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Please find below a selection of articles published this January in Highlights & Insights on European Taxation, plus one freely accessible article.

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(comments by **Marja Hokkanen**) (H&I 2022/411)

The question in the case at hand is whether knowledge of the supplier's reorganisation proceedings and possible insolvency suffices for denying the purchaser the right to deduct the input VAT on the grounds that the purchaser knew or ought to have known that the supplier would not pay VAT on

the relevant supply. The question at hand concerns the definitions of good faith and bad faith of the purchaser in the context of buying the immovable property from a person in economic difficulties and if the right to deduct could be prohibited on that ground. Is the fact that the purchaser knew that the supplier was in financial distress and was in the process of a business reorganization a legal justification to deny the right to deduct input VAT because of the abuse of rights as already defined by the CJ in *Halifax and Others* (CJ 21 February 2006, C-255/02 *Halifax and Others*, ECLI:EU:C:2006:121)? As the CJ stated, the existence of any abuse of rights in the VAT Directive precludes any right of a taxable person to deduct input VAT where the transactions from which that right derives constitute an abusive practice (CJ 21 February 2006, C-255/02 *Halifax and Others*, ECLI:EU:C:2006:121, paragraph 85).

Advocate General Kokott (hereinafter: the 'AG') stated in her Opinion in the case at comment that 'this preliminary ruling procedure might lead one to think of a passage from 'The Sorcerer's Apprentice' by Johann Wolfgang von Goethe: 'Sir, my need is sore. Spirits that I've cited My commands ignore.' Indeed, this preliminary ruling procedure again highlights the uncertainties and problems that arise when value added tax (VAT) law is understood less conventionally but is also used to combat fraud and abuse in the case-law.' (AG Kokott, 5 May 2022, C-227/21 *HA.EN*, ECLI:EU:C:2022:364, point 1). I understand the AG's reasoning here, because it seems that sometimes only the imagination of the decision-maker is the limit to interpreting VAT as a person wishes. Although the VAT system is a system in its own right, with its own aims and purposes, the purpose of VAT is to tax the real world, not ghosts or dreams.

Lithuanian tax authorities regard the acquisition of immovable property from an undertaking experiencing financial difficulties as an abuse of rights which would make it possible to deny the right to deduct input VAT. This, even if the right of taxable persons to deduct from the VAT which they are liable to pay the VAT due or paid on goods purchased and services received by them as inputs is a fundamental principle of the common system of VAT established by EU legislation which may not be limited (CJ 15 September 2016, C-518/14 *Senatex*, ECLI:EU:C:2016:691, paragraphs 26-27 and CJ 16 October 2019, C-189/18 *Glencore Agriculture Hungary*, ECLI:EU:C:2019:861, paragraph 33). Article 168(a) of the VAT Directive provides that, 'In so far as the goods and services are used for the purposes of the taxed transactions of a taxable person, the taxable person shall be entitled, in the Member State in which he carries out these transactions, to deduct the following from the VAT which he is liable to pay: (a) the VAT due or paid in that Member State in respect of supplies to him of goods or services, carried out or to be carried out by another taxable person'.

The AG stated that the mere possibility of non-payment of a tax does not constitute tax fraud as this would make it impossible to do business with undertakings in financial difficulties (AG Opinion's in *HA.EN.*, C-227/21, points 2-4). The CJ held that the purchaser's knowledge of the supplier's financial difficulties, his possible insolvency or the opening of reorganisation proceedings, and the potential impact of such circumstances on the payment of the output VAT, appear to be elements inherent in compulsory sale procedures. Such elements are insufficient to show that the transaction in question is abusive and do not justify a refusal of the right to deduct (paragraphs 41-42 of the judgment). Also, the principle of fiscal neutrality precludes distinctions between taxable persons based on their financial situation (paragraph 46 of the judgment).

As the CJ has already held, whether the supplier pays the output VAT to the Public Exchequer or not is not decisive when deciding if the purchaser has the right to deduct the input VAT or not (CJ 22 October 2015, C-277/14 *PPUH Stehcemp*, ECLI:EU:C:2015:719, paragraph 45 and the case

law cited). The fact that the supplier reports the input VAT but does not pay it is not even regarded as fraudulent behaviour (CJ 2 May 2018, C-574/15 *Scialdone*, ECLI:EU:C:2018:295, paragraphs 38-41). If the supplier himself is not behaving fraudulently, what fraud could the purchaser be guilty of in the same situation? (paragraph 33 of the judgment). The question of whether a supplier or purchaser in bad faith in such a case could be guilty of a lesser offence of tax evasion than fraud is a question to which there is no clear answer. One difficulty in interpreting the CJ's case law in this respect is that the CJ has not precisely defined the different forms of abusive or fraudulent behaviour, nor does it use the different concepts consistently.

The CJ has ruled that the prevention of tax evasion, tax avoidance and abuse is an objective recognised and encouraged by the VAT Directive. The CJ has consistently held that EU law cannot be relied on for abusive or fraudulent ends. It is, therefore, for the national courts and authorities to refuse the right of deduction if it is shown, in the light of objective evidence, that that right is being relied on for fraudulent or abusive ends (CJ 10 July 2019, C-273/18 *Kuršu zeme*,ECLI:EU:C:2019:588, paragraph 34 and the case law cited). When fraudulent behaviour of a taxable person is suspected, the CJ has made it clear that the burden of proof lies with the tax administration. The tax administration must, therefore, be able to prove objectively 'to the requisite legal standard' that abuse of rights or fraud has occurred. The same applies to the fact that the taxable person knew or should have known that the transaction relied on as a basis for the right of deduction was connected with fraud (CJ 11 November 2021, C-281/20 *Ferimet*, ECLI:EU:C:2021:910, paragraph 50 and the case law cited).

The CJ here refers to fraud when speaking of the good faith of a third party. The question arises whether the protection of good or bad faith is linked only to fraud cases. Thus, can a third party not be 'punished', for example, by denying a deduction, unless the elements of fraud are met? Can the deduction of the input VAT be refused also when the criteria of the fraudulent behaviour are not met, but the action may be regarded as another type of abusive behaviour instead? If the case is about tax abuse or evasion, in which situations can the purchaser be denied the right of deduction? In paragraph 29 of *HA.EN*. (C-227/21), the CJ raises this question by extending the analysis also to abuse of rights (paragraph 29 of the judgment: '(…) he or she knew or should have known that he or she was participating in a transaction connected with VAT fraud or was committing an abuse of rights').

The existence of any abuse of rights in the VAT Directive precludes any right of a taxable person to deduct input VAT where the transactions from which that right derives constitute an abusive practice (*Halifax and Others*, C-255/02, paragraph 85). Transactions carried out not in the context of regular commercial operations but solely to wrongfully obtain advantages provided for under EU law are regarded as abusive practices (CJ 22 December 2010, C-103/09 *Weald Leasing*, ECLI:EU:C:2010:804, paragraph 26). In the sphere of VAT, two conditions must be met to determine that an abusive practice exists. First, the transactions concerned, notwithstanding the formal application of the conditions laid down by the relevant provisions of the VAT Directive and the national legislation transposing it, must result in the accrual of a tax advantage, the grant of which would be contrary to the purpose of those provisions. Second, it must be apparent from several objective factors that the essential aim of the transactions concerned is solely to obtain that tax advantage (*Halifax and Others*, C-255/02, paragraphs 74-75, and *Ferimet*, C-281/20, paragraph 54 and the case law cited).

The CJ has analysed the fulfilment of the criteria of abusive rights in terms of the right of deduction by the purchaser acquiring the immovable property (paragraph 36 of the judgment). As

to the first condition, even assuming that the deduction that is sought by the purchaser of immovable property of the input VAT paid by him when taking over that property may be classified as a tax advantage, that advantage cannot be regarded as contrary to the objectives of the VAT Directive. As the AG stated in her Opinion, that is what is revealed by Article 199(1)(g) of the VAT Directive, which permits the Member States, in the case of a supply of immovable property sold by a judgment debtor in a compulsory auction procedure, use the reverse charge mechanism and pass the VAT burden on to the taxable person to whom the taxable supply is made. Although the Republic of Lithuania has chosen not to make use of that mechanism, the mere existence of the option provided for in that provision shows that the EU legislature has not considered that the deduction of the VAT paid by the purchaser of immovable property at a compulsory auction would be contrary to the objectives of the VAT Directive (AG Opinion in *HA.EN.*, C-227/21, points 40-44).

If the financial difficulty is capable of automatically denying the right of deduction of the input VAT by the purchaser because he should understand that the supplier will not pay the output VAT, no one would be advised to buy anything from the company in the arrangement. In practice, the sale of business assets would only be possible for individuals (and companies that do not carry out transactions that are eligible for VAT deduction), as they would not qualify for a reduction in the tax deduction. This would significantly limit the pool of potential buyers and, therefore, would be contrary to the purpose of the forced sale procedure. However, the aim is to make the best possible use of the assets to satisfy creditors as much as possible (AG's Opinion in *HA.EN.*, C-227/21, points 47, 51-56). The CJ correctly states that a financial difficulty as such does not per se mean that the supplier would not pay the VAT in any case (paragraph 38 of the judgment). This is, *per se*, absolutely to be supported. However, this kind of argumentation is a practical, common-sense argumentation which, from my point of view, should not be confused with the theoretical and substantial argumentation of whether a buyer can be considered to be acting abusively based on the criteria of the prohibition of abusive rights. Under the second condition for abuse of rights, it must be clear from all the objective factors that the main objective of the measure in question is merely to obtain a tax advantage. In this respect, it must first be noted that it is clear from the documents available to the CJ that, according to the facts of the main proceedings, HA.EN. was a creditor of the supplier and had a mortgage on the immovable property in question, which was the subject of the compulsory sale procedure. In such a situation, it must be held that the creditor's taking possession of real estate for which it had such security, as a result of an unsuccessful auction, cannot be justified essentially by any tax advantage but by the creditor's desire to recover all or part of its claim against the insolvent debtor in question by means of the legal remedies at its disposal, such as the forced sale procedure (paragraph 39 of the judgment).

Even if the CJ does not reason the judgment based on the good faith of the taxable person, it seems that good faith is the decisive factor behind the criteria of abusive rights. This may be derived from *Kuršu zeme* (*Kuršu zeme*, C-273/18, para. 34), where the right to deduct may be denied in the case of fraudulent or abusive action. Even though the definition of an abusive right concentrates on analysing the subjective behaviour of the taxable person in question, here, the purchaser of the immovable property, it is clear that good faith is connected to this definition. If there is no essential aim of the transactions concerned to obtain a tax advantage which would be contrary to the purpose of those provisions, the action has taken place in good faith. However, if there is an essential aim to gain something contrary to the purpose of the law, there is bad faith. This could be the case where the purchaser knew that the supplier would not pay the VAT, even if the output VAT had been reported correctly by the supplier. This would not be the case of fraudulent behaviour, as stated by the CJ, but it could be the case of abusive behaviour, which would be the reasoning for

denying the right to deduct the input VAT from the purchaser.

The purchaser cannot read the supplier's thoughts. However, the purchaser needs evidence to demonstrate that he has done all he could to ensure that the other taxable persons in the chain acted in good faith. Otherwise, he would risk his right to deduct input VAT. Therefore, the protection of good faith also requires showing the good faith of the other taxable persons in the chain up to a certain point. The purchaser must satisfy this requirement to safeguard its right to deduct the input VAT. The burden of proof placed on the taxable person, perhaps unnoticed, is high. It also raises the question of where the taxable person's burden of proof ends and where the tax authority's obligation to prove objectively that fraud or tax evasion has occurred begins.

The AG referred to the neutrality principle in support of the right to deduct the input VAT by the purchaser (AG Opinion's in *HA.EN.*, C-227/21, point 30) and the CJ also reasoned its judgment by stating (paragraphs 43 and 46-47 of the judgment) that denying the right to deduct the input VAT by the purchaser is contrary to the requirement of neutrality. In my view, the reasoning for the right of deduction is perhaps a little far-fetched, although not wrong. The arguments relating to neutrality are understandable, as this is even what was asked for in the question referred to as a preliminary ruling. In my view, however, it is relevant to interpret good faith in the context of the abusive rights of the purchaser and not whether neutrality is achieved. This is because if the purchaser is shown to have acted in bad faith, the neutrality principle as reasoning is irrelevant.

The CJ's judgment is definitely to be supported. The AG was also very thorough in assessing the purchaser's right to deduct in terms of the prohibition of abuse of rights. However, it must be admitted that following some of the reasoning is complex, and perhaps it goes further than would have been necessary. Ultimately, the question is whether the purchaser has acted in good faith or bad faith and, therefore, whether the criteria of abusive rights have been met.

Marja Hokkanen

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