RESTORING NEUTRALITY OF VAT: THE INTERNAL SUPPLY PROVISIONS

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ABSTRACT

Articles 18(a) and 27 ECVD are instruments within the Directive to restore neutrality of EU VAT, which has been breached by the numerous exemptions. For the purposes of this research neutrality is interpreted as a particular expression of the general EU law principle of equal treatment. The actual field of application of the provisions is studied through a legal dogmatic method and by researching the implementation of the rules in the Netherlands. The provisions aim to prevent distortion of competition by making certain internal transactions taxable as supplies made for consideration. Because the provisions are optional for Member States to implement they fail to bring structural neutrality on a European level. With a more widespread European implementation of the internal supply rules have the potential to do so, however. The self-supply of services of Art. 27 has the potential to be applied in cross-border situations and close the leak caused by the FCE Bank judgment. In addition, a more widespread use of this Article may also provide for a solution for the VAT issued in the troublesome field of public sector bodies.
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# ABBREVIATIONS

<table>
<thead>
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<tr>
<td>AG</td>
<td>Advocate General</td>
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<tr>
<td>Commission</td>
<td>Commission of the European Communities</td>
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<td>Parliament</td>
<td>European Parliament</td>
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<tr>
<td>TEU</td>
<td>The Treaty on European Union</td>
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<td>TFEU</td>
<td>The Treaty on the Functioning of the European Union</td>
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<td>VAT</td>
<td>Value Added Tax</td>
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1. INTRODUCTION

1.1 BACKGROUND
EU VAT is a general tax on consumption, as is stipulated by Art. 1 ECVD. The tax is levied on all stages of the production and distribution chain. Traders within the chain are entitled to deduct the VAT charged on their purchases, if they use these for supplies that are subject to VAT. To VAT as a general tax on consumption many exemptions are made, however. Because of these exemptions certain supplies traders make are not subject to VAT, hence the traders are not entitled to deduct their input VAT. These exemptions make the tax not only less general but also breach the principle of fiscal neutrality. The principle of fiscal neutrality is an important principle in the European VAT system, the Commission has even gone so far as to state that the entire system of VAT is based on the principle of fiscal neutrality. Neutrality of VAT means, *inter alia*, that VAT should not influence business decisions or distort competition.

Taxable persons with mainly exempt activities have an incentive to self-supply goods and services rather than to purchase or to outsource, because the input VAT on purchases of taxable goods and services used for exempt output supplies is non-recoverable. Hence VAT is a cost. The incentive to self-supply is an extreme case of a distortion of input choice whereby the source of supply itself may change. This incentive, or self-supply bias, is seen as a distortion of competition.

The Directive contains measures to counter these problems, these include Art. 18(a) ECVD dealing with the self-supply of goods and Art. 27 ECVD dealing with the self-supply of services. The European Court of Justice and the Commission seem to be in a constant struggle to safeguard and restore neutrality of the VAT system. AG Jacobs notes that it is inherent in the existence of exemptions of the VAT system that these will interfere with the application of the principles of neutrality and of equality of treatment. In recent case-law the ECJ seems to prefer the principle of neutrality over a strict interpretation of the exemptions. Are the provisions regarding the self-supply of goods and services in the ECVD able to serve as arms in this struggle for neutrality the way they are applied now? And can these provisions maybe serve in other fields where neutrality has been breached, i.e. what is their potential field of application?

1.2 PURPOSE
The purpose of this research is to provide for an in-depth analysis and research of the actual and potential field of application of Articles 18(a) and 27 of the ECVD considering the principle of fiscal neutrality.

1.3 METHOD AND MATERIAL
To fulfill the purpose of this research a legal dogmatic method is used. An analysis of jurisprudence of the European Court of Justice, the adopted Directives and Regulations by the European Council and legal writing is made.

Articles 18(a) and 27 ECVD are optional provisions and not widely implemented among Member States. This research studies their implementation in the Netherlands.

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1 Consultation paper (n 8), 10
2 Gendron (2005), p. 517
3 Opinion of AG Jacobs in C-378/02 *Waterschap Zeeuws Vlaanderen*, para. 38
4 See, *inter alia*, ECJ judgments in C-174/11 *Zimmermann*, C-18/12 *Město Zamberk* and C-91/12 *PCF Clinic*
to get a better understanding on how the ECVD’s provisions work in practice. The applicable Dutch provisions have been translated with use of jurisprudence.

1.4 DELIMITATIONS
The geographical focus area of this research is limited to the European Union, it confines to provisions from the ECVD. The principle of fiscal neutrality will only be discussed to the extent that is relevant for this research.

It goes beyond the purposes of this research to give a comprehensive overview of the discussion on cross-border VAT grouping or cost sharing consortia, this research confines itself to the potential application of the self-supply of services in the field of cross-border transactions discussed in chapter 5.

1.5 OUTLINE
Because of the key role the principle of fiscal neutrality has in this research, this paper starts out with this topic in chapter 2. An in-depth analysis in chapter 3 of the actual field of application through legal writing and jurisprudence of the Articles 18(a) and 27 ECVD will follow, including a study on the implementing provisions of the Articles in the Dutch VAT Act. Taken together, the relationship between the provisions and fiscal neutrality is discussed in chapter 4. Following this analysis, the research comes to discussing the potential field of application of the internal supply rules in two specific areas where neutrality has been breached in chapter 5. Chapter 6 concludes this research.

2. THE PRINCIPLE OF FISCAL NEUTRALITY

2.1 INTRODUCTION
A thread of harmonization and integration can be found when reading the preamble of the Treaty on European Union. Within the field of indirect taxes this thread becomes very clear. Article 113 of the TFEU stipulates that the Council must adopt provisions for the harmonization of legislation concerning indirect taxes to the extent that such harmonization is necessary to ensure the establishment and the functioning of the internal market and to avoid distortion of competition. From the preamble of the ECVD it follows that tax neutrality is one of the main goals of the VAT system.

The ECJ has stated that the principle of neutrality is inherent in the system of VAT and constitutes nothing less than a fundamental principle of that system.5 The Commission has even gone so far to state that the entire system of VAT is based on the principle of fiscal neutrality.6 Neither the preambles nor the Directives contain a definition of neutrality, however. The aim of this chapter is to find a definition of the principle of fiscal neutrality for the purposes of this research.

In section 2.2 an analysis is made of the principle through its use in literature. Section 2.3 discusses ECJ jurisprudence to scrutinize the principle. Section 2.4 summarizes this section with a definition of the principle for the purposes of this research.

5 See, inter alia, ECJ judgments in C-283/95 Fischer, para. 27, in C-216/97 Gregg and Gregg, para. 19 and in C-29/08 AB SKF, para. 67 and the case-law cited.
6 Consultation paper (n 8) 10
2.2 THE PRINCIPLE OF NEUTRALITY IN LITERATURE

Article 1(2) ECVD lays down the principle of neutrality as follows:

“The common system of VAT entails the application to goods and services of a general tax on consumption exactly proportional to the price of the goods and services, however many transactions take place in the production and distribution process before the stage at which the tax is charged. On each transaction, VAT, calculated on the price of the goods or services at the rate applicable to such goods or services, shall be chargeable after deduction of the amount of VAT borne directly by the various cost components.”

This provision contains an economic dimension of neutrality in the sense that VAT should be exactly proportional to the price of goods and services, so that the tax does not influence different prices in different ways. In the sense that VAT should not be influenced by the production and distribution process, the provision contains a juridical dimension as well. VAT should be exactly proportional to the price regardless of who the producer or distributor is, i.e. neutral in relation to competition between taxable persons. In this sense neutrality is a particular expression of the general principle of equality.

The OECD Guidelines on Neutrality describe fiscal neutrality as follows: ‘taxation should seek to be neutral and equitable between forms of commerce. Business decisions should be motivated by economic rather than tax considerations. Businesses in similar situations carrying out similar transactions should be subject to similar levels of taxation.’

According to the Commission VAT is a tax on final consumption of goods and services which relieves businesses of the burden of VAT incurred in the process of production of these goods and services. The Commission adds to this that preventing businesses from incurring non-recoverable VAT can only be regarded in a positive light.

From Art. 1(2) ECVD, the OECD Guidelines and the Commissions statements it can be derived that taxable persons should, in principle, not experience VAT as a cost. VAT is a tax on final consumption so only those who actually consume should be taxed. The question then arises whether taxable persons, or businesses, can ever really be final consumers. They are after all, persons that only exist by ways of fiction created by the only real persons, mankind. An in-depth discussion on this matter goes beyond the purposes of this research, however.

2.3 THE PRINCIPLE OF NEUTRALITY IN JURISPRUDENCE

The principle of neutrality is used by the ECJ in a large number of cases. Important aspects of this principle can be found in the case-law discussed below.

2.3.1 DIFFERENT SENSES OF NEUTRALITY

In the Zimmermann case the ECJ notes that the concept of neutrality is used in different senses. On one hand neutrality means that the system of VAT is intended to relieve traders entirely of the burden of VAT payable or paid in the course of

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7 See on this topic also Terra and Kajus (2011), chapter 2.5
9 Commission Staff Working Document, p. 93
10 ECJ judgment in C-174/11 Zimmermann
economic activities, and that the common system of VAT seeks to ensure neutrality of taxation of all economic activities. On the other hand neutrality means that supplies of goods or services that are similar, and which are accordingly in competition with each other, may not be treated differently for VAT purposes. If traders are to be entirely relieved of the burden of VAT, exemptions breach this principle. The, for a just reason legendary, VAT paradox states that who is taxed is exempt, and who is exempt is taxed.

The ECJ acknowledged different dimensions of neutrality in the *Ahold*¹¹ case as well. In this case the Court held that the amount of VAT to be collected by the tax authority must correspond exactly to the amount of VAT declared on the invoice and paid by the final consumer to the taxable person. By virtue of the same principle, neutrality means that taxable persons must not be treated differently in respect of similar services which are in competition with each other. The latter meaning was already expressed in the *Kügler*¹² case, where the Court held that the principle of fiscal neutrality precludes economic operators carrying on the same activities from being treated differently as far as the levying of VAT is concerned.

Regarding competition, the findings from the Court in the *Rank Group*¹³ case state that the actual existence of competition between two supplies of services does not constitute an independent and additional condition for infringement of the principle of fiscal neutrality, if the supplies in question are identical or similar from the point of view of the consumer and meet the same needs of the consumer. Two supplies of services are similar where they have similar characteristics and meet the same needs from the point of view of consumers, the test being whether their use is comparable, and where the differences between them do not have a significant influence on the decision of the average consumer to use one such service or the other.

### 2.3.3 DOUBLE TAXATION

The principle of fiscal neutrality also precludes double taxation, follows from the *Cookies World*¹⁴ case. The ECJ judged that to tax a supply of services in another Member State when it has already lawfully been subject to VAT in the State of the supplier of the services gives rise to double taxation contrary to the principle of fiscal neutrality inherent in the common system of VAT.

### 2.3.2 STATUS OF THE PRINCIPLE

Article 220 of the EC-Treaty established the rule of law for the Community legal order. It provided that: ‘The Court of Justice shall ensure that in the interpretation and application of this Treaty the law is observed.’ The recognition of the law as a source of Community law provided the legal basis for the Court to develop general principles of Community law.¹⁵ One of these general principles is the principle of equal treatment. The principle of equal treatment requires similar situations not to be treated differently unless differentiation is objectively justified. It requires, in particular, that different types of economic operators in comparable situations be treated in the same way in order to avoid any distortion of competition within the internal market.¹⁶

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¹¹ ECJ judgment in C-484/06 *Fiscale eenheid Koninklijke Ahold NV*
¹² ECJ judgment in C-141/00 *Kügler*, para. 30
¹³ ECJ judgment in C-259/10 and C-260/10 *Rank Group plc*
¹⁴ ECJ judgment in C-155/01 *Cookies World*, para. 60
¹⁵ Terra and Wattel (2012)
¹⁶ See, *inter alia*, ECJ Judgment in C-174/08 *NCC Construction*, para. 44
In its juridical sense, the principle of fiscal neutrality is a particular expression of the principle of equal treatment at the level of secondary Community law and in the specific area of taxation.\textsuperscript{17} It requires legislation to be drafted and enacted, which requires a measure of secondary Community law. Unlike the principle of equal treatment the principle of fiscal neutrality does not have constitutional status. From this it can be derived that the principle of fiscal neutrality can not be regarded as an independent general principle of EU law. Rules of primary law, i.e. the general principles of EU law such as the principle of equal treatment or proportionality, are used by the ECJ and national courts to determine the lawfulness of legislative and administrative measures within the European Union. From ECJ case-law it follows that the principle of fiscal neutrality is not a rule of primary law against which it is possible to test the validity of exemptions.\textsuperscript{18}

AG Jääskinen\textsuperscript{19} aptly notes that the difference between fiscal neutrality and the more general equal treatment principle boils down to the question of whether economic operators that do not directly compete with each other are in a comparable situation. The ECJ states that although infringement of the principle of fiscal neutrality may be envisaged only as between competing traders, infringement of the general principle of equal treatment may be established, in matters relating to tax, by other kinds of discrimination which affect traders who are not necessarily in competition with each other but who are nevertheless in a similar situation in other respects.\textsuperscript{20}

From the \textit{NCC Construction Danmark}\textsuperscript{21} case it follows that when implementing provisions Member States must take into account the principle of equal treatment which, like the other provisions having constitutional status, bind those Member States when they take action in the field of Community law. Because the principle of neutrality does not have constitutional status, that principle may be the subject of detailed rules in legislative measures. This means that in certain circumstances the principle cannot be relied upon to preclude the application of certain transposed provisions.\textsuperscript{22}

\textbf{2.4 DEFINITION}

The purpose of this research is to analyze the internal supply provisions, which seek to prevent distortion of competition, and to determine their potential field of application. Therefore the principle of fiscal neutrality must be interpreted as follows:

The principle of fiscal neutrality is a particular expression of the general EU law principle of equal treatment that requires economic operators that carry out transactions which, from the perspective of the average consumer, are similar to be subject to the same rules concerning the levying of VAT in order to avoid distortion of competition. In addition the principle requires that traders are relieved entirely of the burden of VAT.

\textsuperscript{17} ECJ judgment in C-174/11 Zimmermann, para. 50
\textsuperscript{18} See to that extent also ECJ judgment in C-174/11 Zimmermann, para. 50
\textsuperscript{19} Opinion of AG Jääskinen in C-480/10 Commission v. Sweden, para. 20
\textsuperscript{20} ECJ judgment in C-480/10 Commission v. Sweden, para. 17
\textsuperscript{21} ECJ Judgment in C-174/08 NCC Construction Danmark, para. 45
\textsuperscript{22} See to that extent also the ECJ judgment in C-427/10 Banca Antoniana Popolare Veneta, para. 21 in where the ECJ states that the Court will not use the principle of tax neutrality to test national procedural rules.
The principle of neutrality is an instrument for the ECJ to interpret specific provisions in such a way that they fit the overall objective of the system of VAT, and therefore takes a prominent place in the system of VAT, but does not have constitutional status.

3. THE INTERNAL SUPPLY PROVISIONS

3.1 INTRODUCTION

The following example demonstrates the self-supply bias caused by the exemptions of the Directive, and shows that the vital aspect of neutrality of the system is breached. A hospital is in need of a new polyclinic and owns land that is suitable for the clinic to be built on. Management is facing the option of having the polyclinic constructed by a contractor or to construct the clinic using its own technical staff. The price of having the clinic built by a contractor would be €500,000 excluding VAT. The price the hospital pays includes, besides costs for material, labor and overhead costs and a profit for the contractor. On the total amount 25% VAT is charged, making the price for the hospital €625,000. Because this hospital has only VAT exempt activities, it will not be able to deduct the VAT and will hence experience €125,000 as a cost. If management decides to do build the clinic with its own staff, it will also be stuck with non-recoverable VAT on the materials needed. Labor and overhead costs will also arise with the construction but no VAT will have to be paid on these costs, however, thus making this option, ceteris paribus, the cheaper option. From the average consumers point of view a new polyclinic is built, regardless how. From a VAT point of view both transactions are treated differently, however. In this scenario the hospital can build the clinic itself and has an incentive to do so, therefore competition is distorted.

To counter such distortions, by virtue of Arts. 18(a) and 27 ECVD VAT becomes due on fictitious internal transactions, where the VAT on such transactions would not be wholly deductible if they were supplied by an independent third party, e.g. the contractor. Because this is a taxable transaction, the hospital is allowed to deduct the input VAT relating to this taxable supply in conformity with Art. 168(a) ECVD. The hospital will have to pay in the difference between the input VAT on the costs and the output VAT it charges itself. Consequently VAT will be paid on the value added in the course of its business, i.e. the construction, just like VAT would have to be paid on the value added by the contractor if the clinic was acquired in its entirety from the contractor. The rationale of the provisions is that there should be no difference in the amount of VAT due between producing goods or performing services in-house and acquiring them from independent third parties. The provisions establish neutrality between insourcing and outsourcing, so that there will be no distortion of competition.

Let’s consider the same scenario, taking place in a Member State where Art. 18(a) ECVD has been implemented. The hospitals land has a value of € 100,000. Management decides to have the polyclinic constructed by the contractor. The contractor delivers the polyclinic and invoices the hospital for €625,000 including 25% VAT. The VAT on these invoices, €125,000, is deductible for the hospital. The hospital will have to pay VAT on the costs of the self-supply of the polyclinic, which it will not be able to deduct since it performs only exempt medical activities. The costs are €600,000, the value of the land and the construction costs excluding the VAT, and the VAT payable is €150,000.
From this fairly straightforward example a number of issues can be identified. A definition of the concept of construction seems necessary for the provision to be applicable. Clarity on how to determine the applicable taxable amount is needed, and the moment when VAT becomes due seems important as well.

This chapter deals with, *inter alia*, these subjects. This will be done through an in-depth analysis of the provisions concerning the self-supply of goods under Art. 18(a) of the ECVD, in section 3.2, and of services under Art. 27 ECVD, in section 3.3, by a study of the provisions’ legislative context, specific aspects of the provisions, relevant case law and literature.

### 3.2 SELF-SUPPLY OF GOODS

#### 3.2.1 INTRODUCTION

Article 18(a) ECVD grants Member States the option to treat certain fictitious supplies as a supply of goods for consideration, this provision is referred to as the self-supply of goods. This section analyzes this provision. Emphasis will be on the specific aspects of the provision, highlighted in the example above, mainly the concept of production of goods and determining the taxable amount. Because of a lack of quantity of case-law on the taxable amount use is made of the discussion amongst academics in the Netherlands, where the provision is implemented.

This section is structured as follows. Paragraph 3.2.2 describes the provisions context in the Directive, while paragraph 3.2.3 researches the provisions aim through its history and origin. Next, paragraph 3.2.4 contains an analysis of the specific aspect of the production of goods. A study of the applicable taxable amount can be found in paragraph 3.2.5. Paragraph 3.2.6 analyzes the Dutch implementing provisions regarding the self-supply of goods. Paragraph 3.2.7 summarizes this section.

#### 3.2.2 LEGISLATIVE CONTEXT OF THE PROVISION

Article 18(a) ECVD contains the rule of the self-supply of goods and stipulates the following:

> “Member States may treat as a supply of goods for consideration the application by a taxable person for the purposes of his business of goods produced, constructed, extracted, processed, purchased or imported in the course of such business, where VAT on such goods had they been acquired from another taxable person, would not be wholly deductible.”

By virtue of this provision a transaction becomes a supply of goods for consideration and subject to VAT in accordance with Art. 2(1)(a) ECVD, i.e. a taxable transaction. There is no special provision regarding the place of supply for a transaction under Art. 18(a), so the normal place of supply rules apply. Art. 74 ECVD describes the taxable amount in case of a self-supply of goods:

> “Where a taxable person applies or disposes of goods forming part of his business assets, or where goods are retained by a taxable person, or by his successors, when his taxable economic activity ceases, as referred to in Articles 16 and 18, the taxable amount shall be the purchase price of the goods or of similar goods or, in the absence of a purchase price, the cost price, determined at the time when the application, disposal or retention takes place.”
Because the self-supply of goods is a taxable transaction, the taxable person is allowed to deduct the input VAT relating to that supply in conformity with Art. 168(a) ECVD. Article 168(b) guarantees the right of deduction for inputs used for both taxable and exempt transactions, the pro-rata deduction.

3.2.3 HISTORY, ORIGIN AND AIM OF THE PROVISION

Article 18(a) ECVD is a reproduction of Art. 5(7)(a) of the Sixth Directive, the wording in both provisions is identical. Art. 5(7)(a) of the Sixth Directive stems from Art. 5(3)(b) of the Second Directive, which provided that ‘the use for the needs of his undertaking, by a taxable person, of goods produced or extracted by him or by another person on his behalf was to be treated as a supply against payment.’

Paragraph 7 of Annex A to the Second Directive makes it clear that Article 5(3)(b) of that Directive seeks to ensure equality of taxation between, on the one hand, goods purchased and intended for the needs of the business, and in respect of which there is no entitlement to immediate or complete deduction, and, on the other hand, goods produced or extracted by the taxable person or on his behalf by a third person, which are also used for the same needs.

From this explanation it can be derived that the provision finds its origin in the principle of equal treatment. It owes its existence to the idea that taxable persons who produce certain goods themselves and use those goods for business purposes in respect of which VAT is not fully deductible must be brought into the same position as taxable persons who purchase such goods from a third party.\(^{23}\) This view is ratified by the ECJ in the Gemeente Vlaardingen case in which the Court states that the aim of Article 5(7)(a) of the Sixth Directive, and thus of Art. 18(a) ECVD, is to prevent distortion of competition.\(^{24}\)

3.2.4 PRODUCTION OF GOODS

Article 18(a) ECVD requires goods to be produced, constructed, extracted, processed, purchased or imported for it to be applicable. In a preliminary procedure concerning the interpretation of the words ‘produced’ in Art. 5(2)(d) of the Second Directive and ‘made’ in Art. 5(5)(a) of the Sixth Directive the ECJ ruled on this specific aspect of the provision.\(^{25}\)

Van Dijk’s Boekhuis BV carried out repairs, sometimes radical, to school books. The company charged its customers VAT at the reduced rate for the supply of books, the Dutch tax authorities questioned this practice because in their eyes the repairs did not constitute the supply of goods but were to be seen as a supply of services, subsequently to be taxed at the normal rate. The dispute between the parties resulted in the Dutch Supreme Court referring questions to the ECJ.

In its judgment the ECJ states that the above-mentioned concepts objective is to determine the basis of assessment of VAT in a uniform manner according to Community rules and that their meaning has to be the same in all the Member States. Consequently, the word ‘made’ can only be interpreted by reference to common usage, and: ‘in common usage the concept of making an article implies the creation of an article that did not previously exist’. The Court adds to this that a new good is

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\(^{23}\) Swinkels (2008), p. 176

\(^{24}\) ECJ judgment in C-299/11 Gemeente Vlaardingen, para. 26

\(^{25}\) ECJ judgment in 139/84 Van Dijk’s Boekhuis
produced when the work results in a good whose function, according to generally accepted views, is different from that of the materials provided. In a Court order in the case concerning *V.O.F. Dressuurstal Jespers* 26 years later, the ECJ basically repeated its judgment.

Terra and Kajus derive from the above that the ECJ finds that an internal supply based on Art. 18(a) of the ECVD, where a taxable person for the purposes of his business applies goods produced, constructed, extracted, or processed, in other words ‘made’ by that person, cannot occur if on an analysis of, the now deleted but still of relevance for the interpretation of what is an internal supply, Art. 5(5)(a) of the Sixth Directive a good is not made. 27 AG Mazák stresses that if goods remain to have the same function within the meaning of the case-law cited above, they can not be considered goods produced anew. 28

To determine whether or not goods have been produced anew, i.e. whether Art. 18(a) ECVD applies, national courts have to interpret the transactions involved. The scale of the work done and, in connection with that, the costs of the work done in relation to the goods, may be an indicator for courts to determine whether or not goods have been produced anew. 29 Where goods are, thoroughly, repaired by a taxable person owning those goods that will not constitute the production of goods nor a taxable self-supply, if the goods remain to have the same function. *E contrario* it may be derived from this, that where drastic renovations of a building, carried out by the taxable person himself, change its function these works may result in a new good and subsequently in a taxable self-supply. 30

The *Gemeente Vlaardingen* 31 case, see also below, concerned a municipality that for years had rented out sport pitches to different sports associations, an economic activity exempt from VAT. At a certain point the municipality had some of the grass fields replaced with artificial grass and some with an asphalt surface by contractors. When the works were completed the pitches were again rented out to the same sports associations. Although the function of the sports pitches stayed the same, the national court found that they were goods produced anew, the ECJ did not rule on this specific aspect alas. AG Mazák notes in his Opinion that it is far from obvious that in fact the sports pitches should be considered goods produced anew. 32 Taking the above mentioned discussion in consideration it does seem hard to defend the position taken by the Dutch national court.

### 3.2.5 Determination of the Taxable Amount and Chargeability

According to Art. 74 ECVD the taxable amount in case of a self-supply of goods shall be the purchase price of the goods or of similar goods or, in the absence of a purchase price, the cost price, determined at the time when application of the goods takes place. In this paragraph the determination of this amount is discussed. The self-supply rule is often applied in situations concerning real estate, as shown in the hospital example

26 ECJ judgment in C-233/05 *V.O.F. Dressuurstal Jespers*
28 Opinion of AG Mazák in C-299/11 *Gemeente Vlaardingen*, para. 55
29 See to that extent the Opinion of AG Mazák in C-299/11 *Gemeente Vlaardingen*, para. 57 and the Opinion of AG Van Hilten in *Stichting X*, para. 5.4.2.6.
30 Swinkels, (2008), p. 177
31 ECJ judgment in C-299/11 *Gemeente Vlaardingen*, para. 26
32 Opinion of AG Mazák in C-299/11 *Gemeente Vlaardingen*, para. 49
above. In this example the value of the land was included in the taxable amount, special focus will be on this specific aspect.

Art. 74 refers to the situations described in both Arts. 16 and 18 of the ECVD, a closer look at Art. 16 therefore might help to determine the right taxable amount more precisely. Art. 16 ECVD stipulates that the application by a taxable person of goods forming part of his business assets for purposes other than those of his business, shall be treated as a supply of goods for consideration, where the VAT on those goods or the component parts thereof was wholly or partly deductible.

According to Dutch AG Van Hilten the aim of Art. 16 is to prevent a taxable person from acquiring goods for his private use free of VAT, the provision deals with a situation where goods move from within the scope to outside the scope of VAT. Supplies performed under Art. 18(a), on the other hand, do not deal with such a transition. The aim of making these supplies taxable is to equate taxable persons who buy goods in their entirety from a third party with those that produce goods themselves. The complete produced goods will be taxed at the time of application in the latter situation. Consequently this means, according to the AG, that in the case of a supply under Art. 18(a) ECVD the taxable amount de facto includes more than in case of a supply made under Art. 16, because in the latter situation goods that were purchased without the right of deduction of VAT are filtered out of the taxable amount. The reasoning of AG van Hilten points towards a wide scope of Art. 18(a) ECVD.

In the joined cases of Gemeente Leusden and Holin Groep the ECJ decided that Arts. 5(7)(a) and 20(2) of the Sixth Directive, now Arts. 18(a) and 187 ECVD, are two mechanisms with the same economic effect: they oblige a taxable person to pay amounts equivalent to the deductions to which he was not entitled. The methods of payment are different however, because Art. 5(7)(a) of the Sixth Directive entails a single payment and Art. 20(2) provides for adjustments spread out over several years.

Swinkels states it could be deduced from this judgment that the total taxable amount for both provisions should be the same, that the self-supply of goods is to be interpreted as being merely a correction of the previous deduction of input tax. The taxable amount for Art. 18(a) ECVD must be interpreted as not including elements that initially did not bear VAT. He finds support for this view in the judgments in the cases of Wollny and Uudenkaupungin Kaupunki, in where the ECJ judged that the deduction of input tax is linked to the collection of output tax. From Swinkels reasoning it can be deduced that, contrary to AG van Hilten’s opinion, when land is bought VAT exempt, the price of this land should not be included when determining the basis of assessment for the taxable amount of the self-supply.

AG Van Hilten is convinced that the ECJ’s statement in the Gemeente Leusden and Holin Groep judgment is wrong, or at least unluckily formulated. The aim of Art. 5(7)(a) of the Sixth Directive is different from the aim of Art. 20(2) of that Directive and the ECJ meant that in the two situations the taxable persons will experience

33 Opinion of AG Van Hilten in Stichting X, para. 5.4.2.8.
34 ECJ judgment in C-487/01 Gemeente Leusden and Holin, para. 90.
35 Swinkels (2008), p. 178-179
36 ECJ judgments in C-72/05 Wollny, para. 20, and in C-184/04 Uudenkaupungin kaupunki, para. 24
Professor Van der Paardt agrees with AG Van Hilten up to the point that the taxable amount should include costs that a contractor would include in his cost price, like insurance costs. However, he states that VAT is a tax on the value added, and with goods produced by a taxable person in the course of his business the added value lies in the production work. The goal of the self-supply rule is to remove the VAT-advantage of producing a good yourself compared to buying this good in its entirety from a third party. If a property is bought in its entirety from a contractor, and if that contractor has been able to make a profit on the land he purchased and then built on, that profit would be the value added and therefore it should be taxed. But if the taxable person bought the land itself and then has a contractor build upon it, there is no added value on the land itself and, according to the principle of fiscal neutrality, should not be taxed. Van der Paardt refers to the cases of Bakcsi and Fischer and Brandenstein, the rationale in these cases is that when no deduction of VAT can be made upon the purchase of a good, no VAT has to be accounted for upon application of those goods either, this fits very well into the principle of fiscal neutrality according to him.

In the Gemeente Vlaardingen case the ECJ judged that in order to equate a taxable person that produces goods himself with competitors that acquire these goods in their entirety from a third person, pursuant to the aim of Art. 18(a) ECVD, it must be possible for the treatment option available under that provision to be extended to all goods completed or improved by the third party and, accordingly, to cause VAT to be levied on the basis of the overall value of those goods. The ECJ states that this overall value may in principle include every cost aspect when the goods are applied for the exempt activity, including the value of the land and profit costs for example. In the Marinov case the ECJ holds that the taxable amount should be value of the good in question, determined at the time of the application, which corresponds to the market price for a similar good, account being taken of the costs of transforming that good.

However, the Court adds in its judgment, one of the essential characteristics of VAT is that it is imposed on the added value of the goods concerned, since the tax payable on a transaction is calculated after the tax paid on the preceding transaction has been deducted. Consequently, the option of treating certain applications as supplies made for consideration cannot be used in order to charge VAT on the value of goods which the taxable person concerned has made available to the third party who completed or improved them, to the extent that the taxable person has already, in the context of an earlier tax period, paid VAT on that value. As follows from the Cookies World case,

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37 Opinion of AG Van Hilten in Stichting X, para. 5.4.2.8.
38 Annotation Van Zadelhoff in Gemeente Leusden and Holin, BNB 2004/260
39 Van der Paardt (2009), p. 1340
40 ECJ judgment in C-415/98 Bakcsi, para. 44
41 ECJ judgment in C-322/99 and C323/99 Fischer and Brandenstein
42 ECJ judgment in C-299/11 Gemeente Vlaardingen, para. 28 and further
43 ECJ judgment in C-142/12 Marinov, para. 32
44 Terra and Kajus note in The Court of Justice and VAT – Judgments and Opinions in 2012, Lund: ETIL, p. 68, that the Court merely refers to VAT paid and not to, the degree of, non-deduction of VAT paid and that one can only subject to tax once the application by the same taxable person for the same good, whether VAT has been deducted or not.
discussed above, such double taxation is also contrary to the principle of fiscal neutrality.

Pursuant to Article 18(a) ECVD the treatment of certain transactions as supplies for consideration takes place at the moment when the goods are applied, that is to say, at the time when the goods are put to use for the purposes of the exempt activity. In the example this would be the time when the hospital puts the polyclinic to use for the purposes of its exempt medical activities. When materials have already been applied by the taxable person for the purposes of his business, and consequently are used in the production of a new good the value of these materials can no longer be included in the taxable amount, AG Mazák adds to this discussion.\(^{45}\) A risk of double taxation and of endangering the principle of fiscal neutrality exists if no account is taken of the previous. Mazák stresses that when there are different methods of interpretation available, it is necessary to defend the interpretation which best enables double taxation to be avoided.

### 3.2.6 IMPLEMENTATION OF ART. 18(A) ECVD IN THE NETHERLANDS

Since the birth of the Dutch Wet op de omzetbelasting 1968 (the Wet OB), Law on Turnover Tax 1968, the self-supply of goods has been a taxable transaction. Nowadays Art. 3(3)(b) Wet OB implements Art. 18(a) of the ECVD in the Netherlands, this article stipulates that the supply of goods shall mean:

> “The use for business purposes of goods produced in-house in cases where, had the goods been acquired from a trader, the tax on the goods would not have been deductible or would not have been wholly deductible.”

Although Art. 18(a) ECVD also provides the option to tax goods purchased or imported, the Netherlands haven’t made use of this option. Member States have a certain amount of discretion when implementing optional provisions from the Directive. From case law it can be derived that the scope of these provisions may be limited,\(^ {46}\) as long as the principle of fiscal neutrality is taken into consideration.\(^ {47}\)

Article 3(3)(b) Wet OB is supplemented by Art. 3(9):

> “For the application of paragraph 3, section b, goods produced to order with materials being provided, including land, shall be treated as goods produced in-house. For the purpose of paragraph 3, section b, land which has not been built on other than building land as described in article 11, paragraph 4, is excluded from the application.”

In the Netherlands the self-supply of goods as described in these provisions is called ‘the integration tax’. Article 8(3) of the Wet OB determines the taxable amount for internal supplies and corresponds to Art. 74 ECVD:

> “With regard to transactions, described in article 3, paragraph 3, and article 3a, paragraph 1, the consideration shall be the purchase price of the goods or of similar goods or, in the absence of a purchase price, the cost price, calculated at the time when these transactions are performed.”

The ‘integration tax’ is often applied in situations regarding real estate or immovable property in the Netherlands, like in the example with the hospital. It should be borne in mind, however, that the provision is not limited to these situations. If the hospital

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\(^{45}\) Opinion of AG Mazák in C-299/11 Staatssecretaris van Financiën v. Gemeente Vlaardingen, para. 70

\(^{46}\) ECJ judgment in C-136/97 Norbury Developments, para. 20

\(^{47}\) Swinkels (2009), p. 132
owns a generator to produce electricity which it uses for its exempt medical activities it will also make a taxable self-supply of goods under Art. 3(3)(b) of the Wet OB.

3.2.6.1 CONFORMITY OF THE DUTCH PROVISIONS WITH DIRECTIVE

In the Gemeente Vlaardingen case the Dutch tax authorities were of the opinion that VAT was due by the municipality of Vlaardingen because of a self-supply of sports fields when they were applied, i.e. rented out again. The authorities summed up the costs of the works and the value of the land, charged VAT on that aggregate amount and granted a right of deduction in respect of the construction works. This left the municipality to pay the remaining VAT. The municipality disagreed and over this dispute the Dutch Supreme Court referred questions to the ECJ.

Just as in the example provided above, where a hospital had an polyclinic constructed on land it owned, for the municipality there was a taxable self-supply by virtue of Art. 3(3)(b) jo. 3(9) Wet OB. Article 18(a) ECVD does not mention goods produced to order, however, so the Dutch implementing provisions seem to have a wider scope. When implementing provisions of the Directive Member States have discretionary power but must always, in the exercise of their authority, observe the principle of fiscal neutrality. The ECJ states in its judgment that Art. 18(a) must be interpreted as also covering goods constructed, extracted or processed by a third party with materials provided by the taxable person. Such an interpretation is necessary, according to the Court, to truly eliminate all inequalities, in relation to VAT, between taxable persons who have acquired goods from a third party and those who have acquired them in the course of their business. From this judgment it must be concluded that the Netherlands stayed within the boundaries of its discretion when implementing Art. 18(a) ECVD.

In both the example and the Gemeente Vlaardingen case the value of the land was included in the taxable amount. It is common practice in the Netherlands to include in the taxable amount everything that amounts up to the newly produced good. In the Gemeente Vlaardingen case the referring Dutch Court asked the ECJ if Art. 5(7)(a) of the Sixth Directive, now Art. 18(a) ECVD, must be interpreted in such a way that the value of the land, that has been used by the taxable person for the same exempt purposes, becomes included in the VAT charge. In accordance with Art. 74 ECVD, and Art. 8(3) Wet OB to that extent, the VAT payable has to be calculated at the time when the goods are applied for the taxable persons business. According to the ECJ Member States may hold that the tax burden for a business that has had its goods improved by a third party must be at the same level as a competitor that has bought these goods in their entirety. The aggregate value of the ground and the construction costs may constitute as an appropriate basis of assessment. A taxation mechanism of this design cannot give rise to breach of the principles laid down in relation to VAT.

According to Dutch law, if the hospital from the example had bought the land and paid VAT on the value of the land, the situation described above would mean that it had to pay VAT on the value of the land twice. Once upon purchase and once again when the value of the land is included in the taxable amount for the self-supply of the polyclinic. The ECJ states that it is incompatible with both the essential characteristics of VAT and the aim of Art. 18(a) ECVD if the provision was used in order to charge

48 ECJ judgment in C-299/11 Gemeente Vlaardingen, para. 27
49 ECJ judgment in C-299/11 Gemeente Vlaardingen, para. 30, 31
VAT on the value of goods, which the taxable person concerned has made available to the third party who completed or improved them, to the extent that the taxable person has already paid VAT on that value.\textsuperscript{50} On this point the Dutch law is contrary to the ECVD.

3.2.7 CONCLUSION

The aim of Article 18(a) ECVD is to prevent distortion of competition, in other words to safeguard neutrality of VAT between different competitors. The provision does this by making certain internal transactions taxable. The concept of production was discussed in paragraph 3.2.4; although the ECJ has not judged on this concept regarding the self-supply of goods explicitly, guidance can be found in jurisprudence.

As described above there is a discussion amongst academics considering the determination of the correct taxable amount. A strict, literal, interpretation of Art. 74 ECVD points towards including the costs of all goods and materials used for the production of the new goods in the taxable amount. Considered in isolation, VAT on these materials, whether applied or not, is a cost for taxable persons without a right to deduct so this also could then be included in the taxable amount for the purposes of Art. 18(a) ECVD. Regarded in conjunction with the principle of fiscal neutrality the result of this situation is difficult to rationalize. An interpretation of the taxable amount that includes the cost of all materials that have been used for the production of the new goods, unless they have already been applied for the purposes of the taxable persons business, seems to fit the system of VAT as such best. This line of reasoning is ratified by the ECJ’s judgment in the \textit{Gemeente Vlaardingen} case.

If the provision on the internal supply of goods is implemented well and works according to its legislative intent, for the hospital from the example it should make no difference whether it had bought the land first and then had the polyclinic constructed on it, or whether it had bought the polyclinic in its entirety, thus including the land, from a third party. As shown, the same goes in the case where the hospital produces its own electricity or if it buys it from a supplier. In both situations the hospital should feel no incentive, at least from a VAT perspective, to produce goods in-house. The VAT burden in both situations should be the same, i.e. neutral.

3.3 SELF-SUPPLY OF SERVICES

3.3.1 INTRODUCTION

To cope with the ever increasing costs, hospital management is considering different options. One of these options is to insource the hospitals laundry, there is extra room in the new polyclinic anyway, in stead of having it done by a third party. Because there is no transfer of the right to dispose of tangible property, i.e. the laundry, as owner there will be no supply of goods, Art. 14 ECVD. According to Art. 24 ECVD, doing laundry is therefore considered a supply of services. Hence, the insourcing of the laundering by the hospital is not covered by Art. 18(a) ECVD. Without any other Articles covering this situation, the hospital would have an incentive, from a VAT perspective, to insource its laundering. It will save itself the non-deductible VAT on these services. VAT will influence the hospitals business decisions in this case and would therefore infringe the principle of fiscal neutrality.

\textsuperscript{50} ECJ judgment in C-299/11 \textit{Gemeente Vlaardingen}, para. 32
Article 27 ECVD has a solution to this situation, however. What its counterpart Art. 18(a) does for goods, this provision does for services. As mentioned before, not all Member States have implemented the rules on the self-supply of goods. Even less have implemented the rules concerning the self-supply of services. If there is little legal writing on the self-supply of goods, there is even less on the self-supply of services. The Netherlands have, however, implemented Art. 27 ECVD. This section analyzes this provision, mainly through studying the implementing provisions in the Netherlands. This section is structured as follows. Paragraph 3.3.2 describes the legislative context of the self-supply of services. Next, paragraph 3.3.3. discusses the provisions history, origin and aim. The implementing rules of the Netherlands are analyzed together with specific aspects of the provision in paragraph 3.3.4. Paragraphs 3.3.5 summarizes this section.

### 3.3.2 LEGISLATIVE CONTEXT OF THE PROVISION

Article 27 ECVD stipulates that:

“In order to prevent distortion of competition and after consulting the VAT Committee, Member States may treat as a supply of services for consideration the supply by a taxable person of a service for the purposes of his business where the VAT on such a service, were it supplied by another taxable person would not be wholly deductible.”

Transactions covered by this provision will be subject to VAT in conformity with Art. 2(1)(c) ECVD. Article 77 ECVD determines the taxable amount:

“In respect of the supply by a taxable person of a service for the purposes of his business, as referred to in Article 27, the taxable amount shall be the open market value of the service supplied.”

The definition of open market value for the Directive is found in Art. 72 ECVD:

“For the purposes of this Directive, ‘open market value’ shall mean the full amount that, in order to obtain the goods or services in question at the time, a customer at the same marketing stage at which the supply of goods or services takes place, would have to pay, under conditions of fair competition, to a supplies at arm’s length within the territory of the Member State in which the supply is subject to tax. Where no comparable supply of goods or services can be ascertained, ‘open market value’ shall mean, in respect of services, an amount not less than the full cost to the taxable person of providing the service.”

Regarding the right of deduction, the self-supply of services under Art. 27 ECVD is a taxable transaction and therefore Article 168(a) ECVD grants a right of deduction in this case. Article 168(b) guarantees the right of deduction for inputs used for both taxable and exempt transactions.

### 3.3.3 HISTORY, ORIGIN AND AIM OF THE PROVISION

The possibility to tax internal services was at first not included in the Proposal for the Sixth Directive. From the Working Documents it appears that it was the European Parliament that suggested that the self-supplies of services should be taxed. The Parliament pointed out that the principle of fiscal neutrality might be harmed, if for example hospitals would carry out work like window-cleaning and laundry themselves in order to avoid paying VAT thus cutting out service undertakings. In order to avoid excessive deviations among Member States prior consultation was found necessary, that’s why Art. 27 requires the VAT Committee to be consulted.

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51 Working papers on Sixth Directive
52 Terra and Kajus (2013), chapter 4
The Commission followed the Parliaments remarks in the Working Documents and added to its Proposal that the rules on the self-supply of goods shall apply in a like manner with respect to the supply of services. In its Explanatory Memorandum to the amendments of 11 October 1974 the Commission noted that:

“The European Parliament desires that it should continue to be possible to tax, in exceptional cases, services ‘rendered to oneself’, as was provided for in the second subparagraph of Point 9 of Annex A to the Second Directive of 11 April 1967. It is proposed therefore to add a new paragraph to Article 7 [of the Proposal]. This new provision is aimed at introducing a greater competitive equality between suppliers of services in cases where the risk of provoking distortions of competition is serious. In view of the use which Member States could make of this provision it seems desirable that cases where it is applied should be submitted to the VAT Committee.”

From the foregoing it can be derived that Art. 27 ECVD has the same aim as its counterpart, Art. 18(a) ECVD. The purpose of the provision is to prevent distortion of competition, as is described in the Article itself, and to safeguard the principle of fiscal neutrality.

### 3.3.4 IMPLEMENTATION IN THE NETHERLANDS

The Netherlands have implemented Art. 27 ECVD in Art. 4(3) of the Wet OB, which states:

> “In order to prevent serious distortion of competition, for the application of paragraph 1, section a, the supply of services for consideration shall mean the supplies indicated by ministerial regulation by a trader of a service for the purposes of his business where the VAT on such a service, were it supplied by another taxable person would not be wholly deductible”

The taxable amount for a supply under Art. 4(3) Wet OB is, according to Art. 8(4)(b), the ‘normal value’ of the service. The normal value of the service is a concept that corresponds to the ‘open market value’ as stipulated in the Directive.

When discussing the implementation in the Dutch Parliament it was pointed out that safeguarding neutrality is the main goal for a possible internal service. In his reply to the amendment the State Secretary of Finance pointed out that, regarding neutrality the effect will be marginal. Nevertheless he admitted that the amendment could improve the neutrality of the system.

### 3.3.4.1 MINISTERIAL REGULATION

Art. 4(3) Wet OB requires a ministerial regulation that indicates what kind of services should be taxed under the provision. Up until this date no ministerial regulations have been adopted, however, and thus no services have been indicated. Without any indications the Article might provide the option to improve neutrality of the VAT system, but is de facto a dead letter.

The fact that no services have been indicated could mean that there haven’t been any serious distortions of competition in the Netherlands. Prior to treating certain supplies of services taxable, consultation with the VAT Committee is required, in literature it

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has been suggested that this could act as an obstacle. Another reason for why no services have been indicated, could be the marginal effect the measure might have regarding neutrality. From insourcing its laundry services the hospital from the example would save VAT on the labor costs and profit. In a market with full competition professional laundry firms will have economies of scale and should be able to offer such services relatively cheap, so insourcing for the hospital might even be more expensive than outsourcing, if push comes to shove.

Yet another, and perhaps the most important, reason for the indication requirement of Art. 4(3) Wet OB is the following. Theoretically almost everything a company does can be outsourced. Not only the hospital’s laundry but also the reception, cleaning and even the diagnosis its doctors make can, in theory, be outsourced. The hospital would perform an infinite number of self-supplies everyday, if the rule would not be limited to certain indicated services. Besides the fact that the administrative department of the hospital would probably be larger than the hospital itself in a situation like this, it also seems contrary to the principle of proportionality. The consequences would be disproportionate to the aim pursued, the Article would go beyond what is necessary to achieve neutrality. By concluding this the Article’s legality is questioned and could even be contrary to EU law. See further on this topic below in paragraph 4.2.1.

### 3.3.4.2 TAXABLE AMOUNT

The open market value, or the normal value in the Netherlands, is a definition of the taxable amount determined by objective factors. For the majority of transactions covered by the Directive, however, a subjective amount is the standard. The taxable amount for the greater part of transactions is the consideration actually paid in order to obtain the goods or services, regardless of whether the price is, economically speaking, too high or too low.

Van Hilten and Van Kesteren are of the opinion that an objectively determined value better suits the goal of the internal supply, to prevent distortion of competition, than a subjective one. In that same sense it could as well be argued that an objectively determined taxable amount promotes the principle of fiscal neutrality in the way that the price for transactions is determined under conditions of fair competition. An amount determined by subjective factors might not be completely neutral between competitors. For example, a hospital with a wholly owned subsidiary that does its laundry will probably pay less for the laundry services than a hospital that does not have such a subsidiary. Because the purpose of the internal supply of goods and services is to prevent distortion of competition, an objectively determined taxable amount might suit this aim better than a subjectively determined taxable amount.

### 3.3.4.3 DISTORTION OF COMPETITION

Article 27 ECVD explicitly mentions that the provisions goal is to prevent distortion of competition. The Parliament talks about ‘serious disturbances of competition’ in the Working Documents for the Sixth Directive. The word ‘serious’ has been omitted from Art. 27 ECVD, but the provision implementing the rule in the Netherlands still contains it. Van Hilten and Van Kesteren note that the adding of the word ‘serious’ indicates that the competition should be completely skewed. Because the word is no

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54 Van Hilten and Van Kesteren (2010), p. 217  
55 Van Hilten and Van Kesteren (2010), p. 217  
56 Van Hilten and Van Kesteren (2010), p. 133
longer in Art. 27 ECVD it is defendable to state that milder forms of disturbances of competition also allow for self-supplies of services to be taxed.

Van Norden thinks that the introduction of the requirement of distortion of competition correlates to the feasibility for taxable persons. According to him, if this requirement would not have been added it would be possible for Member States to tax almost every internal ‘transaction’, as was illustrated in the hospital example above. In this line of thought, the requirement of distortion of competition should prevent taxation of almost an infinite number of transactions. Internal transactions can then only be taxed where they have the potential to distort competition. However, as described above, virtually every transaction can be outsourced and, hence, has the potential to distort competition.

3.3.5 CONCLUSION
Article 27 ECVD aims to prevent distortion of competition. The provision has the potential to do so: with a correct implementation the hospital from the example would again experience no gain from insourcing its laundry. Certain aspects and mainly the scope of the provision are unclear, however. Without jurisprudence on the provision and without extensive implementations in national VAT laws, i.e. little practical experience, it’s hard to give a proper practical analysis of the article.

4. THE RELATION OF THE INTERNAL SUPPLY PROVISIONS TO NEUTRALITY

4.1 INTRODUCTION
As shown the exemptions of the VAT system cause an incentive for taxable persons with mainly exempt activities to insource, the self-supply bias, which causes distortions of competition and breaches neutrality of VAT. Articles 18(a) and 27 of the ECVD both aim to counter this problem through making certain fictitious internal supplies taxable, hence aiming to safeguard neutrality of the system. This chapter researches to what extent Art. 18(a) and 27 ECVD de lege lata achieve their goals, and what can be done to improve their effect.

An in-depth analysis of Articles 18(a) and 27 ECVD has been done in chapter 3. Section 4.2 discusses the technical shortcomings of the provisions de lege lata regarding their aim of neutrality. Section 4.3 discusses the provisions and their aim from a more general point of view and puts the discussion in perspective. This chapter is summarized by section 4.4.

4.2 TECHNICAL SHORTCOMINGS

4.2.1 OPTIONAL PROVISIONS
Articles 18(a) and 27 ECVD are both optional provisions in the sense that Member States are free to transpose them from the Directive in to their national systems. In the rules being optional their first, and perhaps biggest, shortcoming becomes clear. If the rules are left as optional for the Member States they can never bring any structural neutrality to the system on a European level, if not every Member State implements them.

In the EU only a handful of Member States have implemented the rules on internal supplies, of which the Netherlands is one. When it comes to Art. 27 ECVD even fewer Member States have implemented the provision. The Netherlands have done so, but, as described above, the provision is not used in practice.

From a European perspective, this ‘full’ implementation in the Netherlands can be perceived as not being a level playing field. Entities established in the Netherlands are confronted with the internal supply provisions while their competitors established in other Member States are not. As long as there is no clear guidance from the ECJ on the exact scope of the provisions, and there are differences between the implemented national provisions and the articles in the Directive there will be uncertainty regarding the application of the rules. While legal uncertainty might be a source of income for advisory firms, this will generally bring more costs for businesses. Also from the cost perspective, the self-supply of a building, for example, requires highly skilled accounting and brings administrative and compliance costs. In this sense the result of the rules can be seen as a breach of neutrality between competitors on a European level. This is hard to justify from a harmonized internal market perspective.

4.2 IMPLEMENTING DISCRETION

Because the rules are optional for Member States to implement, Member States have discretion on how exactly to implement the rules. If Member States are left with implementing discretion, there can be different implementing provision in different Member States. This means that there can be a different treatment for identical transactions of competitors established in different Member States. Considering the fact that these competitors are active on the same European internal market this is clearly a distortion of competition and not a level playing field.

Swinkels notes that the discretion includes limiting the scope of provisions.58 Neither Art. 18(a) nor 27 ECVD prescribes which transactions should be included in their scope. This power is therefore delegated to the Member States, taking into account the principle of fiscal neutrality and the aim of preventing distortion of competition, which is not at all easy.59

On one hand, making every transactions taxable would potentially mean that all labor and profit costs are subject to VAT. As shown in the example in paragraph 3.3.4.1, regarding the self-supply of services virtually every transaction can be outsourced in theory. Eskildsen notes that this would undermine the effect of public-interest exemptions, which intend to reduce the cost of the transaction in question, and be a substantial administrative burden for entities carrying out VAT exempt transactions.60 One of the objectives of the exemptions of medical activities is to reduce the cost of medical care for example.61

On the other hand, limiting the scope of the provision limits the potential structural neutrality the provision can bring at the same time. As mentioned in paragraph 3.2.6, Art. 18(a) ECVD is implemented in the Netherlands but only to the extent that goods

58 Swinkels (2008), p. 179
60 Eskildsen (2012), p. 446
61 ECJ judgment in C-262/08 CopyGene, para. 30 and the case law cited
are produced, not when they are purchased or imported. For these kind of transactions there can still be distortions of competition.

### 4.2.3 TAXABLE AMOUNT

As demonstrated by the *Gemeente Vlaardingen* case, issues can arise when determining the correct taxable amount in case of the self-supply of goods or services. Open norms, such as those used for the determination of the taxable amount which are to be interpreted. For the self-supply of services Art. 77 ECVD refers to the open market value, for example. Open norms can be seen as an advantage making the provisions more flexible and sustainable. At the same time the disadvantage is that they cause legal uncertainty when there is no clear guidance on their interpretation on a European level or from the ECJ, this is especially the case for not widely implemented provisions.

Eskildsen notes that Arts. 18(a) and 27 ECVD can induce cumulative effects, which are clearly undesirable within the VAT system. He explains this through application of the provisions resulting in non-deductible VAT for a taxable person. When this taxable person is not the final consumer, this VAT will be included as a cost in the price of his output transactions and the buyer will not be able to recover this ‘hidden’ VAT. If this buyer is also not the last in the chain, a third buyer that does carry out taxable transactions will have to pay VAT on VAT.

### 4.3 A PERSPECTIVE VIEW

As briefly mentioned in the example in paragraph 3.3.4.1, there are other factors than costs, or more specific VAT, that influence outsourcing. Gendron notes that cultural, socio-economic and political factors would appear to impose more severe constraints on the contracting out of public services than VAT. Especially prices of in-house produced basic goods, available on a full-competition market, may very well be higher than purchased goods including VAT. Edgar provides examples that suggest that the pre-tax price advantage of outsourced services does not have to be large to contradict the incentive to self-supply.

To put the discussion into perspective, Gendron states that the severity of the self-supply bias is directly proportional to the VAT rate of Member States. According to the economist it is no surprise that a large part of the literature on the nefarious effects of VAT on outsourcing originates from the EU, a group of countries with a high average VAT rate and many public services outside the scope of VAT. Notwithstanding the arguments of professor Gendron, VAT remains an important factor in business decisions in cases where the tax is experienced as a cost. This is especially the case when VAT rates are relatively high like in the European Union, the focus area of this research.

In a general sense, adding rules to a system can be seen as adding complexity to a system. When VAT is considered in its essence to be a general tax on consumption, when exemptions are made to this generality and then rules are made to take away the side-effects of these exemptions, it is, in my view, safe to conclude that the system

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62 ECJ judgment in C-299/11 Gemeente Vlaardingen
63 Eskildsen (2012), p. 446
64 Gendron (2005), p. 517
65 Edgar (2001)
66 Gendron (2005), p. 517
becomes more complex. Gale and Holtzblatt define the complexity of a tax system as the sum of the compliance and administrative costs.\textsuperscript{67} The application of Article 18(a) ECVD requires skilled administration and brings larger compliance and administrative costs for entities facing this rule. So also from a cost perspective the internal supply rules increase the complexity of the tax system. Swinkels wonders whether the argument of distortion of competition is sufficient to justify the existence of the fairly complex rules on taxable self-supplies. Abolition of those rules would, according to him, lead to a considerable simplification of the VAT legislation.\textsuperscript{68}

4.4 CONCLUSION

Articles 18(a) and 27 ECVD have the potential to bring structural neutrality to the VAT system on a European level, but fail to do so with the law as it stands right now. One of the reasons is that the Articles are left optional for Member States to implement, and Member States have broad discretion when doing so. The exercise of this discretion can lead to distortions of competition within the internal market. In order to put the full potential of the Articles to use, thus trying to achieve structural neutrality, the optionality of the provisions could be removed.

Besides the Articles being optional, technical shortcomings such as their precise scope and determination of the taxable amount cause interpretive issues and can be delimited in order for the rules to achieve an optimal effect. Delimiting these open norms would make the system less sustainable, however, and should therefore not be preferred. Once the Articles become a fully functioning part of the Directive more literature and jurisprudence will emerge and should shed more light on the provisions’ interpretation, although this does not per definition mean more clarity for taxable persons.

It should not be overseen that the provisions on internal supplies undoubtedly bring more complexity to the system. In today’s situation, where the rules are not widely used and only implemented in a few Member States, their result might be seen as disproportionate for taxable persons facing application of the internal supply rules compared to others who are not. In my view, however, this is a justifiable sacrifice in the struggle for perhaps the most vital part of VAT, fiscal neutrality.

5. POTENTIAL FIELD OF APPLICATION

5.1 INTRODUCTION

In the above chapters it has been shown that the provisions on internal supplies can serve as means to restore neutrality of the VAT system. With examples of scenarios based on the way the provisions are implemented in the Netherlands the Articles legislative intent and potential were discussed. Within VAT there are other fields where the principle of fiscal neutrality is breached than by way of exemptions. This chapter identifies some of these fields and researches if Arts. 18(a) and 27 ECVD can be applied to restore the breached neutrality.

\textsuperscript{67} Gale and Holtzblatt (2002), p. 181
\textsuperscript{68} Swinkels (2008), p. 180
5.2 CROSS-BORDER SITUATIONS
As a general rule internal transactions are not subject to VAT, unless a *lex specialis* derogates from this rule. Transactions within one and the same entity will not be subject to VAT because there are no transactions between separate taxable persons. Derogations from the general rule include the self-supply rules of Arts. 18(a) and 27 ECVD but also, *inter alia*, Arts. 16, 21, and 26 of the Directive.

For taxable persons with an organizational structure that covers multiple entities, VAT grouping and cost-sharing consortia are instruments provided by the Directive to reduce the burden of non-deductible VAT, where this arises from transactions with subsidiaries, partners or other associated parties, i.e. separate taxable persons. With these instruments transactions between these persons will not be subject to VAT. They are deemed to be one taxable person and hence the transactions are considered to be internal.

These instruments are, however, designed only to work when the transactions take place, in their entirety, within one Member State. Cross-border transactions between subsidiaries, that could in principle be seen as internal, will be subject to VAT and non-recoverable VAT can be incurred. In the sense that VAT should be a tax on final consumption that relieves businesses of the burden of VAT this can not be regarded as a desirable effect of the system.

From the case *FCE Bank* it follows that where the organization of a company takes the form of several branches throughout Europe, and these branches do not have any economic independence, it will be considered one legal entity for VAT purposes. This means that services supplied between the branches established in different Member States are not subject to VAT.

### 5.2.1 FCE BANK
FCE Bank, a UK company, performs mostly financial services which are exempt from VAT and, as a head office, it provides certain services to its branches. The Italian branch of FCE Bank, FCE Bank IT, received these services. It consecutively claimed repayment of the VAT on those supplies on the basis of the invoices it issued to itself, a process known as ‘self-invoicing’. According to the branch it did not have separate legal personality, thus it was not a separate taxable person and could therefore not be liable for VAT. The Italian tax authorities refused the refund and this dispute resulted in preliminary questions from the Italian supreme court.

The ECJ stated in this case that for a taxable supply of services to exist there must be a legal relationship between the service provider and the recipient in which there is a reciprocal performance. To establish whether there is such a relationship between a non-resident company and one of its branches it is necessary to determine whether the branch carries out an independent economic activity and whether the branch may be regarded as being independent, in particular in that it bears the economic risk arising from its business.

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69 Commission Staff Working Document, p. 92
70 See to that extent also Commission Staff Working Document, p. 93
71 ECJ judgment in C-210/04 *FCE Bank plc*
The ECJ established that in this case the Italian branch did not bear the required economic risk so it could not be regarded as a separate legal entity and therefore the services provided could not be subject to VAT. The ECJ concluded that the various establishments of a single legal entity cannot be treated as individual taxable persons and as a result, there can be no supply for VAT purposes between them.

The Commission claims that the judgment is consistent with the principle that activities carried out by part of a single legal person for the benefit of other parts of the same legal person cannot be treated as a transaction subject to VAT, and with the principle of freedom of establishment within the EU, since an internal border between those parts does not undermine that favorable treatment. Furthermore, the Commission notes that the fact that financial and insurance institutions are usually not entitled to deduct input VAT leads to accumulating and cascading tax, and that is against the principle of neutrality governing VAT. Hence the Commission finds a strong pragmatic argument for the non-taxation of intra-EU transactions in services between various parts of the same entity.\(^2\)

In its judgment the ECJ limited its answers to situations in where the entities involved are established within the EU. This leaves open the question of what the correct treatment is when dealing with a branch outside the EU. From the Courts reasoning in the FCE Bank case it can be derived that the Court is of the opinion that services provided within one and the same entity should never be taxed, regardless of whether branches are established inside or outside the EU. In its reasoning the ECJ focuses on the legal relationship between the parties and to establish that relationship it is necessary to determine whether or not the branch carries out an independent economic activity.

Along with the Commission some Member States are of the opinion that non-taxation of ‘internal’ supplies is indeed the correct treatment.\(^3\) The practical problem with this practice is that it opens up a leak in the VAT system. If a non-EU head office buys services in a non-EU country and reroutes them to an EU branch, no EU VAT will be incurred. If the non-EU country regards this supply of services as an export, the head office might even be able to recover the input tax. Also for transactions entirely within the EU there is a risk of distortion because of the different VAT rates Member States maintain.

At the time of writing a reference for a preliminary ruling in the Skandia America Corporation\(^4\) case is pending before the ECJ. The case concerns a scenario where services are supplied by a head-office of a company established in a non-EU country to a branch of the same company in an EU Member State, where the latter establishment is a member of a VAT group in that Member State. With its questions the Swedish court essentially asks whether the services should be disregarded for VAT purposes, thus applying the FCE Bank scenario, and if the VAT group should be treated as a separate taxable person for VAT purposes. The ECJ is expected to deliver its judgment somewhere in 2014. If the ECJ decides in consistency with its reasoning

\(^{2}\) Commission Staff Working Document, p.93
\(^{3}\) Commission Staff Working Document, p.92
\(^{4}\) Reference for a preliminary ruling in C-7/13 Skandia America Corporation
in the *FCE Bank* case and the opinion of the Commission and several Member States, the leak opened up by the *FCE Bank* judgment will become definitive.

The *FCE Bank* treatment only works when the organization has the form of several branches, fixed establishments or divisions, not when the transactions concern subsidiaries for example. The different treatment of similar transactions is not consistent and therefore a breach of the principle of fiscal neutrality. Distortions of competition may arise where competitors whose corporate structure does not allow them to benefit from the leak or the *FCE Bank* treatment, because of domestic laws for example, are less off than competitors that are in a position to benefit from this.

### 5.2.2 FICTITIOUS INTRA-COMMUNITY ACQUISITIONS

The *FCE Bank* judgment has resulted in certain supplies of services between the different establishments of a single entity in different Member States being outside the scope of VAT. As discussed, this opens up a leak in the VAT system and that constitutes a breach of the principle of fiscal neutrality. However, this leak does not exist in transactions involving goods. Art. 21 ECVD deals with the supply of fictitious Intra-Community acquisition. This Article stipulates that the cross-border internal supply of goods is to be treated as an Intra-Community acquisition of goods, and thus as taxable, where these goods were produced or imported in one Member State and then dispatched or transported to another. When Art. 21 is applied, Art. 168(d) guarantees a right of deduction.

The following example based on an *FCE Bank* scenario with goods instead of services, demonstrates the provision for fictitious Intra-Community acquisition. FCE Bank UK would make a zero-rated supply of goods, with a right to deduct. The Italian branch, FCE Bank IT, would then make an Intra-Community acquisition on the grounds of Article 21 ECVD and would have to account for Italian VAT on this purchase. Also when goods would be imported from a non-EU country this supply would be taxable with EU VAT.

### 5.2.3 SOLUTION

The leak in the VAT system and the resulting distortion of competition, as a result of the current situation, only exists when it comes to the supply of services. The application of Art. 27 ECVD in this situation could correct this problem. The Article is specifically designed to prevent distortion of competition and allows Member States to tax any supply by a taxable person of a service for the purposes of his business where the VAT on such a service, were it supplied by another taxable person, would not be wholly deductible. In a *Skandia America Corporation* scenario this would mean that the branch receiving the services from its head office, established either within or outside of the EU, would make a fictitious internal supply and be liable to pay VAT on the transaction. The leak would be closed by application of this Article.

As mentioned, Art. 27 ECVD is ready-to-use and Member States are free to implement the rule, albeit that consultation of the VAT Committee is required. The functional and general shortcomings of the provision discussed in Chapter 4 will have to be dealt with. One of the functional shortcomings is the determination of the taxable amount. Service transactions within the same legal entity are not always invoiced, in the *FCE Bank* case a process known as self-invoicing was applied. The Commission notes that in order to deal with the risk of double taxation or tax-
cascading, the application the self-supply of services would require a corresponding right to deduct input tax elsewhere or, alternatively, limitation of the tax on the deemed self-supply to the part of the value of the services that had not yet effectively been subject to VAT elsewhere.\textsuperscript{75} Another issue is that when only a few Member States make use of the option, distortions of competition may arise because of the different treatments in different Member States. Therefore, for an optimal effect of this option, the Article should be enforced in the Directive.

The Commission wonders whether the result of the option described above might simply be excessively complicated and be seen as disproportionate in the search for neutrality, and that the option should maybe be limited to transactions concerning non-EU countries.\textsuperscript{76} In my view, and I repeat, this is a justifiable sacrifice in the struggle for perhaps the most vital part of VAT, fiscal neutrality.

\textbf{5.2.4 CONCLUSION}
Through application of the \textit{FCE Bank} case there is currently a leak in the European VAT system. How big, economically speaking, exactly this leak is, is unknown. The judgment in the \textit{Skandia America Corporation} case will most likely bring more guidance on this leak, but up until this judgment the leak will remain. This means that within the internal market the risk of distortion of competition exists and neutrality of the VAT system is breached.

In 2003 the Commission tried to amend the Directive by clarifying that supplies of services within one and the same legal entity should not be taxed, confirming its own view and, as appeared later, corresponding to the \textit{FCE Bank} judgment.\textsuperscript{77} As in many other issues pending before the Council, it could, however, not reach consensus. Reforms to deal with a leak like this one could take a long time. Application of Art. 27 ECVD in \textit{FCE Bank} situations could therefore prove to be a solution.

\textbf{5.3 PUBLIC BODIES}
Public sector bodies, local governments and government institutions like universities for example, deal with a mixed treatment of their activities. Some activities are outside the scope of VAT, some are exempt and some are taxable. Activities that are outside the scope of VAT are activities engaged in as public authorities, as stipulated by Art. 13 ECVD. Public bodies are often engaged in activities not functioning as public authorities, and are therefore not outside the scope of VAT, but lie in the public interest and are therefore exempt by virtue of Art. 132 ECVD for example. The third and last group of activities are taxable transactions.

De la Feria states that the reasoning behind not taxing public bodies is a mixed conceptual and political one. Because of the many different activities they engage in, there is a view that the activities are hard to tax. In addition to this there is the view that the exclusion of public bodies from the VAT system achieves social and distributional aims. Non-taxation should increase consumption of merit goods and the non-taxation of these products is said to diminish the natural regressivity of

\textsuperscript{75} Commission Staff Working Document, p. 98
\textsuperscript{76} Commission Staff Working Document, p. 98
\textsuperscript{77} COM(2003) 822
consumption taxes.\textsuperscript{78} The ECJ has stated that public interest exemptions intend to reduce the cost of the transaction in question.\textsuperscript{79}

The mixed treatment of activities public bodies have to deal with is complicated, because it forces entities in the public sector to apportion input taxes for different purposes. While in theory this may sound not all too difficult, in practice this has proven to be a tough trick. Increased complexity of the VAT system creates opportunities for fraud, Gendron notes.\textsuperscript{80} This statement may very well be true, there are multiple ECJ cases dealing with public sector bodies and VAT avoidance.\textsuperscript{81} The attempts to avoid payment of VAT can be explained by the fact that for certain transactions VAT is experienced as a cost. Public sector bodies are one of the main groups of taxable persons to be affected by exemptions because many of their activities lie in the public interest section. As mentioned earlier, because of these exemptions public bodies will feel an incentive to insource their activities and therefore distortions of competition may arise.

The current treatment of public sector bodies is generally seen as undesirable and complicated. Gendron for example suggests that the best treatment would be full taxation.\textsuperscript{82} De la Feria also advocates for change.\textsuperscript{83} However, it has proven to be tough to get major reforms within the VAT system, as shown in section 4.2, because consensus is required and Member States disagree with each other.

One of the methods currently in use in some Member States to counter the self-supply bias of public bodies are VAT compensation schemes. These schemes rebate the VAT incurred on specific transactions for certain public sector bodies. Such transactions mainly comprise of activities not engaged in as a public authority, e.g. the outsourcing of garbage disposal by a municipality. The rebate schemes are able to take away the incentive for public bodies to insource, and are therefore able to restore neutrality of the system to some extent. The downside, however, is that these schemes will have to be implemented by Member States on their own initiative. This means that, just like the optional provisions of the ECVD, Member States have broad discretion when implementing such schemes and the schemes will not bring any structural neutrality on a European level. Distortions of competition will persist between, for example, garbage disposal companies operating on the internal market.

Uniform application of the internal supply provisions can provide for a solution here. If a municipality would be subject to the self-supply of services rule, it should feel no incentive to insource its garbage disposal activities, for example. Without this incentive private garbage disposal companies will, in principle, have equal chances of being contracted and therefore no distortions of competition should arise. The self-supply rules are already applied to public bodies in some Member States, like in the Netherlands. The real potential of Art. 27 ECVD in this field lies in a more widespread use of the rules throughout Europe.

\textsuperscript{78} De la Feria (2009), p. 148
\textsuperscript{79} See to that extent, \textit{inter alia}, the ECJ judgments in C-262/08 CopyGene, para. 30, C-106/05 \textit{L.u.P}, para. 25, C-498/03 	extit{Kingscrest Associates}, para. 30, C-287/00 \textit{Commission v Germany}, para. 47 and C-76/99, \textit{Commission v France}, para. 23
\textsuperscript{80} Gendron (2005), p. 517
\textsuperscript{81} See, \textit{inter alia}, the ECJ judgments in C-419/02 \textit{BUPA Hospitals} and C-223/03 \textit{University of Huddersfield}
\textsuperscript{82} Gendron (2005), p. 514
\textsuperscript{83} De la Feria (2009), pp. 148-165
6. CONCLUSION

The current VAT system in Europe is intended to be neutral between competitors and should relieve traders entirely of the burden of VAT. The principle of fiscal neutrality is a particular expression of the general EU law principle of equal treatment that requires economic operators that carry out transactions which, from the perspective of the average consumer, are similar to be subject to the same rules concerning the levying of VAT in order to avoid distortion of competition. In addition the principle requires that traders are relieved entirely of the burden of VAT. Because of the numerous exemptions the current VAT system counts, this neutrality is breached. To achieve full neutrality one option would be to get rid of all the exemptions in the VAT system, making VAT a true general tax on all consumption. Besides raising a lot of other issues, this option can not be seen as politically feasible, however.

Articles 18(a) and 27 ECVD are instruments within the Directive that provide Member States with a measure to restore neutrality of the system. The provisions make certain internal transactions taxable as supplies made for consideration. From case-law and the practice in the Netherlands it was shown that the application of the provisions is not straightforward. The ECJ has stated that for Art. 18(a) ECVD the applicable taxable amount, as stipulated in Art. 74 ECVD, may in principle include all costs that contribute to the value of the goods concerned, unless the VAT has already been paid on the components used in the production of the goods. Article 27 has proven to be more difficult to analyze because of the lack of literature, case-law and practical experience with the provision.

The internal supply provisions definitively have to potential to restore neutrality to the system of VAT, but fail to do so in a structural way with the law as it stands today. Because the Articles are optional, structural neutrality on a European level can not be reached unless all Member States implement the rules in a more or less similar manner. Different ways of implementation may still cause distortions of competition. Obligatory implementation of the Articles will, however, make the system of VAT more complicated as a whole. Although this can not be seen as a positive effect, this is a justifiable sacrifice in the struggle for neutrality.

Article 27 ECVD has potential to be applied in cross-border situations. Its application can close a leak that has been identified within the VAT system. In addition to this, the provision can also be applied in a more widespread European way in the troublesome field of public sector bodies, where reform is wanted by many but proves hard to achieve.
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