no agreement can be reached with relevant third countries to tax the relevant services in an internationally coordinated reform.

## V. Non-deductability of input VAT

The input tax credit granted under a VAT system ensures that, ideally, only consumption expenditure is taxed[231] in proportion to the price of goods and services, as contemplated in Art. 1 (2) RVD. This is a fundamental principle of the common system of VAT established by the relevant EU legislation[232], and the main distinction from predecessor turnover taxes. As a general rule, though, under the EU system of VAT the credit can be claimed only in so far as input goods and services are used for the purposes of taxed transactions, pursuant to Art. 168 RVD. The denial of an input tax credit as a consequence of carrying out exempt transactions has been referred to as the "original sin"[233] of the common system of VAT[234].

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[231] Cf. *Gottfried/Wiegard*, Journal of Public Economics 46 (1991), p. 307 (308).
[232] Cf. ECJ 12 May 2011, Case C-107/10, Iztok 3, n.y.r., paras. 31 et seq., and the case-law cited therein.
[233] Cf. Opinion of AG *Colomer* 22 February 2005, case C-498/03, Kingscrest [2005] ECR I-4427, heading before para. 14. See also the references cited by *Mollard*, Archiv für schweizerisches Abgaberecht 1994, p. 443 (445). *Ebrill* et al., The modern VAT, Washington 2001, p. 83, refer to this feature as an "aberration in terms of the basic logic of VAT".
[234] It was already contemplated in Art. 11 (2) of the Second VAT Directive.

## 1. General observations

### *a) Technical vs. substantive coherence*

Admittedly, the nexus between the exemption of a transaction, on the one hand, and the ensuing non-deductability of any input VAT for supplies that have been used to carry out the exempt transaction[235], on the other hand, is *technically* coherent if the "principle of deduction" contemplated in the common system of VAT since its inception is understood to require a correlation between input tax and output tax[236]. This is indeed suggested by what is now Art. 1 (2) RVD and Art. 168 RVD. But such technical consistency of the mechanism of input VAT deduction, if assessed in isolation, does not imply that the inherent limitation of a credit or refund for input VAT also forms a consistent and integral part of the overall system of VAT[237]. To the contrary, any element of harmonized EU VAT must comply with – and therefore has to be scrutinized in the light of – the essential requirements of fiscal neutrality (in the sense of equal taxation of competing supplies and suppliers, and of relieving business entirely from any substantive VAT burden), and it has to respect the principle of equality of taxation of consumer expenditure. Any shortcomings in this regard need special justification[238].

### *b) Ill-conceived origins and lack of judicial awareness*

Historically, none of these fundamental principles and considerations seems to have been much of a concern when the rules on exemptions and the ensuing restrictions with respect to

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[235] Cf. Art. 168 RVD *e contrario*. An input supply is generally deemed to have been used for a specific output transaction if the former constitutes a "direct" cost component of the latter, cf. Art. 1 (2) RVD; see also ECJ 6 April 1995, Case C-4/94, BLP Group [1995] ECR I-983, paras. 18 et seq.; ECJ 8 June 2000, Case C-98/98, Midland [2000] ECR I-4177, paras. 20 and 30; ECJ 22 February 2001, Case C-408/98, Abbey National [2001] ECR I-1361, paras. 25 et seq.; ECJ 29. October 2009, Case C-29/08, Skatteverket/AB SKF [2009] ECR I-10413, para 57. For further details, see *Kofler*, in Achatz/Tumpel (eds.) Vorsteuerabzug, Wien 2005, p. 105 (pp. 107 et seq.).

[236] This is emphasized by *Stadie*, in Seer (ed.), Umsatzsteuer im Europäischen Binnenmarkt, Köln 2009, p. 143 (p. 151). Likewise *de la Feria*, The EU VAT System and the Internal Market, 2009, pp. 142 et seq., who concludes that the ensuing restrictions to the right to deduct in case of exempt supplies are therefore coherent with the principles of EU VAT.

[237] Likewise *Ruppe*, in Lang (ed.) Die Steuerrechtsordnung in der Diskussion. Festschrift für Klaus Tipke, Köln 1995, p. 457 (pp. 469 et seq.); *Tipke*, Die Steuerrechtsordnung, Vol. II, 2. ed., Köln 2003, p. 999.

[238] The ECJ routinely limits the scope of the principle of VAT neutrality to economic activities "subject in principle to VAT", cf. ECJ 29 Juli 2010, Case C-188/09, Profaktor, n.y.r., para. 20; ECJ 22 December 2010, case C-438/09, Dankowski, n.y.r., para. 24; ECJ 22 December 2010, case C-277/09, RBS Deutschland Holdings, n.y.r., para. 38; settled case-law. However, this is a mere restatement of the status quo under the present directives, rather than a normative statement based on the Court's own – and correct – characterization of the principle of fiscal neutrality as a VAT-specific manifestation of the equality principle, whose scope cannot be limited by referring to the shortcomings of the secondary Union law that it is supposed to control. For an extensive critique, see above at III. 2. b) (2).

input VAT credit and refund were drawn up[239]. Indeed, the denial of input VAT credit or refund is probably a relict of the past perception of VAT as a special form of transactional turnover tax on business output[240]. For some governments, it seemed "out of the question to grant [exempt] business sectors that do not contribute to the collection of tax revenue a refund for taxes paid by other businesses"[241]. However, in the harmonized system of European VAT such a conception of value added tax is no longer in conformity with its fundamental orientation as a tax on consumption[242], as it has been expressly formulated in Art. 1 (2) RVD, and as it is apparent from various provisions of this Directive[243].

For the purposes of constitutional scrutiny, it must therefore be assumed that according to the now prevailing theory of VAT, the non-deductible VAT is *supposed* to be implicitly shifted on the recipient of the supply in the price of the goods or services. This would seem to be within a margin of appreciation and generalization to be conceded to the legislation, notwithstanding the fact that empirically, the incidence of VAT depends not only on the design of VAT legislation, but also on a variety of marketplace factors that are beyond control of the legislator. Otherwise, the fundamental principle that harmonized European VAT is a tax on consumption to be born by the final consumer rather than by the taxable person, would be blatantly infringed without any apparent justification[244]. It should be noted, though, that

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[239] Only the European Parliament pointed out that the number of exemptions contemplated in the Commission's proposal for the Sixth VAT Directive "…must remain limited…[because] the tax applied at an earlier stage [than retail stage] is retained in the price of the entrepreneur's end product as supplied to the customer, which means that the turnover tax paid by the ultimate consumer is not exactly proportional to the price of the product or service…"; cf. European Parliament, Documents of session 1973-1974, Document 360/73 of 14 February 1974, as cited by *Amand*, International VAT Monitor 2010, p. 409 (pp. 410 (411).

[240] Cf. *Ruppe*, in Lang (ed.) Die Steuerrechtsordnung in der Diskussion. Festschrift für Klaus Tipke, Köln 1995, p. 457 (pp. 469 et seq.).

[241] Cf. explanatory memorandum to the 1963 draft of a German VAT Act, Bundestags-Drucksache IV/1590, p. 26; similar concerns have been raised in the explanatory memorandum to the Austrian VAT Act 1972, as cited by *Ruppe*, Umsatzsteuergesetz, 3. ed., Wien 2005, § 6 para. 15. This line of reasoning can be regarded as paradigmatic for the predominant approach to exemptions at the time when the first VAT Directives were enacted. The same idea is obviously also underlying Art. 99 (2) RVD that deals with reduced VAT rates and stipulates that "each reduced rate shall be so fixed that the amount of VAT resulting from its application is such that the VAT deductible … can normally be deducted in full", hence refunds for VAT levied at former stages from other businesses should be avoided.

[242] In German literature, this has been pointed out by *Friedrich-Vache*, Verbrauchsteuerkonforme Umsatzbesteuerung von Finanzdienstleistungen, Köln 2005, p. 41; *Kirchhof*, Umsatzsteuer Gesetzbuch, Heidelberg 2008, § 11 para. 55; *Stadie*, in Seer (ed.), Umsatzsteuer im Europäischen Binnenmarkt, Köln 2009, p. 143 (p. 152); *Teichmann*, Der Verlust des Vorsteuerabzugs im steuerfreien Bereich der Mehrwertsteuer, Köln 1975, p. 140. See also *Krever*, in Krever (ed.), VAT in Africa, Pretoria 2008, p. 9 (p. 13): A consumption-type VAT is not a tax on value added; its denomination as such refers merely to the mechanism by which the tax operates.

[243] In particular, the entitlement of taxable persons (acting as such) to an input VAT deduction or credit, and the provisions on taxable self-supplies for private purposes.

[244] This has already been firmly established in the PhD thesis written by Knud M. Teichmann in 1975, cf. *Teichmann*, Der Verlust des Vorsteuerabzugs im steuerfreien Bereich der Mehrwertsteuer, 1975, pp. 101 et seq. Likewise *Reiß*, in Reiß/Kraeusel/Langer, UStG, loose-leaf commentary, Einführung UStG (Dec. 2007) para. 46.

the ECJ seemingly has not as yet become fully aware of these implications of the consumption tax principle for the non-deductability of input VAT[245].

***c) Infringement of the neutrality principle and other shortcomings***

But even under the premise that non-deductible input VAT is ultimately born by the recipient of the exempt supply, its effects are incompatible with virtually all of the tax policy and constitutional benchmarks discussed above at III.

With respect to exempt B2C transactions at the retail stage, the non-deductibility of input VAT implies that only the tax burden of the final layer of value added is removed[246]. This mechanism thus converts a tax "exemption" into a mere reduction of the tax burden, the exact scale of which is not discernible for the consumer, though[247]. Hence the wording and the effect of the relevant rules is not in line with the principle of transparency of tax burdens. Moreover, the non-deductibility of individually divergent (although possibly sector-specific) input VAT injects an element of arbitrariness into the determination of the final tax burden, contrary to the principle of equal taxation[248]: Depending on an unknown and often also unpredictable amount of input VAT incurred, and on the ratio between capital, intermediate goods and external services used as input, on the one hand, and in-house labour not carrying a VAT burden, on the other hand, the tax relief ensuing from the provisions on exempt supplies will range from anywhere between coming close to zero rating and applying the regular tax rate. Such a disparate impact constitutes, by itself, a *prima facie* infringement of the principle of equality of taxation at least in so far as it affects the same type of exempt transactions. For example, it requires some explanation why the provision of high-tech medicine services should bear a relatively higher implicit VAT burden than equally expensive medical care that is provided by a general practitioner who hardly incurs any input VAT.

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[245] Cf. ECJ 19 January 1982, Case 8/81, Becker [1982] ECR 53, para. 44; ECJ 24 September 2007, Case C-460/07, Puffer [2007] ECR I-3251, para. 59; see also opinion of AG *Saggio* 30 September 1999, Case C-98/98, Midland Bank [2000] ECR I-4179, para. 18.

[246] See above at note 127.

[247] Cf. *van Brederode*, Systems of General Sales Taxation, Alphen aan den Rijn 2009, p. 130; *Camenzind/Honauer/Vallender*, Handbuch zum MwSt-Gesetz, 2. ed., Bern 2003, p. 236 (para. 655: „taxe occulte"); *Heidemann*, Die Umsatzsteuerbefreiungen von Finanzdienstleistungen, Berlin 2008, p. 38; *Mollard*, Archiv für schweizerisches Abgaberecht 1994, p. 443 (pp. 454 et seq.); *Söhn*, Steuer und Wirtschaft 1976, p. 1 (p. 26) *Stadie*, Das Recht des Vorsteuerabzugs, Köln 1989, p. 151; *Stadie* in Rau/Dürrwächter, UStG, loose-leaf commentary, Einf. paras. 283 and 438 et seq.; *Tait*, Value-Added Tax, Washington 1988, pp. 52 et seq.; *Terra/Kajus*, Introduction to European VAT, Amsterdam 2010, p. 281; *Thuronyi*, Comparative Tax Law, 2003, p. 321.

[248] Likewise *Ruppe*, Umsatzsteuergesetz, 3. ed., Wien 2005, § 6 paras. 16 et seq.; *Tonner*, Umsatzsteuerbefreiung heilberuflicher Leistungen, Berlin 2005, pp. 31 et seq.

With respect to exempt B2B transactions, the non-deductibility of input VAT can compromise the destination principle[249] and provoke cascading effects[250], which have been referred to as "perverse tax repercussions" by an Advocate General[251]. The tax is thus converted into a partial tax on investment[252], contrary to its conception. This undermines its neutrality and impairs production efficiency[253]. In particular, the denial of input tax deduction creates an incentive for vertical integration – a self-supply bias – and thus distorts market decisions about optimal business organization[254]: The outsourcing of constituent elements of an exempt transaction to a legally independent service provider will imply an additional and irrecoverable VAT burden for the supplier of the exempt goods or services[255], and is thus avoided unless efficiency gains exceed the additional VAT burden. Moreover, this tends to favour large firms over their smaller competitors due to economies of scale. The same logic

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[249] For further details, consult *Ebrill* et al., The modern VAT, Washington 2001, p. 88. See also *Cnossen*, International Tax and Public Finance 10 (2003), p. 625 (p. 627); *Crawford/Keen/Smith*, in Mirrlees et al. (eds.), Dimensions of Tax Design: the Mirrlees review, Oxford 2010, p. 275 (p. 305).

[250] For further details, consult *Copenhagen Economics / KPMG*, VAT in the public sector and exemptions in the public interest, Final Report for TAXUD/2009/DE/316, 2011, p. 48; *Ebrill* et al., The modern VAT, Washington 2001, p. 85; *Frink*, Der Ausschluss des Vorsteuerabzugs bei der Ausführung steuerfreier Umsätze im Umsatzsteuerrecht, Regensburg 2002, pp. 85 et seq.; *Gottfried/Wiegard*, Journal of Public Economics 46 (1991), p. 307 (p. 308); *Guía del Impuesto sobre el Valor Añadido*, 8. ed., Valencia 2006, pp. 289 et seq.; *Raboy*, in Weidenbaum et al. (eds.), The Value Added Tax: Orthodoxy and New Thinking, Boston 1989, p. 87 (97); *Ruppe*, Umsatzsteuergesetz, 3. ed., Wien 2005, § 6 para. 16; *Forgách*, in Reiß/Kraeusel/Langer (eds.), UStG, loose-leaf commentary, March 2010, Bonn, § 15, para. 23; *Tait*, Value-Added Tax, Washington 1988, p. 50; *Terra/Kajus*, Introduction to European VAT, Amsterdam 2010, p. 280; see also *Poblet*, Manual del IVA, 3. ed., Madrid 2006, p. 391: "efecto de piramidación del gravamen".

[251] Cf. Opinion of AG *Ruiz-Jarabo Colomer* 22 February 2005, Case C-498/03, Kingscrest Associates [2005] ECR I-4427, para. 15.

[252] Cf. *Crawford/Keen/Smith*, in Mirrlees et al. (eds.), Dimensions of Tax Design: the Mirrlees review, Oxford 2010, p. 275 (p. 292 and p. 305); *Gottfried/Wiegard*, Journal of Public Economics 46 (1991), p. 307 (p. 319 and p. 323). For a different – but unfounded – opinion, see *Stadie*, Umsatzsteuerrecht, Köln 2005, para. 10.68.

[253] As regards the requirement to leave capital goods and intermediate goods untaxed so as to not distort production decisions and thus achieve production efficiency under the assumptions of the *Diamond-Mirrlees* production efficiency theorem see *Diamond / Mirrlees, American Economic Review 61 (1971), pp. 8 et seq.*. As regards the strength of this argument also when the underlying assumptions of *Diamond* and *Mirrlees* are not fully met, see the considerations following this footnote; see furthermore *Crawford/Keen/Smith*, in Mirrlees et al. (eds.), Dimensions of Tax Design: the Mirrlees review, Oxford 2010, p. 275 (283).

[254] Cf. *Bird/Gendron*, The VAT in Developing and Transitional Countries, Cambridge 2007, p. 89; *van Brederode*, Systems of General Sales Taxation, Alphen aan den Rijn 2009, p. 130; *Cnossen*, International Tax and Public Finance 5 (1998), p. 399 (404); *the same*, International Tax and Public Finance 10 (2003), p. 625 (p. 627); *Crawford/Keen/Smith*, in Mirrlees et al. (eds.), Dimensions of Tax Design: the Mirrlees review, Oxford 2010, p. 275 (p. 305); *Dietl/Jaag/Lang/Trinkner*, The B.E. Journal of Economic Analysis and Policy 11 (2011), p. 1 (pp. 8 et seq. and pp. 22 et seq.); *Ebrill* et al., The modern VAT, Washington 2001, pp. 86 et seq.; *Teichmann*, Der Verlust des Vorsteuerabzugs im steuerfreien Bereich der Mehrwertsteuer, Köln 1975, pp. 119 et seq.; *Terra/Kajus*, Introduction to European VAT, Amsterdam 2010, p. 281. See also *Pérez Herrero*, La Sexta Directiva Comunitaria del IVA, Barcelona 1997, pp. 201 et seq.

[255] Cf. *Ebrill* et al., The modern VAT, Washington 2001, pp. 86 et seq.; *Swinkels*, International VAT Monitor 2007, p. 262. See also – with respect to public sector entities that carry out non-taxable or exempt transactions – *Copenhagen Economics / KPMG*, VAT in the public sector and exemptions in the public interest, Final Report for TAXUD/2009/DE/316, 2011, pp. 10 et seq., p. 13, and p. 51.

applies to labour saving investment decisions, because the capital asset to be acquired for this purpose is burdened with irrecoverable input VAT, whereas in-house labour is not[256].

The aforementioned detrimental effects could be avoided to a large degree in a B2B context if taxable persons had an option to treat their supplies to other businesses as taxed transactions. However, the Directive contemplates an option for taxation only with respect to very few exemptions, and moreover leaves its implementation at the discretion of the Member States.

With respect to all kinds of exempt transactions, the non-deductibility of input VAT is also objectionable due to an increase of compliance and administrative costs. This is especially the case when taxable persons carry out both, taxed and exempt supplies, in the course of their business[257]. For them it is necessary to establish and apply often complex criteria for a sufficient economic link between a particular input transaction and a taxed output transaction with right to deduct[258]. In case of mixed use of input supplies, a realistic but also feasible formula to determine the pro rata deduction must be decided upon and consistently applied. If based on a simple formula like turnover ratios, this apportionment will be "inherently arbitrary" and provide tax planning opportunities[259]; otherwise, it will be complex and it will thus frequently give rise to disputes between the taxpayer and tax authorities. It should also be noted that with respect to capital goods, the initial deduction must arguably be adjusted when due to subsequent changes in their use the appropriate deduction is significantly higher or lower than that to which the taxable person was originally entitled[260]. The adjustment mechanism, too, results in an increase of complexity, i.e. in higher compliance and administrative costs. Moreover, different rules as regards the calculation of the deductible pro rata in each of the 27 EU Member States[261] lead to international distortions of competition[262]. But even wholly exempt traders may have resort to complex tax planning strategies, such as the interposition of foreign fixed establishments that are situated in a jurisdiction where no exemption applies, or artificial and abusive schemes.

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[256] Cf. *Copenhagen Economics / KPMG*, VAT in the public sector and exemptions in the public interest, Final Report for TAXUD/2009/DE/316, 2011, p. 13.

[257] Cf. *Cnossen*, in Mirrlees et al. (eds.), Dimensions of Tax Design: the Mirrlees review, Oxford 2010, p. 370 (p. 382); *Crawford/Keen/Smith*, in the same volume, p. 275 (p. 305).

[258] Cf. *Bird/Gendron*, The VAT in Developing and Transitional Countries, Cambridge 2007, pp. 89 and 99.

[259] Cf. *Cnossen*, International Tax and Public Finance 5 (1998), p. 399 (pp. 406 et seq., incl. footnote 19); *Genser/Winker*, Finanzarchiv 54 (1997), p. 563 (p. 567); see also *van Brederode*, Systems of General Sales Taxation, Alphen aan den Rijn 2009, p. 136. As regards groups of companies in particular, they may be incentivated to manipulate their transfer prices, as acknowledged by the special provision of Art. 80 RVD.

[260] This is provided for by Art. 184 et seq. RVD.

[261] There is a lack of (full) harmonization in this regard, cf. Art. 173 RVD.

[262] Cf. *Amand*, International VAT Monitor 2010, p. 409 (p. 415).

Finally, some of the exemptions provided for in the EU VAT system are asymmetric, because they apply only for some of the firms or economic agents within the relevant market sector. A prominent example is the supply of postal services discussed already above, which are exempt only under the condition that the operator provides universal postal service within the respective Member State[263]. In these instances, the denial of input VAT deduction will reduce the price advantage that the exempt firms enjoy over their non-exempt competitors in B2C transactions and with respect to business customers who cannot deduct VAT themselves (since they, too, are exempt traders). However, at the same time the cost disadvantage of not being able to deduct input VAT will translate into a competitive disadvantage with respect to taxed business customers who can deduct invoiced VAT but not the "taxe occulte" resulting from a shift of irrecoverable input VAT incurred by their supplier. The net effect on the competitive position of the exempt firms in the market will depend mainly on two factors: the fraction of non-labour inputs for the supplies at issue (input VAT on labour can be avoided by insourcing it, although often at the cost of some efficiency loss), on the one hand, and the fraction of non-taxable or exempt customers, on the other hand[264]. Since the former factor in particular can only be estimated, and since it may also change over the course of time, e.g. due to technical innovations, or between different Member States, the denial of input VAT deduction obscures the extent – if any – of the privilege conveyed by the exemption.

It is submitted that in the Union legal order, these severe deficiencies of the link between taxation of output transactions and deduction of input VAT are not a mere "inconvenience"[265]. They must not be accepted as "a consequence of a deliberate choice on the part of the Community legislature"[266], as if the latter could liberate itself from any constitutional requirements in the area of taxation. Rather, if measured by the standards established – but unfortunately not consistently enforced – by the ECJ itself and discussed above at III.2, the denial of input VAT deduction infringes primary Union law and the VAT-specific principles to be derived from it. If one takes the constitutional dimension of the principle of fiscal neutrality seriously, such an infringement has to be justified or the rule

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[263] See, in this regard, Art. 132 (1) a RVD, as interpreted by ECJ 23 April 2009, Case C-357/07, TNT Post UK [2009] ECR I-3025, para. 36.

[264] See, in this regard, *Dietl/Jaag/Lang/Trinkner*, The B.E. Journal of Economic Analysis and Policy 11 (2011), p. 1 and pp. 3 et seq.

[265] Cf. Explanatory Memorandum (note 8), p. 15.

[266] Cf. ECJ 8 May 2003, Case C-269/00, Seeling [2003] ECR I-4101, para. 54; ECJ 14 September 2006, Case C-72/05, Wollny [2006] ECR I-8297, paras. 46-48; in a similar vein, ECJ 2 June 2005, Case C-378/02, Waterschap Zeeuws Vlaanderen [2005] ECR I-4685, para. 43.

responsible for it must be declared in breach of superior Union law and thus void. It would then be up to the Union legislator to amend the RVD.

## 2. Possible justifications in the context of different categories of exemptions

### *a) Admissible and inadmissible justifications*

As regards possible justifications for the denial of an input VAT credit, it should first be pointed out that mere revenue effects[267] can never serve as a valid justification within the framework of a constitutional analysis[268]. If government needs additional revenue, it must not overburden individual taxpayers contrary to requirements of tax fairness and to equal taxation according to individual taxpaying capacity, but rather distribute the higher tax burden equally[269]. In so far as the VAT exemption pursues extra-fiscal objectives unrelated to tax equity considerations of the aforementioned kind, its extent may be subject to budgetary constraint, but not in a way that renders the exemption internally incoherent.

The same applies for a possible variation of such considerations, according to which the treasury should always be entitled to keep at least the revenue that has been collected at earlier stages of production[270]. Such an argument was possibly a legitimate one prior to the harmonization of turnover taxes, as long as the latter were conceived as a tax on the value added, because under such a premise it could seem consistent that only the value added by the taxable person who qualifies for an exemption should be truly exempt from VAT. However, the common system of EU VAT has been firmly based on the concept of an indirect tax on (expenditure for) consumption from its very inception, which necessarily implies a shift of perspective to the tax burden of the final consumer.

Against that background, the original concern of the Commission that the granting of an input VAT credit or refund would inevitably imply an increase of the regular tax rate[271] might adequately reflect the political constraints that the Commission faced in drafting its proposal on a harmonized system of VAT, but it cannot be regarded as relevant in the context of a constitutional review of the rules on exemptions. Indeed, when exemptions are too costly for

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[267] Obviously, total tax revenue under an exemption exceeds that under zero rating, cf. *Gottfried/Wiegard*, Journal of Public Economics 46 (1991), p. 307 (p. 310 and p. 326).

[268] As regards an economist's viewpoint, see *Ebrill* et al., The modern VAT, Washington 2001, p. 94. The need to raise the standard VAT rate to compensate for the revenue cost of zero rating was also a major concern of the EC Commission, cf. Report from the Commission to the Concil, COM(82) 885 final, 17 January 1983, reproduced in Intertax 1983, 137 (138).

[269] This is also the position adopted by the German Constitutional Court, cf. Constitutional Court 9 December 2008, joined cases 2 BvL 1/07 a.o., BVerfGE 122, p. 210 (at pp. 236 et seq), and the case-law cited there.

[270] See the references in note 241.

[271] Cf. explanatory memorandum of the preceding proposal of the Second VAT Directive (cited in fn. 5), p. 16.

Member States, they should be abolished already for this reason, in so far as they are not (exceptionally) mandated by considerations of tax equity, administrative efficiency or the design of VAT as a tax on final consumption.

The denial of an input VAT credit can therefore be regarded as justified, if at all, primarily on grounds of the tax policy or extra-fiscal policy objectives underlying the exemption itself. Since the output and input consequences of an exemption are not intrinsically linked in the sense that granting an input VAT credit would be *technically* unfeasible if the corresponding output transactions are exempt, though, the legitimacy of privileging certain supplies is not in itself sufficient justification. Instead, it will be necessary to show that the "input taxation" of a particular category of exempt supplies, and its negative consequences, are a proportionate corollary of the purpose based on which the exemption itself can be regarded as justified. A comprehensive analysis of the compatibility of the non-deductibility of input VAT with superior principles of EU law – and the principles of tax equality, consistency and fiscal neutrality in particular – therefore has to distinguish between the different types of objectives of the provisions on exempt supplies.

***b) No justification in the context of equity-based exemptions***

In so far as an exemption can be regarded as legitimate and indeed required because the expenditure incurred for the exempt item or service by a final consumer *typically* does not indicate any taxpaying capacity, regardless of the amount spent, any form of "input taxation" through a denial of a right to deduct input VAT is obviously inconsistent. Tax equity requires that goods and services the cost of which can clearly be identified as expenditure related to the minimum subsistence, even when considering the restrictions to such an approach in the context of VAT as an indirect tax, must not be made dearer by imposing a VAT burden. Relief for such expenditure that is typically incurred for indispensable items and services in order to serve essential human needs must be granted in full, excluding both, explicit *and implicit* VAT burdens. Hence, effective zero rating of the corresponding supplies would be appropriate[272].

In economic literature, it is often pointed out that zero rating or the application of a reduced rate implies an increase in the number of assessable taxable persons and may thus result in

[272] Likewise *Ruppe*, in Lang (ed.), Die Steuerrechtsordnung in der Diskussion, Festschrift für Klaus Tipke, Köln 1995, p. 457 (461 et seq.). See also *Kirchhof*, Umsatzsteuer Gesetzbuch, Heidelberg 2008, § 11 para. 37 (with respect to the leasing and letting of residential apartments and housing).

additional compliance and administrative costs[273]. This seems to have been an argument against zero rating for the Commission, too[274]. However, it can be expected that any additional costs will to some degree already be offset by the elimination of the costs and possible distortions associated with the calculation and verification of the pro rata VAT deduction in case of mixed-used input supplies[275] by taxable persons who carry out both, taxed and exempt supplies (partially exempt traders)[276]. Moreover, any remaining negative welfare effects are very likely to be (over-)compensated by a reduction in tax planning schemes[277], and due to efficiency gains by removing the barriers for outsourcing and the other distortive effects of input taxation discussed above. It is also noteworthy that economic analysis suggests that the additional compliance costs for formerly exempt businesses that are associated with a transition to zero rating are relatively low[278]. To some extent (although considering the nature of the goods and services at issue, probably only to a small extent), the shift towards a system that permits input VAT deduction may also reduce VAT cascading within the system and thus enhance investment. Finally, only a relatively small number of taxpayers would have to be additionally registered for zero rating if one accepts that the letting of residential housing is not included within the category of exemptions discussed here.

Some also argue that zero rating would be welfare decreasing if implemented in a revenue neutral fashion (by increasing the standard VAT rate), because this can generally be observed when the gap between the lowest and the highest rate widens[279]. Due to the higher VAT relief effect of zero rating, it is also conceivable that the legal uncertainty with respect to the exact borderlines between privileged products and services, on the one hand, and regularly taxed goods and services, on the other hand, gives rise to even fiercer disputes between taxable

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[273] Cf. *Ebrill* et al., The modern VAT, Washington 2001, p. 91; *Gottfried/Wiegard*, Journal of Public Economics 46 (1991), p. 307 (p. 327); *Raboy*, in Weidenbaum et al. (eds.), The Value Added Tax: Orthodoxy and New Thinking, Boston 1989, p. 87 (98). See also *Cnossen*, International Tax and Public Finance 5 (1998), p. 399 (400); *Tait*, Value-Added Tax, Washington 1988, p. 50.

[274] Cf. EC Commission, cf. Report from the Commission to the Concil, COM(82) 885 final, 17 January 1983, reproduced in Intertax 1983, 137 (138).

[275] Cf. *Ebrill* et al., The modern VAT, Washington 2001, pp. 88 et seq.

[276] This is also admitted by *Gottfried/Wiegard*, Journal of Public Economics 46 (1991), p. 307 (p. 327).

[277] Cf. *Mollard*, Archiv für schweizerisches Abgaberecht 1994, p. 443 (473).

[278] See *Copenhagen Economics / KPMG*, VAT in the public sector and exemptions in the public interest, Final Report for TAXUD/2009/DE/316, 2011, pp. 19 et seq. and pp. 149 et seq., regarding the similar issue of establishing refund schemes for public sector entities. These findings can probably be explained to a large degree by the fact that often, bookkeeping and recording requirements for VAT may already be demanded for income tax purposes, anyways.

[279] Cf. *Bird/Gendron*, The VAT in Developing and Transitional Countries, Cambridge 2007, p. 123; *Gottfried/Wiegard*, Journal of Public Economics 46 (1991), p. 307 (p. 325); see also *Krever*, in Krever (ed.), VAT in Africa, Pretoria 2008, p. 9 (p. 19), concerning VAT concessions in general: "…increasing gap… exacerbates the economic distortions…"

persons and tax authorities[280]. However, in the author's view neither these concerns nor a remaining net increase of administrative costs – if any – can tilt the balance of the proportionality analysis: One should be aware that by legal standards, the constitutional dimension of the argument for zero-rating essential supplies (in so far as the corresponding expenditure can be targeted sufficiently precise within the system of an impersonal indirect tax such as VAT) outweighs efficiency concerns as well as a possible welfare decrease that might occur under the condition of revenue neutrality of a reform, unless the net negative effects could reasonably be assessed as grave. The margin of discretion and appreciation of the Union legislator is thus significantly reduced in this regard.

By contrast, if mere reasons of *social policy* are underlying an exemption, it may reasonably be assumed that a mere reduction in the tax burden is sufficient to realize the social objectives pursued by the (European) legislator. Since this is the actual effect of an exemption without credit, it cannot be concluded *a priori* that the latter is inconsistent with respect to the pursuance of its underlying objective. Notwithstanding this acknowledgement, it would still be more appropriate to tax such supplies at a lower than regular rate instead[281]. Such an approach could be fine-tuned so as to yield the same tax revenue, and it would not distort the functioning of the system and would render a clearer picture of the extent of aid[282]. The insistence on the antiquated tradition of denial of input VAT deduction therefore is disproportionate.

### *c) Other instances of insufficient justification*

If theatres, museums, or other institutions that predominantly pursue activities in the public interest on a non-profit basis are intended to be subsidized by granting an exemption for their supplies, the same criticism applies. Admittedly, equality of taxation with respect to final consumers might not be impaired if the privileged traders are in the minority so that the exemption will not have a noticeable influence on consumer prices, and the privileged operators will thus be able to fix prices as if VAT were charged. Moreover, in the

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[280] For some examples, see *Tait*, Value-Added Tax, Washington 1988, pp. 53 et seq.

[281] Likewise *Bird/Gendron*, The VAT in Developing and Transitional Countries, Cambridge 2007, p. 110; *Dziadkowski*, Umsatzsteuer-Rundschau 2006, p. 87 (p. 91); see also *Aujean/Jenkins/Poddar*, VAT Monitor 1999, p. 144 (p. 148).

[282] This has rightfully been pointed out by *Gottfried/Wiegard*, Journal of Public Economics 46 (1991), p. 307 (p. 309); *Heidemann*, Die Umsatzsteuerbefreiungen von Finanzdienstleistungen, Berlin 2008, pp. 144 et seq. and pp. 146 et seq.; *Ruppe*, in Lang (ed.), Die Steuerrechtsordnung in der Diskussion, Festschrift für Klaus Tipke, Köln 1995, p. 457 (462); *Söhn*, Steuer und Wirtschaft 1976, p. 1 (p. 27) See also *Mollard*, Archiv für schweizerisches Abgaberecht 1994, p. 443 (p. 473), who regards this solution as second-best, if a complete abolition of tax concessions should not be politically feasible. The transparency and political accountability aspect is also highlighted by *Ebrill* et al., The modern VAT, Washington 2001, p. 91.

(exceptional) case of a personal exemption intended to subsidize the taxable person, a limitation of the fiscal aid to the value added by the taxable person might *prima facie* seem plausible[283]. Thus, the denial of deduction is not necessarily counterproductive. However, for the reasons set out above, it is unnecessarily distortive and furthermore produces arbitrary results[284]. It complicates the system without any real need; a rate reduction would therefore be preferable should zero-rating be regarded as a step too far or too costly.

If the avoidance of double burdens resulting from the simultaneous application of VAT and excise or stamp duties were to be accepted as a valid justification for certain exemptions, the denial of input VAT deduction is obviously inconsistent, because it will lead to the persistence of a double burden[285].

As explained above, several exemptions and especially some regarding financial services can be justified – and should be maintained – in order to avoid a tax burden on expenditure that does not reflect consumer spending, but rather constitutes savings or investment, or is directly linked to such activity. Such services must then also not be implicitly "input taxed" by way of denying an input tax credit[286]. It has to be acknowledged, though, that scholars of economy and law have not as yet reached consensus as to the exact dividing line between consumption and savings, and regarding the adequate treatment of related services, in the field of financial transactions. The same applies to a lesser agree for the supply of land; and regarding educational services, the extent of the consumption element inherent to their use is debatable. Therefore, any political decision on these aspects that is based on a reasonable and consistent theory of the concept of consumption vs. savings and investment will have to be accepted as compatible with the requirements of superior principles of law and their VAT specifications. In so far as the legislator assumes consumption expenditure, an exemption without credit might then be justified in so far as it can be maintained on grounds of administrative efficiency or for technical reasons:

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[283] Cf. *Ruppe*, in Lang (ed.), Die Steuerrechtsordnung in der Diskussion, Festschrift für Klaus Tipke, Köln 1995, p. 457 (pp. 467 et seq.).

[284] See also *Ruppe*, in Lang (ed.), Die Steuerrechtsordnung in der Diskussion, Festschrift für Klaus Tipke, Köln 1995, p. 457 (p. 463).

[285] See also *Frink*, Der Ausschluss des Vorsteuerabzugs bei der Ausführung steuerfreier Umsätze im Umsatzsteuerrecht, Regensburg 2002, pp. 119 et seq.; *Ruppe*, in Lang (ed.), Die Steuerrechtsordnung in der Diskussion, Festschrift für Klaus Tipke, Köln 1995, p. 457 (467); *Ruppe*, Umsatzsteuergesetz, 3. ed., Wien 2005, § 6 para. 257; *Teichmann*, Der Verlust des Vorsteuerabzugs im steuerfreien Bereich der Mehrwertsteuer, Köln 1975, pp. 123 et seq.

[286] Likewise *Ruppe*, Umsatzsteuergesetz, 3. ed., Wien 2005, § 6 para. 99.

***d) Partial justification where taxing output would be hard or inefficient***

As analyzed above, some exemptions can be justified because taxation of output supplies is technically unfeasible or would result in considerable complexity of the tax system, thus arguably causing high compliance burdens and excessive costs. Here, an "input-taxation" might be defended despite the distortions that it causes, because it ensures that there will be at least some form of tax burden placed on the consumer of such services, in accordance with the concept of VAT as a tax on expenditure for consumption[287]. Admittedly, the denial of input VAT may in itself also result in higher compliance and administrative costs, in so far as it becomes necessary to determine an adequate pro-rata for the input VAT deduction for suppliers of both, exempt and taxed services. This can affect private landlords and real estate companies in particular, when they let partially to business tenants and partially to private tenants, provided the respective Member State grants an option to taxation for B2B supplies[288]. But it is far from obvious that this occasional complication compromises the objective of technically feasible and efficient taxation underlying the exemption to the same degree as a taxing the output supplies would[289]. At present, it is therefore not inconsistent to exempt such services without input VAT credit.

However, the denial of an input VAT credit for transactions that should be taxed in conformity with the inherent logic of VAT is always only a second-best solution. As emphasized already above[290], technical developments and academic discussions should therefore be carefully monitored by the legislator – also from a constitutional viewpoint.

Moreover, it might be recommendable and indeed consistent to grant an input VAT credit in so far as the relevant exemption can additionally be justified for reasons of international tax competition. This aspect is of special relevance for the financial services industry. Here, an implicit input VAT burden can constitute a significant obstacle for European financial institutions and put them as a competitive disadvantage in their home market vis-a-vis

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[287] Likewise *Cnossen*, International Tax and Public Finance 5 (1998), p. 399 (p. 405), regarding the exemption for rental charges; *Ruppe*, in Lang (ed.), Die Steuerrechtsordnung in der Diskussion, Festschrift für Klaus Tipke, Köln 1995, p. 457 (p. 464). See also in more general terms *Newbery*, Economic Letters 20 (1986), pp. 267 et seq., who discusses the desirability of input taxes when taxation of final goods is not possible. For a different opinion, see *Heidemann*, Die Umsatzsteuerbefreiungen von Finanzdienstleistungen, Berlin 2008, pp. 174 et seq.

[288] As authorized by Art. 137 (1) d RVD, and provided that the supplier has made use of that option.

[289] For a different opinion, see *Hoffsümmer*, Steuerbefreiungen für Inlandsumsätze, Frankfurt a.M. 2009, p. 147; *Crawford/Keen/Smith*, in Mirrlees et al. (eds.), Dimensions of Tax Design: the Mirrlees review, Oxford 2010, p. 275 (p. 304), who give too much weight to administrative concerns, though.

[290] See above at IV.6.

financial institutions established in third countries (import bias)[291], since the VAT rates in EU Member States and thus input VAT are often comparatively high[292]. This is particularly true with respect to competitors from countries that do not as yet levy any VAT on input supplies of services, such as e.g. the United States. In so far as EU-based customers view such third-country supplies as a viable alternative, zero-rating could therefore not be objected to.

[291] Cf. *Bird/Gendron*, The VAT in Developing and Transitional Countries, Cambridge 2007, p. 99.
[292] Likewise *Kirchhof*, Umsatzsteuer Gesetzbuch, 2008, § 11 para. 58 et seq.; *Heidemann*, Die Umsatzsteuerbefreiungen von Finanzdienstleistungen, Berlin 2008, pp. 36 et seq.

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