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**The Principle of Fiscal Neutrality and Economic
Reality in EU VAT: Two Peas in a Pod?**

by

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HARN60 Master Thesis
Master's Programme in European and International Tax Law
2021/2022

Spring semester 2022
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Summary

Economic reality constitutes a fundamental criterion for the application of the common VAT system. Its reference by the CJEU, and consequently its importance, has increased throughout the past decades. It prioritises a neutral VAT outcome over the contractual provisions agreed upon by the parties involved. In this regard, the question arises to what extent economic reality might be comparable to the principle of fiscal neutrality. This research aims to shed light on this relationship.

Fiscal neutrality is a fundamental principle which underlies the common system of VAT. Three separate components can be distinguished. First, external neutrality serves as an equaliser of the VAT burden in the international trade of goods and services, preserving a level playing field. Second, legal neutrality reflects the general EU law principle of equal treatment in the field of VAT. Third, system neutrality prevents the distortion of economic decision-making. These three components ensure that VAT is levied in as neutral a manner as possible and does not interfere with the EU internal market.

In contrast to the principle of fiscal neutrality, economic reality is not as widely recognised. Moreover, the concept is covered in uncertainty, particularly regarding its origin, legal status, function and terminology. Nonetheless, two appearances of economic reality can be distinguished: as a standard of normality in the abuse of law doctrine and as a benchmark of VAT reality to ensure neutrality. Whereas the former is not as closely related to the principle of fiscal neutrality, the latter shares two significant similarities.

First, in several CJEU judgments and AG opinions, legal neutrality and economic reality seem to merge to a significant extent. The interpretive function of VAT reality ensures equal treatment of economically similar supplies. In addition, the CJEU and AG even include economic reality in the comparability analysis of legal neutrality. This raises the question of whether this principle requires similarities from a purely legal or economic point of view. Nonetheless, the conclusion can be made that the benchmark of VAT reality and legal neutrality seem to merge to a significant extent.

Second, this interpretive function of economic reality preserves several norms of system neutrality. Most notably, the concept has been applied to ensure proportionality between VAT and prices, grant the right of input tax deduction and tax self-supplies. Although differing in the subject of interpretation, the principle of system neutrality and economic reality aim for a neutral VAT outcome by interpreting legislation and facts.

To conclude, economic reality's benchmark of VAT reality is closely related to the principle of fiscal neutrality. In addition to its function as a standard of normality in abusive practices, neutrality is printed on the other side of the coin. As long as the CJEU is not flipping this coin arbitrarily but applies economic reality carefully on a case-by-case basis, legal certainty should not be endangered.

Preface

Before the tax conference ‘Value Added Tax and Beyond’ held in Lund, Sweden in memory of Ben Terra, I had never heard of the notion of economic reality in relation to EU VAT. However, during Ad van Doesum’s contribution, I developed an interest in the topic. Notably, the concept’s vagueness and unclarity grabbed my attention. After conducting preliminary research, I decided to study the subject in depth during my master thesis.

However, before exploring the comparability of economic reality with the principle of fiscal neutrality, I would like to express my gratitude to several individuals. First, since this research is conducted as a master thesis for the programme in European and International Tax Law at Lund University, I would like to thank all (guest) teachers throughout this master’s programme, particularly Cécile Brokelind, Giorgio Beretta, Sigrid Hemels, Mariya Senyk and Marta Papis-Almansa. Second, I want to express my gratitude to Ad van Doesum for his contribution to the aforementioned tax conference and for sharing a concept of his forthcoming paper, to be published by the IBFD in ‘EU Value Added Tax and Beyond – Essays in honour of Ben Terra’. Third, I would like to thank Giorgio Beretta, in particular, for his helpful and excellent supervision during this research. Last but surely not least, I want to thank my classmates, friends and family for their continuous support, in particular my late mother who passed away in the summer of 2016.

Abbreviation List

App	Appendix
AG	Advocate General
Ch	Chapter
CJEU	Court of Justice of the European Union
Ed	Editor
Edn	Edition
EU	European Union
GC	General Court
GST	Goods and Services Tax
IBFD	International Bureau of Fiscal Documentation
OECD	The Organisation for Economic Co-operation and Development
UN	United Nations
VAT	Value Added Tax

1 Introduction

1.1 Background

‘In this world nothing can be said to be certain, except death and taxes.’ Although this wisdom dates back to a letter written by Benjamin Franklin to Jean-Baptiste Leroy in 1789, it is still applicable over two centuries later. Nowadays, nearly all jurisdictions levy some sort of tax, either on income, capital, consumption or production. Taxation has become part of our everyday life, and there is almost no way to escape it.

Unfortunately, taxes have a negative side effect since they have the potential to influence economic decision-making. Besides direct taxation impacting investment decisions, indirect taxes could affect consumer preferences towards goods or services. As such, taxation might distort fair competition. Therefore, taxes should ideally be levied in a neutral manner.¹

Neutrality is critical to indirect taxes such as VAT and GST.² In an EU context, unneutral taxation distorting competition would threaten the preservation of the internal market, which aims for a level playing field. Therefore, the neutrality of VAT has been recognised in Recital 5 in the Preamble to the VAT Directive³. It states that the ‘VAT system achieves the highest degree of simplicity and of neutrality when the tax is levied in as general a manner as possible’. Besides codification, this purpose has been acknowledged by the CJEU, establishing the principle of fiscal neutrality.⁴ It serves as a method of interpretation of EU VAT legislation.⁵

Besides the principle of fiscal neutrality, the concept of economic reality serves as a safeguard of a neutral VAT system as well. In *Temco Europe, AG Ruiz-Jarabo Colomer* ruled that the tax treatment should be based on a transaction’s economic reality instead of its legal classification, to prevent the neutrality of VAT from being undermined.⁶ Hence, in addition to the principle of fiscal neutrality, economic reality might also ensure a neutral EU-wide VAT system, especially considering the Member States’ different legal systems.

The concept of economic reality has gained importance over the past decades. The numerical analysis in Appendix A illustrates a significant development in CJEU judgements and AG opinions referring to economic reality, or its

¹ OECD, *Taxation and Electronic Commerce: Implementing the Ottawa Taxation Framework Conditions* (OECD Publishing 2001) 17-18.

² OECD, *International VAT/GST Guidelines* (OECD Publishing 2017) 18.

³ Whenever this research mentions the ‘VAT Directive’, it refers to Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax [2006] OJ L347/1.

⁴ Case C-62/12 *Kostov* [2013] EU:C:2013:391, para 29; Case C-51/18 *Commission v Austria* [2018] EU:C:2018:1035, para 2; and Case C-214/18 *PSM "K"* [2019] EU:C:2019:301, para 3.

⁵ Case C-366/12 *Klinikum Dortmund* [2014] EU:C:2014:143, para 40; Case C-204/13 *Malburg* [2014] EU:C:2014:147, para 43; and Case C-334/14 *De Fruytier* [2015] EU:C:2015:437, para 37.

⁶ Case C-284/03 *Temco Europe* [2004] EU:C:2004:287, Opinion of AG Ruiz-Jarabo Colomer, para 25.

supposed synonyms identified in academic literature.⁷ Whilst covered in only 20 cases during the initial 20 years after its first citation (1982-2001), reference to the notion of economic reality has more than tripled to 61 over the second half of its existence (2002-2022).

Despite this extensive coverage, there is still considerable doubt about the actual meaning of economic reality. In particular, three areas of uncertainty can be identified. First, neither the CJEU nor the AGs have clearly defined the terms or functions concerned. This conceptual or semantic uncertainty can be illustrated by the asymmetric application of economic reality by the CJEU and the AGs.⁸ Consequently, this gap needs to be filled in by academic literature.⁹ Second, the legal status of economic reality has never been established. It is unsure whether it forms a fundamental principle of EU VAT or, in contrast, is just a rule. Third, it is ultimately unclear which terms capture the same notion as economic reality. Hence, it is difficult to accurately grasp its scope. These three factors illustrate the legal uncertainty surrounding the concept of economic reality.

1.2 Aim

As identified in the last section, the principle of fiscal neutrality and economic reality seem to overlap to a certain extent. Both principles point to a VAT-neutral outcome. However, whereas fiscal neutrality¹⁰ and economic reality¹¹ have been studied in isolation, their relationship has not yet been researched in-depth. Hence, from an academic perspective, it is relevant to compare the two theories and identify where they might overlap.

Besides academic relevance, studying this relationship has societal implications too. Legal certainty is valuable to businesses. In principle, taxable persons should be allowed to rely on the contractual provisions agreed upon with their counterparties. However, the principle of fiscal neutrality and economic reality deviate from this legal status quo as they prioritise a VAT-neutral outcome. As identified in the last section, legal certainty is especially low regarding economic reality. A thorough understanding of the conditions under which businesses should depart from the contractual provisions and should follow a neutrality-based result is of significant importance. Consequently, in addition to academic importance, this study has societal relevance too.

⁷ Ad van Doesum and Frank Nellen, 'Economic Reality in EU VAT' (2020) 29 EC Tax Review 213, 214. Besides their identified terms, this study includes 'real economic situation' (Case 42/83 *Dansk Denkavit* [1984] EU:C:1984:254, para 3.4.3) and 'economic approach' (Case C-43/19 *Vodafone Portugal* [2020] EU:C:2020:465, para 49). See app A for an extensive description of the research conducted. For reasons of clarity and consistency, unless explicitly stated otherwise, this research refers to 'economic reality' to capture all terms.

⁸ As identified in app A by the fact that there are significantly more cases where either the CJEU (26) or AG (40) unilaterally mention the term than where they do simultaneously (15).

⁹ Ad van Doesum and Frank Nellen, 'Economic Reality in EU VAT' (2020) 29 EC Tax Review 213, 213-214.

¹⁰ See, e.g., Charlène Herbain, *VAT Neutrality* (Promoculture-Larcier 2015).

¹¹ See, e.g., Ad van Doesum and Frank Nellen, 'Economic Reality in EU VAT' (2020) 29 EC Tax Review 213.

Therefore, this research aims to identify to what extent economic reality is (in)comparable to the principle of fiscal neutrality in EU VAT. To do so, both theories are initially subject to individual analysis. Regarding the principle of fiscal neutrality, it is essential to distinguish between three different components, being external, legal and system neutrality. A more extensive analysis is required concerning economic reality, as the concept is still relatively unexplored. Interesting questions relate to its potential status as a principle, functions, differences in terminology and adherence to the principle of legal certainty. After these two fundamental components have been individually analysed in-depth, their overlap can be studied. Subsequently, the primary research question can be answered, being to what extent economic reality is (in)comparable to the principle of fiscal neutrality in EU VAT.

1.3 Method and Material

This study relies on traditional legal methodology. In particular, the analysis is conducted through four main research methods. First, this study employs descriptive analysis, as a considerable number of CJEU judgments and AG opinions are discussed. Second, it conducts explorative research, since it explores the principle of fiscal neutrality and economic reality, compares them and identifies where they might overlap. Third, this research deploys a normative assessment of the concept of economic reality, investigating to what extent it might infringe the principle of legal certainty. Fourth, since this study aims to identify the relationship between the principle of fiscal neutrality and economic reality in EU VAT, it conducts comparative research. Consequently, this study applies traditional legal methodology to answer the research question and entails a descriptive, explorative, normative and comparative analysis.

Regarding the materials used, three primary sources can be identified. First, the principle of fiscal neutrality and economic reality have primarily been developed in case law. Hence, several CJEU judgments and AG opinions are analysed. Second, the principle of fiscal neutrality and economic reality have been discussed in academic literature. Consequently, this research includes various peer-reviewed books and journal articles. Third, economic reality has occasionally been touched upon in explanatory notes issued by the European Commission. Therefore, this research also covers institutions' official documentation. To conclude, the three primary sources of material used to answer the research question are case law, scholarly publications and institutions' official documentation.

1.4 Delimitation

Four limitations reduce the scope of this research. First, the CJEU judgments and AG opinions covered in this research dealing with economic reality explicitly refer to this term, or its identified synonyms. Hence, cases where the Court seems to apply, yet does not expressly mention these terms in their

judgments, are not discussed.¹² Second, regarding the principle of fiscal neutrality, particular attention is paid to legal and system neutrality. As sections 4.1.2 and 4.1.3 illustrate, these principles are most closely related to economic reality, and hence, most relevant for this research. Third, of the two manifestations of economic reality identified by Van Doesum and Nellen¹³, its function as a benchmark of VAT reality is discussed more in-depth. Since its role as a standard of normality in the abuse of law doctrine is less relevant to the principle of fiscal neutrality, less attention is paid to it. Finally, this research covers sources published until 27 May 2022, i.e., the date of this thesis's submission.

1.5 Outline

After this introductory part, the remainder of this research is structured as follows. Chapter 2 covers the principle of fiscal neutrality. Following a general background, distinctions are made between external, legal and system neutrality. Subsequently, chapter 3 relates to the concept of economic reality. In particular, this chapter discusses whether it can be considered a fundamental principle or if it is just a legal concept. Afterwards, the two functions of economic reality in EU VAT are elaborated upon. Next, the differences in the terminology used by the CJEU and AGs are addressed, and potential conflicts with the principle of legal certainty are discussed.

After establishing this legal framework by analysing the two theories in isolation, chapter 4 brings them together and investigates their relationship. In separate sections, the similarities and differences between the principle of fiscal neutrality and economic reality are highlighted. This chapter answers the primary research question, being to what extent economic reality is (in)comparable to the principle of fiscal neutrality in EU VAT. Chapter 5 concludes the study.

¹² Ad van Doesum and Frank Nellen, 'Economic Reality in EU VAT' (2020) 29 EC Tax Review 213 fn 45; and Ad van Doesum, 'Capital Contributions: VAT Neutrality, Economic Reality and Legal Certainty' in *EU Value Added Tax and Beyond – Essays in honour of Ben Terra* (IBFD 2022 forthcoming) para 3 discuss several cases where the CJEU's reasoning seems to build on the notion of economic reality, yet does not explicitly refer to it.

¹³ Ad van Doesum and Frank Nellen, 'Economic Reality in EU VAT' (2020) 29 EC Tax Review 213, 214.

2 The Principle of Fiscal Neutrality

2.1 Background

The principle of fiscal neutrality has a rich history. Whereas referred to by the CJEU for the first time in 1979¹⁴, it was already codified in Article 2 of, and Recital 5 in the Preamble to, the First VAT Directive¹⁵ in 1967. Currently, the principle of fiscal neutrality can be found in six Recitals in the Preamble to the VAT Directive.¹⁶ Consequently, the principle is very well represented in secondary VAT legislation.

Besides codification, the CJEU has also contributed to establishing the principle of fiscal neutrality. According to the Court, fiscal neutrality is a fundamental principle which underlies the common VAT system.¹⁷ However, regarding its legal classification, the CJEU has concluded that it lacks constitutional status and is not a rule of primary EU law.¹⁸ Therefore, it cannot invalidate the provisions of the VAT Directive, in contrast to the general principles of EU law.¹⁹ Nonetheless, it forms a principle of interpretation²⁰, that ensures a neutral VAT outcome. From this perspective, its teleological interpretation²¹ complements and competes with the other hermeneutic methods, being the textual and contextual interpretation.

The principle of fiscal neutrality is a broad concept which has several appearances. Although consensus seems to be found among academics concerning its main characteristics, the devil is in the details. Whereas some

¹⁴ Case 126/78 *Nederlandse Spoorwegen v Staatssecretaris voor Financiën* [1979] EU:C:1979:150, paras 6-8.

¹⁵ Council Directive 67/227/EEC of 11 April 1967 on the harmonisation of legislation of Member States concerning turnover taxes [1967] OJ Spec Ed 14.

¹⁶ In Recitals 5, 7, 30 and 34, neutrality is explicitly mentioned. In Recitals 4 and 13, non-distortion of competition and non-discrimination are mentioned, which are fundamental to system and legal neutrality, as discussed in the upcoming sections.

¹⁷ Joined Cases C-80/11 and C-142/11 *Mahagében and Dávid* [2012] EU:C:2012:373, para 57; Case C-138/12 *Rusedespred* [2013] EU:C:2013:233, para 29; and Case C-259/12 *Rodopi-M 91* [2013] EU:C:2013:414, para 32.

¹⁸ Case C-174/08 *NCC Construction Danmark* [2009] EU:C:2009:669, para 42; Case C-44/11 *Deutsche Bank* [2012] EU:C:2012:484, para 45; and Case C-573/15 *Oxycure Belgium* [2017] EU:C:2017:189, para 32.

¹⁹ Christian Amand, 'VAT Neutrality: A Principle of EU Law or a Principle of the VAT System?' (2013) 2 *World Journal of VAT/GST Law* 163, 181 argues that fiscal neutrality might be based on the principle of non-discrimination and should supersede the rules in the VAT Directive.

²⁰ Case C-366/12 *Klinikum Dortmund* [2014] EU:C:2014:143, para 40; Case C-204/13 *Malburg* [2014] EU:C:2014:147, para 43; and Case C-231/19 *Blackrock Investment Management (UK)* [2020] EU:C:2020:513, para 51.

²¹ Teleological interpretation 'refers to a particular systemic understanding of the EU legal order that permeates the interpretation of all its rules', according to Miguel Maduro, 'Interpreting European Law: Judicial Adjudication in a Context of Constitutional Pluralism' (2008) 1 *European Journal of Legal Studies* 137, 140.

scholars distinguish three²² separate components, others identify up to four²³: external, legal, competition and system²⁴ (or economic²⁵) neutrality.

This discrepancy in academic literature concerns the principle of competition neutrality. Whereas Van Doesum and others²⁶ seem to equate this component with legal neutrality, Terra and Kajus²⁷ recognise it separately. The latter authors claim that competition neutrality prescribes a similar VAT burden, regardless of the production and distribution chain length. On the other hand, the argumentation for assimilating the two components by Van Doesum and others²⁸ likely relies on the fact that competition is a condition for applying the principle of legal neutrality.²⁹ Whilst they agree that the eventual VAT burden should not depend on the length of the production and distribution chain, this is covered under system, rather than competition, neutrality.

Although the discrepancy is of little or no relevance since both views only differ in subdivision, this research agrees with Van Doesum and others, as their considerations seem to be confirmed by the CJEU.³⁰ Although not explicitly recognising the external component, economic and legal neutrality are clearly identified. Whereas no reference is made to a separate element ensuring neutrality in competition, this term is used under legal neutrality. Hence, in the remainder of this chapter, the principle is divided into external, legal and system neutrality.

2.2 External Neutrality

Academic literature makes a distinction between internal and external neutrality.³¹ Whereas the principle of internal neutrality covers transactions

²² Ad van Doesum and others, *Fundamentals of EU VAT Law* (2nd edn, Kluwer Law International 2020) 40-43; and Giorgio Beretta, 'VAT and the Sharing Economy' (2018) 10 *World Tax Journal* 381, 395-396.

²³ Ben Terra and Julie Kajus, *Introduction to European VAT* (2022 edn, IBFD 2022) ch 7.3; and Marta Papis, 'The Principle of Neutrality in EU VAT' in Cécile Brokelind (ed), *Principles of Law: Function, Status and Impact in EU Tax Law* (IBFD 2014) ch 16.4.1.

²⁴ Ad van Doesum and others, *Fundamentals of EU VAT Law* (2nd edn, Kluwer Law International 2020) 41.

²⁵ Christian Amand, 'VAT Neutrality: A Principle of EU Law or a Principle of the VAT System?' (2013) 2 *World Journal of VAT/GST Law* 163, 169; Marta Papis, 'The Principle of Neutrality in EU VAT' in Cécile Brokelind (ed), *Principles of Law: Function, Status and Impact in EU Tax Law* (IBFD 2014) ch 16.4.1; and Giorgio Beretta, 'VAT and the Sharing Economy' (2018) 10 *World Tax Journal* 381, 396-397. For reasons of clarity and consistency, this research refers to system, instead of economic, neutrality.

²⁶ Ad van Doesum and others, *Fundamentals of EU VAT Law* (2nd edn, Kluwer Law International 2020) 41-42.

²⁷ Ben Terra and Julie Kajus, *Introduction to European VAT* (2022 edn, IBFD 2022) ch 7.3.1.2.

²⁸ Ad van Doesum and others, *Fundamentals of EU VAT Law* (2nd edn, Kluwer Law International 2020) 41.

²⁹ Case C-695/19 *Rádio Popular* [2021] EU:C:2021:549, para 43; Case C-846/19 *Administration de l'Enregistrement, des Domaines and de la TVA* [2021] EU:C:2021:277, para 67; and Case C-515/20 *Finanzamt A* [2022] EU:C:2022:73, para 43.

³⁰ Case C-174/11 *Zimmermann* [2012] EU:C:2012:716, paras 46-48.

³¹ Ben Terra and Julie Kajus, *Introduction to European VAT* (2022 edn, IBFD 2022) ch 7.3; Ad van Doesum and others, *Fundamentals of EU VAT Law* (2nd edn, Kluwer Law International 2020) 40-43; Marta Papis, 'The Principle of Neutrality in EU VAT' in Cécile

within one Member State, external neutrality relates to international supplies. Rendahl makes a further distinction between trade with Third Countries and intra-EU business. In her opinion, the latter can be captured in a separate principle, called intra-external neutrality.³²

The principle of external neutrality has primarily established itself in the provisions of the VAT Directive. Whereas it requires exports to be relieved of any existing VAT burden to allow for taxation in the country of destination, imports should be taxed to keep a level playing field with local supplies.³³ In a sense, it serves as an equaliser by levelling the VAT burden on goods and services produced domestically and abroad.

Besides codification, the principle of external neutrality can be found in jurisprudence. In this regard, the case *Collée* is an excellent example.³⁴ It concerned the denial of the exemption on intra-Community supplies, on the ground that the proof of transport to the other Member State was not submitted in time. According to the Court, non-compliance with such formal requirements should not prevent the application of the exemption³⁵, except in cases of fraud³⁶, as this would infringe the principle of external neutrality.

2.3 Legal Neutrality

Whereas external neutrality has been codified in the VAT Directive, the principle of legal neutrality can primarily be found in the case law of the CJEU. According to the Court, it ‘was intended by the EU legislature to reflect, in matters relating to VAT, the general principle of equal treatment’.³⁷ This latter is applicable in all fields of EU law, not just taxation.³⁸ The principle of equal treatment entails a prohibition of ‘treating similar situations differently and treating different situations in the same way unless there are objective reasons for such treatment’.³⁹ Consequently, the primary condition

Brokelind (ed), *Principles of Law: Function, Status and Impact in EU Tax Law* (IBFD 2014) ch 16.4.1; Giorgio Beretta, ‘VAT and the Sharing Economy’ (2018) 10 *World Tax Journal* 381, 395; and Han Kogels, ‘Making VAT as Neutral as Possible’ (2012) 21 *EC Tax Review* 230, 230.

³² Pernilla Rendahl, *Cross-Border Consumption Taxation of Digital Supplies* (IBFD 2009) 90.

³³ Han Kogels, ‘Making VAT as Neutral as Possible’ (2012) 21 *EC Tax Review* 230, 230 equates external neutrality with the destination principle, prescribing taxation at the place of consumption. For an extensive analysis of this latter principle, see Mariya Senyk, *The Origin and Destination Principles as Alternative Approaches towards VAT Allocation: Analysis in the WTO, the OECD and the EU Legal Frameworks* (IBFD 2020).

³⁴ Case C-146/05 *Collée* [2007] EU:C:2007:549.

³⁵ *ibid* para 31.

³⁶ Case C-285/09 *R*. [2010] EU:C:2010:742, para 54.

³⁷ Case C-576/15 *Maya Marinova* [2016] EU:C:2016:740, para 49; Case C-534/16 *BB construct* [2017] EU:C:2017:820, para 29; and Case C-449/19 *WEG Tevesstraße* [2020] EU:C:2020:1038, para 48.

³⁸ Case C-441/14 *DI* [2016] EU:C:2016:278, para 26; Case C-56/19 *P - RFA International v Commission* [2021] EU:C:2021:102, para 25; and Case C-463/19 *Syndicat CFTC* [2020] EU:C:2020:932, paras 8-9.

³⁹ Case C-422/02 *P - Europe Chemi-Con (Deutschland) v Council* [2005] EU:C:2005:56, para 33; Case T-401/06 *Brosmann Footwear (HK) and Others v Council* [2010]

of the principle of equal treatment, and hence legal neutrality, should be the similarity of situations.

Nonetheless, the CJEU appears to demand a second requirement. On numerous occasions, the Court required taxable persons to compete with each other.⁴⁰ Consequently, this condition might limit the scope of the principle of fiscal neutrality, by excluding similar situations which are not in competition. This scenario occurred in the case *Commission v France*.⁴¹ Hence, in addition to the condition of similar situations for equal treatment, the principle of legal neutrality appears to require competition between taxable persons.

However, the CJEU seems to have downplayed this requirement in *Rank Group*.⁴² Here, competition simply results from a similarity in the nature of goods and services, which is the underlying requirement of equal treatment.⁴³ Therefore, the sole condition for applying the principle of fiscal neutrality seems to be identical or similar supplies from a consumer's view, meeting the same needs. De la Feria shares this opinion.⁴⁴ Hence, the condition requiring taxable persons to be in competition seems not to be interpreted too strictly.

Nonetheless, should legal neutrality be inapplicable, the question arises whether the general EU law principle of equal treatment might be applied instead. This relates to the hierarchy between the two. As aforementioned, legal neutrality reflects the principle of equal treatment in VAT matters, which seems to indicate a relationship of *lex specialis* and *lex generalis*.⁴⁵ Regarding the difference between equal treatment and legal neutrality, AG Jääskinen argues that it 'boils down to the question of whether economic operators that do not directly compete with each other are in a comparable situation'.⁴⁶ The CJEU appears to have accepted this reasoning.⁴⁷ Consequently, case law seems to indicate that both the principles of equal treatment and legal neutrality can be applied alternatively, to the preference of the applicant.

EU:T:2010:67, para 81; and Case T-424/13 *Jinan Meide Casting v Council* [2016] EU:T:2016:378, para 156.

⁴⁰ Case C-29/08 *SKF* [2009] EU:C:2009:665, para 67; Case C-41/09 *Commission v Netherlands* [2011] EU:C:2011:108, para 66; Case C-310/11 *Grattan* [2012] EU:C:2012:822, para 28; and Case C-566/16 *Vámos* [2018] EU:C:2018:321, para 48.

⁴¹ Case C-481/98 *Commission v France* [2001] EU:C:2001:237, para 27.

⁴² Joined Cases C-259/10 and C-260/10 *The Rank Group* [2011] EU:C:2011:719.

⁴³ *ibid* paras 33-36.

⁴⁴ Rita de la Feria, 'VAT: A New Dawn for the Principle of Fiscal Neutrality?' [2011] Oxford University Centre for Business Taxation Policy Paper 11/04 <<https://core.ac.uk/download/pdf/288286521.pdf>> accessed 27 May 2022 5-6.

⁴⁵ Ad van Doesum and others, *Fundamentals of EU VAT Law* (2nd edn, Kluwer Law International 2020) 42.

⁴⁶ Case C-480/10 *Commission v Sweden* [2013] EU:C:2012:751, Opinion of AG Jääskinen, para 20.

⁴⁷ Case C-309/06 *Marks & Spencer* [2008] EU:C:2008:211, paras 49-50; Case C-480/10 *Commission v Sweden* [2013] EU:C:2013:263, para 17; Case C-38/16 *Compass Contract Services* [2017] EU:C:2017:454, para 24; and Case C-462/16 *Boehringer Ingelheim Pharma* [2017] EU:C:2017:1006, para 28.

2.4 System Neutrality

2.4.1 Background

Before analysing the principle of system neutrality in depth, the underlying foundation of an economically neutral tax system shall be established. Already in the eighteenth century, Adam Smith theorised that the ‘invisible hand’ of the economy guides a market towards its most efficient outcome if all economic actors behave in their self-interest.⁴⁸ This theory entails that unregulated competition generally provides for the best allocation of production factors.⁴⁹ In terms of taxation, this means that from an efficient market perspective, relative prices should remain unchanged.

Nonetheless, throughout the years, unneutral taxation has established itself in almost all jurisdictions, for several reasons. In direct taxation, personal income taxes redistribute income across social classes based on the ability-to-pay principle. Regarding indirect taxation, whereas excises discourage consumption of undesired products, customs duties intentionally impair the competitiveness of goods originating from Third Countries. However, VAT simply serves as a general tax on private consumption and aims to generate tax revenues.⁵⁰ In contrast to the taxes mentioned above, there is no intent to redistribute wealth or influence economic behaviour. Therefore, Adam Smith’s economic efficiency theory requires minimal distortion of the market. The principle of system neutrality serves to safeguard this objective in the field of EU VAT.⁵¹

Throughout the years, scholars have tried to grasp this underlying theory. Whereas all capture a similar idea, they differ in wording. Van Doesum and others argue that VAT should not distort the optimal allocation of wealth.⁵² Beretta adds that the productive capacity of the economy should not be affected.⁵³ Papis completes this theory by favouring taxpayers’ behaviour based on economic merits.⁵⁴ In short, they all capture the same idea: VAT should not influence economic decision-making.

In economic theory, the solution is simple. If a tax is not to influence economic decision-making, relative prices of goods and services should remain unchanged. Therefore, taxation should be proportional to prices and tax rates should be uniform across all supplies. Whilst complete neutrality cannot be achieved in EU VAT due to national tax rate differentiation and

⁴⁸ Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (Oxford University Press 2008).

⁴⁹ Called Pareto efficiency, as long as the industry is not subject to market failure. See Francis Bator, ‘The Anatomy of Market Failure’ (1958) 72 *The Quarterly Journal of Economics* 351.

⁵⁰ Art 1 para 2 of the VAT Directive.

⁵¹ Fiscal neutrality is not specific to the EU. For an analysis of the Turkish and Australian variants, see Ali Sanver, ‘In Search of VAT Neutrality for BOTs and PPPs in Turkey’ (2012) 23 *International VAT Monitor* 258; and Gordon Brysland, ‘Fiscal neutrality: Foreign Ghost in our GST Machine?’ (2020) 18 *eJournal of Tax Research* 193.

⁵² Ad van Doesum and others, *Fundamentals of EU VAT Law* (2nd edn, Kluwer Law International 2020) 41.

⁵³ Giorgio Beretta, ‘VAT and the Sharing Economy’ (2018) 10 *World Tax Journal* 381, 396.

⁵⁴ Marta Papis, ‘The Principle of Neutrality in EU VAT’ in Cécile Brokelind (ed), *Principles of Law: Function, Status and Impact in EU Tax Law* (IBFD 2014) ch 16.2.1.

exemptions⁵⁵, the proportionality of VAT has been codified in Article 1 paragraph 2 of the VAT Directive. This constitutes the legal foundation for the principle of system neutrality.⁵⁶

As aforementioned, the primary aim of system neutrality is the proportionality of VAT with prices. In its case law, the CJEU has established four norms which should be observed to achieve a neutral VAT system. First, the length of the supply chain should be irrelevant to the tax burden. If not, this would influence economic decision-making, creating tendencies for in- or outsourcing or biases towards locally produced goods or services. Second, input VAT shall be deductible, to free businesses of the tax burden. Third, each transaction should be taxed once, preventing double (non-)taxation both in internal and cross-border situations. Finally, all forms of private consumption should be taxed, including self-supplies. The upcoming sections discuss these four norms individually.

2.4.2 Supply Chain Length

Recital 7 in the Preamble to, and Article 1 paragraph 2 of, the VAT Directive prescribe that goods and services should bear the same tax burden, irrespective of the length of the production and distribution chain. This clearly expresses the idea that taxation should not influence economic decision-making, in this case, the length of a supply chain. This norm of system neutrality is closely related to input VAT deduction, discussed in the upcoming section. It allows for the neutralisation of taxes paid at prior stages, causing the net VAT burden to be proportional to the value added.

Regarding the norm that the supply chain length should be irrelevant to the VAT burden, *Faxworld* is a textbook example.⁵⁷ It concerns the refusal of input VAT deduction for a company not performing any taxable transactions. Instead, its totality of assets was transferred under Article 19 of the VAT Directive to a company under shared ownership actually performing taxed transactions. The CJEU ruled that the principle of system neutrality entitled the transferor to input VAT deduction.⁵⁸ Lengthening the supply chain by an intermediary, solely founded for economic reasons, should not increase the VAT burden, as it would infringe the principle of system neutrality.

2.4.3 Input VAT Deduction

Recital 30 in the Preamble to the VAT Directive captures the norm of input VAT deduction to ensure system neutrality. In contrast to economic theory⁵⁹,

⁵⁵ This imperfection has been recognised in Recital 7 in the Preamble to the VAT Directive.

⁵⁶ Case C-240/05 *Eurodental* [2006] EU:C:2006:763, paras 38-39; and Case C-520/10 *Lebara* [2012] EU:C:2012:264, para 42.

⁵⁷ Case C-137/02 *Faxworld* [2004] EU:C:2004:267.

⁵⁸ *ibid* para 42.

⁵⁹ Independent of the statutory incidence, the economic incidence of unit taxes (like VAT and GST) depends on the price elasticities of the supply and demand functions. See Harvey Rosen and Ted Gayer, *Public Finance* (8th edn, McGraw-Hill 2007) 311-313.

VAT aims to tax consumers. Therefore, input VAT deduction should relieve taxable persons of the tax burden along each stage of the supply chain⁶⁰, until the final consumer is unable. Excluding taxation of taxable persons should ensure that the levying of VAT does not influence economic decision-making.⁶¹

The right of input VAT deduction has a prominent place in EU VAT law. According to the CJEU, it might even be considered a separate principle.⁶² Henkow speaks of the ‘neutrality of VAT for taxable persons’.⁶³ According to the CJEU, input VAT on investments is deductible for businesses with intentions to perform taxed transactions in the future.⁶⁴ This holds true even if the economic activity is eventually not completed for profitability reasons.⁶⁵ This analysis is extended to situations where the acquired supplies are not used for taxed transactions beyond the control of the taxable person.⁶⁶ Moreover, VAT on expenditures made after the business has stopped operating is also deductible, as long as it does not involve fraud or abuse.⁶⁷ To conclude, the norm of input VAT deduction is quite broad and ensures that businesses do not carry any tax burden during their economic lifetime.

2.4.4 Double (Non-)Taxation

The prevention of double (non-)taxation is a norm not limited to VAT⁶⁸, but taxation in general⁶⁹. In direct taxes, most jurisdictions conclude treaties to ensure that income and capital are taxed once.⁷⁰ However, such agreements do not exist in the field of indirect taxation.⁷¹ This leaves room for double (non-)taxation, both within and across VAT or GST systems.⁷² In an intra-EU

⁶⁰ Case C-25/03 *HE* [2005] EU:C:2005:241, para 70; Case C-536/03 *António Jorge* [2005] EU:C:2005:323, para 21; and Case C-515/07 *Vereniging Noordelijke Land- en Tuinbouw Organisatie* [2009] EU:C:2009:88, para 27.

⁶¹ Also recognised by the OECD, *International VAT/GST Guidelines* (OECD Publishing 2017) 27-28.

⁶² Case C-228/05 *Stradasfalti* [2006] EU:C:2006:578, paras 56-58; Case C-25/07 *Sosnowska* [2008] EU:C:2008:395, para 23; and Case C-395/09 *Oasis East* [2010] EU:C:2010:570, paras 19, 24.

⁶³ Oskar Henkow, ‘Neutrality of VAT for Taxable Persons: A New Approach in European VAT?’ (2008) 17 *EC Tax Review* 233.

⁶⁴ Case 268/83 *Rompelman v Minister van Financiën* [1985] EU:C:1985:74, para 23.

⁶⁵ Case C-110/94 *Inzo v Belgische Staat* [1996] EU:C:1996:67, para 22.

⁶⁶ Case C-37/95 *Belgische Staat v Ghent Coal Terminal* [1998] EU:C:1998:1, para 20.

⁶⁷ Case C-32/03 *Fini H* [2005] EU:C:2005:128, paras 30-31.

⁶⁸ Case 168/84 *Berkholz v Finanzamt Hamburg-Mitte-Altstadt* [1985] EU:C:1985:299, para 14; Case C-327/94 *Dudda v Finanzamt Bergisch Gladbach* [1996] EU:C:1996:355, para 20; and Case C-218/10 *ADV Allround* [2012] EU:C:2012:35, para 27.

⁶⁹ Case C-6/16 *Eqiom and Enka* [2017] EU:C:2017:641, para 36.

⁷⁰ Based on OECD, *Model Tax Convention on Income and on Capital: Condensed Version* (2017 edn, OECD Publishing 2017); and UN, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (2021 edn, UN Publishing 2021).

⁷¹ For possible remedies against double (non-)taxation in VAT and GST, see Thomas Ecker, *A VAT/GST Model Convention* (IBFD 2013).

⁷² As acknowledged in OECD, *International VAT/GST Guidelines* (OECD Publishing 2017) 3.

context, this risk has materialised even though the place of supply rules are supposedly harmonised.

In this regard, the case *KrakVet Marek Batko* is relevant.⁷³ It takes place under the former intra-EU distance sales regime, where two Member States claimed the place of supply, due to different interpretations of the VAT Directive. The question arose whether the principle of economic (and external) neutrality prohibits tax authorities from taxing the supply, since this had already been done in another Member State. The Court answered negatively. The CJEU noted that the risk of double taxation could be avoided by correct interpretation of the VAT Directive's provisions, acknowledging the principle of system neutrality.⁷⁴ However, this case is just the tip of the iceberg, and there might be more cases under the threat of double (non-)taxation.⁷⁵

Nonetheless, AG Kokott has recently suggested a solution to this problem in *DuoDecad*⁷⁶, a case building upon the apparently unsolved *WebMindLicenses*⁷⁷. Notably, she discusses three remedies against double taxation, of which the third is quite remarkable. AG Kokott takes the sensitive view that, on an exceptional basis, the CJEU might assess the facts if the Member States cannot agree upon a uniform interpretation, which until now, has always been the duty of the national courts.⁷⁸ Nonetheless, this should only serve as an ultimate remedy to prevent double (non-)taxation, if other possibilities to exchange information between the tax authorities have been exhausted beforehand. It will be interesting to see whether the CJEU upholds this view in its judgment, as it would definitely enhance the norm of double non-taxation.

2.4.5 Self-Supplies

The final norm of system neutrality relates to the fact that VAT serves as a general tax on all private consumption. Whereas supplies made to taxable persons give rise to deduction, non-taxable persons are burdened with the tax. However, private consumption remains untaxed if goods or services are used for non-business purposes or are supplied free of charge. Therefore, these so-called 'self-supplies' are deemed to be taxable transactions according to Articles 16 and 26 of the VAT Directive.

The CJEU has covered this topic quite extensively in its case law. On numerous occasions, the Court ruled that taxation of self-supplies ensures equal treatment between ordinary consumers and taxable persons using

⁷³ Case C-276/18 *KrakVet Marek Batko* [2020] EU:C:2020:485.

⁷⁴ *ibid* paras 50-53.

⁷⁵ For non-taxation, see Case C-277/09 *RBS Deutschland Holding* [2010] EU:C:2010:810, paras 40-42. The CJEU explicitly accepted the possibility of non-taxation, despite harmonisation of EU VAT, 'in so far as differences in the laws and regulations of the Member States continue to exist in this area'.

⁷⁶ Case C-596/20 *DuoDecad* [2022] EU:C:2022:91, Opinion of AG Kokott, paras 66-80.

⁷⁷ Case C-419/14 *WebMindLicenses* [2015] EU:C:2015:832.

⁷⁸ Case 104/79 *Foglia v Novello* [1980] EU:C:1980:73, paras 12-13. According to AG Kokott, the CJEU already made de facto assessment of the facts in Case C-185/01 *Auto Lease Holland* [2003] EU:C:2003:73.

business assets for private use.⁷⁹ This wording comes close to the principle of legal neutrality, reflecting equal treatment in matters relating to VAT. Nonetheless, as differences in the level of taxation would significantly influence economic decision-making, this research covers this norm under the principle of system neutrality.

A delicate aspect of self-supplies relates to the input VAT deduction on goods used for both business and private purposes. Whilst, on the one hand, non-deductibility would burden taxable persons, on the other hand, a full right of deduction would influence economic decision-making, that is towards private consumption of assets bought as a taxable person. Whereas these two norms usually go hand-in-hand, they contradict each other in the field of mixed-use assets. This causes confusion, in conflict with the principle of legal certainty. Luckily, many cases have provided more clarity, developing the Lennartz principle.⁸⁰ Nonetheless, as the asset labelling doctrine is not subject to this study, it is not discussed in further detail.⁸¹

⁷⁹ Case C-20/91 *De Jong v Staatssecretaris van Financiën* [1992] EU:C:1992:192, para 15; Case C-230/94 *Enkler v Finanzamt Homburg* [1996] EU:C:1996:352, para 33; and Case C-412/03 *Hotel Scandic Gåsabäck* [2005] EU:C:2005:47, para 23.

⁸⁰ Case C-97/90 *Lennartz v Finanzamt München III* [1991] EU:C:1991:315.

⁸¹ For an extensive analysis, see Ad van Doesum and others, *Fundamentals of EU VAT Law* (2nd edn, Kluwer Law International 2020) 456-463.

3 Economic Reality

3.1 Background

The notion of economic reality is a mysterious yet familiar concept in EU VAT. Whereas frequently used by the CJEU, it has never clearly defined the term. This leaves taxpayers with legal uncertainty, especially given the fact that the Court's and AGs' reference to economic reality has increased over the past decades.⁸² Besides unclarity regarding the notion's ultimate meaning, its textual wording creates confusion. The CJEU has interchangeably used words like economic reality⁸³, commercial reality⁸⁴, economic and commercial reality⁸⁵, actual economic situation⁸⁶, real economic situation⁸⁷ and economic approach⁸⁸. The question arises whether these terms entail similar ideas, or whether subtle differences might be identified.⁸⁹

Exploring the origins of economic reality might shed more light on the concept. However, whereas fiscal neutrality is extensively covered in the VAT Directive, economic reality and its synonyms are not even referred to once. Like its definition, neither the Court nor the AGs mention the origins of the notion. Consequently, it is impossible to identify whether and where the concept has its legal basis.

Nonetheless, academics have been speculating about the origin of economic reality. Three theories have emerged.⁹⁰ First, economic reality might join in the harmonisation process, since it does not rely on any unharmonised national civil law definitions in the Member States. However, this objective has already been achieved by the autonomy of uniform concepts in EU law. Second, economic reality might preserve legal neutrality. If supplies are similar in substance, yet differ in form or legal classification, interpretation of the facts in line with economic reality allows for similar tax treatments. This ensures legal neutrality, which reflects the principle of equal treatment in matters relating to VAT.⁹¹ Last but not least, Van Doesum and Nellen suggest that economic reality is based on the nature of VAT as a transaction tax. Its treatment should be based on a supply's substance, rather than its

⁸² See app A for a numerical analysis.

⁸³ Case C-277/09 *RBS Deutschland Holding* [2010] EU:C:2010:810, para 51; and Case C-419/14 *WebMindLicenses* [2015] EU:C:2015:832, para 35.

⁸⁴ Case C-581/08 *EMI Group* [2010] EU:C:2010:559, para 22; and Joined Cases C-318/11 and C-319/11 *Daimler and Widex* [2012] EU:C:2012:666, para 49.

⁸⁵ Case C-653/11 *Newey* [2013] EU:C:2013:409, paras 43-45, 52; and Case C-544/16 *Marcandi* [2018] EU:C:2018:540, para 45.

⁸⁶ Case C-260/95 *Commissioners of Customs and Excise v DFDS* [1997] EU:C:1997:77, para 23.

⁸⁷ Case 42/83 *Dansk Denkavit* [1984] EU:C:1984:254, para 3.4.3.

⁸⁸ Case C-295/17 *MEO - Serviços de Comunicações e Multimédia* [2018] EU:C:2018:942, para 61; and Case C-43/19 *Vodafone Portugal* [2020] EU:C:2020:465, para 49.

⁸⁹ See section 3.4 for the differences in terminology.

⁹⁰ See Ad van Doesum and Frank Nellen, 'Economic Reality in EU VAT' (2020) 29 *EC Tax Review* 213, 214-215. The first and second theories have originally been developed by Albert Bomer, *Unierechtelijke beginselen en BTW* (Wolters Kluwer 2013) 25.

⁹¹ Case C-502/13 *Commission v Luxembourg* [2015] EU:C:2015:143, para 50; Case C-566/17 *Związek Gmin Zagłębia Miedziowego* [2019] EU:C:2019:390, para 36; and Case C-51/18 *Commission v Austria* [2018] EU:C:2018:1035, para 55.

form. Economic reality disregards any contractual provisions contradicting the facts and circumstances. These two latter theories might very well present a suitable legal foundation for the concept.

3.2 Economic Reality: A Fundamental EU VAT Principle

As identified in the last section, the origin of economic reality is unknown. This includes its legal status. Whereas fiscal neutrality is unanimously recognised among academics as a fundamental principle of EU VAT law, economic reality enjoys less attention. It cannot be placed on equal footing. Therefore, the question might be raised about how the concept should be classified; is it a fundamental principle underlying the common system of VAT?

The answer to this question is not so straightforward. Unfortunately, no official checklist identifies the conditions under which a concept becomes a principle of EU VAT law. According to Brokelind, principles and rules should be distinguished based on their decisiveness.⁹² Whereas principles are directional, rules are decisive. The CJEU classifies economic reality as a fundamental criterion for the application of the common system of VAT.⁹³ However, whereas the Court speaks of the principle that VAT is a consumption tax designed to be borne only by the final consumer⁹⁴, the principle of the right to deduct VAT⁹⁵, the principle of strict interpretation of exemptions⁹⁶ and the principle of fiscal neutrality⁹⁷, it refers to just a ‘consideration’ of the economic (and commercial) reality⁹⁸. According to Dworkin, classification as either a principle or rule should be left to academics.⁹⁹ In this regard, De Wilde does not explicitly call it the ‘principle’ of economic reality either.¹⁰⁰ However, more recently, Van Doesum and Nellen refer to it as a ‘fundamental principle in EU VAT’.¹⁰¹

Whether or not to call economic reality a fundamental principle should not depend on its decisiveness, branding by the CJEU, AG or highly respected academics. Its status should be deduced from the importance the concept has

⁹² Cécile Brokelind, ‘Introduction’ in Cécile Brokelind (ed), *Principles of Law: Function, Status and Impact in EU Tax Law* (IBFD 2014) ch 1.2.

⁹³ Case C-73/06 *Planzler Luxembourg* [2007] EU:C:2007:397, para 43; and Case C-71/18 *KPC Herning* [2019] EU:C:2019:660, para 21. For economic and commercial reality, see Case C-653/11 *Newey* [2013] EU:C:2013:409, para 42; Case C-295/17 *MEO - Serviços de Comunicações e Multimédia* [2018] EU:C:2018:942, para 43; and Case C-333/20 *Berlin Chemie A. Menarini* [2022] EU:C:2022:291, para 38.

⁹⁴ Case C-291/03 *MyTravel* [2005] EU:C:2005:591, para 30.

⁹⁵ Case C-74/08 *PARAT Automotive Cabrio* [2009] EU:C:2009:261, para 34.

⁹⁶ Case C-40/15 *Aspiro* [2016] EU:C:2016:172, para 31.

⁹⁷ Case C-581/19 *Frenetikexito* [2021] EU:C:2021:167, para 22.

⁹⁸ Case C-71/18 *KPC Herning* [2019] EU:C:2019:660, para 21; and Case C-276/18 *KrakVet Marek Batko* [2020] EU:C:2020:485, para 61.

⁹⁹ Ronald Dworkin, *Taking Rights Seriously* (Harvard University Press 1978) 29.

¹⁰⁰ Lex Neijtzell de Wilde, ‘Difficulties in Determination of VAT Treatment of Various Categories of Financing Solved by “Economic Reality”?’ (2021) 32 *International VAT Monitor* 30.

¹⁰¹ Ad van Doesum and Frank Nellen, ‘Economic Reality in EU VAT’ (2020) 29 *EC Tax Review* 213, 223.

in the field of VAT. Whereas economic reality has not been applied as frequently in the past, it appears to have gained importance over the past decades, as illustrated in Appendix A. Consequently, this study adopts Van Doesum's and Nellen's view. Therefore, whilst refraining from using the term before, from hereon, this research refers to the 'principle' of economic reality.

3.3 Functions of Economic Reality

As aforementioned, the principle of economic reality has made a long journey to arrive at the status it enjoys today. So have its functions. Although the principle's meaning and implications are not yet fully known, academic literature has progressed throughout the years. Van Doesum and Nellen characterise economic reality 'as a judicial perception of an existing state of affairs that defines the economic relations between two or more parties'.¹⁰² In this regard, two distinct functions of economic reality have been identified in the field of EU VAT.¹⁰³

First, it serves as a benchmark of normality to establish whether there is abuse of law. This doctrine requires two conditions to be met.¹⁰⁴ First, despite the formal application of national and EU VAT law, the transactions should result in the accrual of a tax advantage contrary to its purpose. Second, it requires the conclusion from objective factors that the transaction's essential aim is to obtain this tax advantage. Section 3.3.1 discusses the role of economic reality in establishing abusive practices based on the CJEU's case law.

Second, a function of the principle of economic reality is that as a benchmark of VAT reality to purposefully apply domestic and EU legislation.¹⁰⁵ In that regard, it serves as a tool for selection and interpretation of the facts. Whilst fiscal neutrality interprets the VAT Directive, economic reality focuses on the circumstances on which the tax treatment is based. Section 3.3.2 concentrates on this function and discusses several cases where the principle of economic reality fulfils this role.

3.3.1 Benchmark of Normality in Abuse of Law

The prohibition of abuse of law is not unique to EU VAT. Actually, it is not even limited to taxation. The first CJEU case relating to abusive practices was *Van Binsbergen*, concerning unemployment benefits.¹⁰⁶ After the turn of the millennium, the abuse of law doctrine was extended to the field of indirect taxation in *Emsland-Stärke*. Here, the Court developed its two-step approach

¹⁰² *ibid* 214.

¹⁰³ *ibid*. See also Ad van Doesum, 'Capital Contributions: VAT Neutrality, Economic Reality and Legal Certainty' in *EU Value Added Tax and Beyond – Essays in honour of Ben Terra* (IBFD 2022 forthcoming) para 3.

¹⁰⁴ Joep Swinkels, 'Abuse of EU VAT Law' (2011) 22 *International VAT Monitor* 223, 224.

¹⁰⁵ Ad van Doesum and Frank Nellen, 'Economic Reality in EU VAT' (2020) 29 *EC Tax Review* 213, 217.

¹⁰⁶ Case 33/74 *Van Binsbergen v Bedrijfsvereniging voor de Metaalnijverheid* [1974] EU:C:1974:131, para 13.

for establishing abusive practices.¹⁰⁷ First, as an objective criterion, despite the formal conditions being met, the purpose of the rules should not be achieved. Second, it requires a subjective criterion, consisting of the taxpayer's intention to obtain an advantage by artificially fulfilling the formal conditions. In *Halifax*, the Court reproduced the same two conditions in the field of VAT, specifying that the second criterion requires the obtention of a tax advantage to be the 'essential' aim of the transactions.¹⁰⁸ In *Part Service*, the CJEU speaks of the 'principal' aim.¹⁰⁹

In the CJEU's case law, economic reality plays a minor role in assessing the first objective criterion. In *Weald Leasing*, the Court ruled that if rentals are set unusually low, this might defeat the purpose of VAT legislation.¹¹⁰ Instead of purchasing an asset itself, a taxable person leased it from an associated company acquiring the good with the sole purpose of the subsequent lease. Whereas the former situation would not entitle the taxpayer to deduct the input VAT charged upon acquisition due to exempt output transactions, the latter gave rise to full deduction to the lessor. Although the VAT on the subsequent lease terms was still non-deductible for the lessee, the tax burden was postponed. Moreover, its future pro-rata deduction might increase, generating a higher VAT recovery rate.¹¹¹ Nonetheless, the Court ruled that indirect leasing instead of purchasing directly does not satisfy the objective condition of abuse of law, as long as the rentals are not set usually low contradicting economic reality. Hence, the principle was used to evaluate whether the VAT treatment would defeat the purpose of the VAT Directive.

Whereas economic reality has been applied only once regarding the first criterion of abusive practices, it is engaged more often in the subjective condition. As ruled on numerous occasions, transactions not reflecting the economic reality constitute wholly artificial arrangements, which might indicate that their sole aim is to obtain a tax advantage.¹¹² In this capacity, infringement of the principle of economic reality serves as proof of the subjective condition for abuse of law.

In this regard, *Newey* is a textbook example.¹¹³ It concerned the place of supply of advertisement services received, and exempt loan broking services performed, by Paul Newey living in the UK. Despite still making all economic decisions himself, he founded a company in Jersey, outside the scope of the EU VAT Directive, legally replacing him in the transactions mentioned above. According to the CJEU, the contractual provisions are in principle leading, unless it concerns a purely artificial arrangement not corresponding with the economic reality of the transactions.¹¹⁴ If ascertained by the referring court, this would qualify as abuse of law, which requires re-

¹⁰⁷ Case C-110/99 *Emsland-Stärke* [2000] EU:C:2000:695, paras 52-53.

¹⁰⁸ Case C-255/02 *Halifax and Others* [2006] EU:C:2006:121, paras 74-75.

¹⁰⁹ Case C-425/06 *Part Service* [2008] EU:C:2008:108, paras 40, 45, 58, 62.

¹¹⁰ Case C-103/09 *Weald Leasing* [2010] EU:C:2010:804, para 39.

¹¹¹ In accordance with arts 173-175 of the VAT Directive.

¹¹² Case C-162/07 *Ampliscentifica and Amplifin* [2008] EU:C:2008:301, para 28; Case C-326/11 *J.J. Komen en Zonen Beheer Heerhugowaard* [2012] EU:C:2012:461, para 35; and Case C-4/20 *ALTI* [2021] EU:C:2021:397, para 35.

¹¹³ Case C-653/11 *Newey* [2013] EU:C:2013:409.

¹¹⁴ *ibid* paras 42-45.

establishing the situation that would have prevailed in the absence of the transactions constituting that abusive practice. This would identify Paul Newey as supplier and recipient.¹¹⁵ Besides this case¹¹⁶, a significant number of other CJEU rulings identify the tax advantage as an essential aim by means of ‘economic normality’.¹¹⁷

3.3.2 Benchmark of VAT Reality

Besides as a benchmark of normality in abusive practices, economic reality acts as a selection and interpretation tool of facts and circumstances to ensure the purposeful application of VAT legislation. Van Doesum and Nellen refer to this as ‘fiscal’ or ‘VAT reality’.¹¹⁸ This process consists of two steps. First, the Court picks several facts and circumstances relevant for its analysis. Second, these are interpreted and classified in such a way as to secure purposeful application of VAT law. In the upcoming paragraphs, this two-step approach is dissected. Subsequently, three CJEU cases are discussed, each identifying a different level of economic reality that should be reflected in the VAT treatment.

First, the CJEU selects the facts and circumstances it deems crucial for the purposeful application of VAT legislation. This goes beyond the general description of the disputes in the main proceedings, provided at the start of its rulings. Second, the Court interprets the selected facts and circumstances in such a way as to ensure the purposeful application of VAT law. This often involves disregarding the contractually agreed provisions concerning the supply chain direction¹¹⁹, a taxable transaction’s consideration¹²⁰ or its classification as composite supply¹²¹. This method of favouring this economic reality over the contractual clauses can also be found in the European Commission’s explanatory notes, especially regarding the application of the deemed-supplier fictions for electronic and e-commerce platforms.¹²²

¹¹⁵ *ibid* paras 50-52.

¹¹⁶ In *Newey*, there is considerable doubt whether disregarding the contractual provisions was based on abuse of law or on economic reality as benchmark of VAT reality, as discussed in the upcoming section. See Case C-5/17 *DPAS* [2018] EU:C:2018:592, Opinion of AG Saugmandsgaard Øe, para 70 where he mentions that the application of VAT must be based on economic reality and refers to *Newey*, without mentioning abuse of law.

¹¹⁷ Case C-251/16 *Cussens and Others* [2017] EU:C:2017:881, paras 60-63; Case C-419/14 *WebMindLicenses* [2015] EU:C:2015:832, para 35; and Case C-504/10 *Tanoarch* [2011] EU:C:2011:707, para 51.

¹¹⁸ Ad van Doesum and Frank Nellen, ‘Economic Reality in EU VAT’ (2020) 29 *EC Tax Review* 213, 217-218. For reasons of clarity and consistency, from hereon this research refers to economic reality as benchmark of ‘VAT reality’.

¹¹⁹ Joined Cases C-53/09 and C-55/09 *Loyalty Management UK and Baxi Group* [2010] EU:C:2010:590, paras 38-42.

¹²⁰ Case C-295/17 *MEO - Serviços de Comunicações e Multimédia* [2018] EU:C:2018:942, paras 43-44; Case C-242/18 *UniCredit Leasing* [2019] EU:C:2019:558, paras 73-76; and Case C-43/19 *Vodafone Portugal* [2020] EU:C:2020:465, paras 40-49.

¹²¹ Case C-607/14 *Bookit* [2016] EU:C:2016:355, para 27.

¹²² Commission, ‘Explanatory notes on the EU VAT changes to the place of supply of telecommunications, broadcasting and electronic services that enter into force in 2015’ (Guidelines) (2014) 27-28, 32; and Commission, ‘Explanatory Notes on VAT e-commerce rules’ (Guidelines) (2020) 18.

The benchmark of VAT reality as function of the principle of economic reality can be identified in the *A* case.¹²³ This company entered into a contract to demolish a building and sell the scrap metal. The estimated sales revenues reduced the service fee to be received for the demolition services. The taxable person and the Finnish tax authorities disagreed about the VAT treatment of these activities. The national supreme court referred two questions to the CJEU, in essence asking whether the obtained scrap metal should be regarded as separate supplies of goods, and to what extent the value incorporated into the price of the demolition services is important.

According to the CJEU, this situation concerns a barter transaction. Consequently, it identifies two separate transactions, being a demolition service and a supply of scrap metal. The taxable amount of this latter is the internal valuation of the scrap metal. For the demolition services, the tax base includes both the monetary value paid and the estimated resale of the goods received. Finally, the Court concludes that the economic reality should be observed and reflected in the discount calculation.¹²⁴ Hence, the contractual provisions should adhere to the principle of economic reality.

Whereas in the previous preliminary ruling a contract was evaluated, in *T-2* a judicial decision *res judicata* was under review.¹²⁵ Under supervision of a Slovenian regional court, a company (*T-2*) came to an agreement with its creditors, permitting it to pay only 44% of its debts. Since the decision acquired the force of *res judicata*, it had been closed for further litigation. In prior years, *T-2* had fully deducted VAT on its purchases. Hence, the Slovenian tax authorities held that this input tax deduction should be corrected, under the national transposition of Articles 184 and 185 of the VAT Directive. This is supported by the fact that the suppliers are allowed to reduce the taxable amount of the underlying supplies based on Article 90 of the VAT Directive.

The referring court asks three questions to the CJEU. Concerning the principle of economic reality, the second question is particularly interesting. In essence, the referring court asks whether Article 185 paragraph 2 of the VAT Directive must be interpreted as meaning that the situation mentioned above does not give rise to an adjustment of the initial deduction. After contextual interpretation, involving Article 90 of the VAT Directive, the Court arrives at the interpretation of the facts. Whether or not the underlying transaction is covered under the exception in Article 185 paragraph 2 of the VAT Directive, depends on the finality of the price reduction. If the obligations of the debtor have been reduced, the derogation cannot be applied.¹²⁶ Concerning the economic reality of the judicial arrangement, the CJEU rules that ‘from an economic point of view, that decision leads to a reduction of the debtor’s obligations vis-à-vis its creditors, and not just to a default’.¹²⁷ This case highlights that, whereas the underlying provision has to be understood along the lines of contextual interpretation, economic reality serves as a tool to purposefully interpret the facts, in this case to find

¹²³ Case C-410/17 *A* [2019] EU:C:2019:12.

¹²⁴ *ibid* paras 48 and 60.

¹²⁵ Case C-396/16 *T - 2* [2018] EU:C:2018:109.

¹²⁶ *ibid* para 42.

¹²⁷ *ibid* para 44.

consistency between the taxable amount (Article 90 of the VAT Directive) and input VAT deduction (Article 195 paragraph 2). This principle is not limited to bilateral contracts but includes court decisions *res judicata*.

Nonetheless, the economic reality goes yet a step further. Whilst in the last two cases, it serves as interpretation of the facts, in *Budimex*¹²⁸, it includes socially accepted practices in specific sectors as well. A supplier of installation works and the Polish tax authorities were in disagreement regarding the moment at which VAT becomes chargeable. Whereas Article 63 of the VAT Directive identifies the time when the goods or services are supplied, Article 66 sub c allows for a derogation, implemented by Poland. Consequently, VAT is to become chargeable where an invoice is not issued, or issued late, within a specified time no later than on expiry of the time limit for issuance of invoices. In Poland, this was 30 days following the actual performance of the work. To interpret and apply this rule, the referring court asks when construction and installation works are deemed to be performed.

In *Budimex*, this was not so clear cut. Its contractual provisions of the underlying supply included that the client who ordered the work must accept it in a formal record of acceptance. According to the supplier, this should serve as the start of the 30 days for the chargeability of VAT, regardless of when the final installation and construction activities are performed. According to the Court, the field in which the service is supplied is important when characterising the economic reality.¹²⁹ Consequently, the CJEU extends the application of the principle of economic reality as an interpretive tool to realise purposeful application beyond the mere facts of the case, by including socially accepted practices in specific sectors.

3.4 Terminology

Although, for reasons of simplicity, this research primarily refers to economic reality, the principle has developed multiple appearances throughout the decades. This alternating terminology has caused confusion among academics, since it is unsure whether all concepts capture one single theory. Consequently, it is important to establish whether all terms entail similar notions, or if there might be subtle differences in their applications. Identifying discrepancies would enhance legal certainty.

The first instance in which ‘economic reality’ has been mentioned does not concern a CJEU judgment, but an AG opinion. In *Hong-Kong Trade*, AG Van Themaat refers to the term to highlight the broad spectrum between services for payment and for free, which should not matter for the classification as a taxable person.¹³⁰ It is not used in line with the modern application of economic reality, as a benchmark in abuse of law or interpretation of the facts. In contrast, the AG applies the concept to justify the haziness in the taxable person notion in the VAT Directive, allowing for flexibility.

¹²⁸ Case C-224/18 *Budimex* [2019] EU:C:2019:347.

¹²⁹ *ibid* para 29.

¹³⁰ Case 89/81 *Hong-Kong Trade* [1982] EU:C:1982:73, Opinion of AG Van Themaat, para 3.6.

Prior to the CJEU's first reference to economic reality, it mentions the 'real economic situation' in *Dansk Denkavit*.¹³¹ It was the first and final time the Court used the term. Here, the CJEU applied the real economic situation to justify a comparison between the VAT payment period for internal transactions and the credit term for imports, to fight a claim of discrimination made by the applicant. Hence, similar to the first reference by the AG, the Court did not employ the modern functions of economic reality and its synonyms. Rather, the real economic situation seems to have been used as justification for the Court's comparability analysis.

However, this differs in the subsequent application by the AGs. In *Intiem*, AG Da Cruz Vilaça considered that the fact that petrol is pumped directly into the tank of an employee's car does not reflect the economic reality of the transaction, identifying the employer as recipient of the supply, entitling it to input VAT deduction.¹³² Subsequently, AG Jacobs concluded that classifying total coin inserts (without deducting pay-out) as the taxable amount for gambling machines would be inconsistent with the 'commercial reality' of the transaction.¹³³ In both cases, the AGs clearly interpret the facts through 'economic and commercial binoculars' to reach a purposeful VAT application, similar to two later cases dealing with the commercial reality of vouchers and coupons.¹³⁴ To conclude, both economic and commercial reality appear to have evolved in conjunction from an early stage and seem to entail a similar theory.¹³⁵ Moreover, it is remarkable that the terms initially have not been developed by the CJEU, but rather by the AGs.

Nonetheless, the notion seems to have reached the Court during the second half of the nineties in *ARO Lease*¹³⁶ and *DFDS*¹³⁷. Nonetheless, again it appears that the AGs have stimulated reference to the principle.¹³⁸ In *ARO Lease*, it concerned the place of supply of car leases. Whereas the lessor was formally established in the Netherlands, it had a fleet in Belgium rented out to Belgian lessees. Although both the Court and AG acknowledged the arguments by the Commission, France, Belgium and Denmark that, in line

¹³¹ Case 42/83 *Dansk Denkavit* [1984] EU:C:1984:254, para 3.4.3. In the Dutch version, the term *economische realiteit* is used, literally translating to 'economic reality'.

¹³² Case 165/86 *Intiem v Staatssecretaris van Financiën* [1988] EU:C:1988:122, Opinion of AG Da Cruz Vilaça, para 23.

¹³³ Case C-38/93 *Glawe v Finanzamt Hamburg-Barmbek-Uhlenhorst* [1994] EU:C:1994:188, Opinion of AG Jacobs, para 18.

¹³⁴ Case C-288/94 *Argos Distributors v Commissioners of Customs & Excise* [1996] EU:C:1996:253, Opinion of AG Fennelly, para 9; and Case C-317/94 *Elida Gibbs v Commissioners of Customs and Excise* [1996] EU:C:1996:255, para 21.

¹³⁵ This can also be identified by the fact that neither the CJEU nor AGs have referred to 'commercial reality' since Case C-251/16 *Cussens and Others* [2017] EU:C:2017:881, paras 19, 20, 61; and Case C-303/16 *Solar Electric Martinique* [2017] EU:C:2017:507, Opinion of AG Mengozzi, para 64 respectively. An emerging trend is reference to the 'economic and commercial realities', for the first time in Case C-452/03 *RAL (Channel Islands) and Others* [2005] EU:C:2005:65, para 44.

¹³⁶ Case C-190/95 *ARO Lease v Inspecteur der Belastingdienst Grote Ondernemingen te Amsterdam* [1997] EU:C:1997:374, paras 23-26.

¹³⁷ Case C-260/95 *Commissioners of Customs and Excise v DFDS* [1997] EU:C:1997:77, para 23.

¹³⁸ Case C-190/95 *ARO Lease v Inspecteur der Belastingdienst Grote Ondernemingen te Amsterdam* [1997] EU:C:1996:494, paras 17, 19, 25; and Case C-260/95 *Commissioners of Customs and Excise v DFDS* [1997] EU:C:1997:20, Opinion of AG La Pergola, paras 32, 35.

with the principle's modern application ensuring VAT reality, economic reality should be taken into account when determining the place of establishment or whether a fixed establishment exists, the clear, simple and practical criterion in VAT legislation was decisive for the CJEU.¹³⁹

This differs from *DFDS*. It concerned the place of supplies by a travel agency established in Denmark. However, it had a subsidiary in the UK. The question arose whether the subsidiary could be a supplying fixed establishment, even though it was a separate legal entity. The AG¹⁴⁰ refers to the actual economic situation as a justification ground for the alternative place of supply rule based on the notion of fixed establishment, which the CJEU¹⁴¹ confirms. Hence, the actual economic situation was used to justify EU VAT legislation.

This approach in *DFDS* conflicting with modern application shows similarities with *Dansk Denkavit*.¹⁴² Here, a divergence in terminology and application might be observed. Whilst in *Dansk Denkavit*, the term was used to justify their comparison in a discrimination analysis, in *DFDS* it served as justification for the notion of fixed establishment in the place of supply rule. In these cases, the Court uses the 'real' and 'actual economic situation' as a justification ground, similar to the first AG reference of 'economic reality' in *Hong-Kong Trade*¹⁴³. This differs from the modern functions of economic reality and its synonyms illustrated under section 3.3. This might explain why the terms 'real' and 'actual economic situation' have fallen out of favour and have not been used in by the Court in the subsequent 25 years. Therefore, these two terms are no longer covered in the remainder of this research.

After separating the real or actual economic situation from economic and commercial reality, only one associated term has not yet been covered: taking an economic approach. Whereas the real and actual economic situation have been developed in the early stages, the CJEU has referred to the economic approach relatively recently. However, the terms share one similarity, in that their frequency is quite low compared to the economic and commercial reality. The economic approach has been referred to in only two cases, *MEO*¹⁴⁴ and *Vodafone Portugal*¹⁴⁵.

Both judgments are quite similar. They relate to major telecommunication providers in Portugal. The contracts with their customers include a penalty clause in case of early termination. However, the cases differ in the calculation method of this value. Whereas in *MEO*, this concerned the full value of the remainder of the payment terms, in *Vodafone Portugal*, a unique formula was applied. The question arose whether these penalties constitute

¹³⁹ Case C-190/95 *ARO Lease v Inspecteur der Belastingdienst Grote Ondernemingen te Amsterdam* [1997] EU:C:1997:374, paras 23-26.

¹⁴⁰ Case C-260/95 *Commissioners of Customs and Excise v DFDS* [1997] EU:C:1997:20, Opinion of AG La Pergola, para 32.

¹⁴¹ Case C-260/95 *Commissioners of Customs and Excise v DFDS* [1997] EU:C:1997:20, para 23.

¹⁴² Case 42/83 *Dansk Denkavit* [1984] EU:C:1984:254, para 3.4.3.

¹⁴³ Case 89/81 *Hong-Kong Trade* [1982] EU:C:1982:73 Opinion of AG Van Themaat, para 3.6.

¹⁴⁴ Case C-295/17 *MEO - Serviços de Comunicações e Multimédia* [2018] EU:C:2018:942, para 61.

¹⁴⁵ Case C-43/19 *Vodafone Portugal* [2020] EU:C:2020:465, para 49.

consideration for the supply of services. The Court answered positively in both cases, making the penalty subject to VAT.

In *MEO*, the CJEU refers to economic reality on multiple occasions.¹⁴⁶ It uses the principle in the modern function of VAT reality by not putting value on the contractual classification as termination penalty and the moment of chargeability. When dealing with the second preliminary question, whether the payment aims to discourage early termination and damage compensation, the CJEU includes the term ‘economic approach’ when disregarding the goal of discouragement as relevant for VAT, referring to the AG opinion.¹⁴⁷ Here, AG Kokott uses the similar value between the cumulative contractual payments and lump-sum to mark the latter as consideration.¹⁴⁸ Hence, in this case, the economic approach seems to serve as some sort of specialisation of economic and commercial reality, ruling that the similar value of different payment methods seems to allow the Court to ignore the different aims of the payment (whether or not as discouragement).

However, this conclusion would contrast with the Court’s judgement in *Vodafone Portugal*, where the cumulative contractual payments and lump-sum penalty differed in value. Nonetheless, the CJEU used the same term of ‘economic approach’.¹⁴⁹ So which similarity between the two cases could then explain the fact that the same term was used? Perhaps, the fact that the values were predetermined, although differing between both cases, might bridge this gap. So, to conclude, the economic approach seems to serve as a specialisation of economic and commercial reality, applied in the specific case of predetermined cancellation fees, ignoring the contractual aim as discouragement. In this regard, it might be considered as a sort of *lex specialis* of the principle of economic reality.

Nonetheless, another, rather simplistic, explanation for the sudden emergence of the economic approach might be of linguistic nature. As aforementioned, the only two cases referring to this term originate from Portugal. Consequently, the judgments’ original language is Portuguese. Quite coincidentally, *MEO* and *Vodafone Portugal* are not just the only two Portuguese judgments dealing with the economic approach, but with all supposed synonyms. Although two AGs have provided their opinions in Portuguese cases covering economic reality, these were delivered in their native tongue.¹⁵⁰ Since the Court has not followed the AG opinions in these cases, economic and/or commercial reality has never been translated from Portuguese to English before. Moreover, in Kokott’s German opinion on *MEO*, the ‘economic approach’ was not mentioned either, only the ‘economic reality’. This coincidence leaves this research to the fruitless hypothesis that the economic approach does not deviate from the economic and commercial reality, but results from a translation from Portuguese to English. The fact that

¹⁴⁶ *ibid* paras 43, 44, 51, 61, 62.

¹⁴⁷ *ibid* para 61.

¹⁴⁸ Case C-295/17 *MEO - Serviços de Comunicações e Multimédia* [2018] EU:C:2018:413, Opinion of AG Kokott, para 46.

¹⁴⁹ Case C-43/19 *Vodafone Portugal* [2020] EU:C:2020:465, para 49.

¹⁵⁰ Case C-174/14 *Saudaçor* [2015] EU:C:2015:430, Opinion of AG Jääskinen, para 55; and Case C-692/17 *Paulo Nascimento Consulting* [2019] EU:C:2019:362, Opinion of AG Saugmandsgaard Øe, paras 32-33.

the Portuguese judgments in *MEO* and *Vodafone Portugal* contain two different terms¹⁵¹ for the ‘economic approach’, makes this conclusion even more plausible. Future case law originating from Portugal should provide a confirmation or rejection of this hypothesis, as the nature of the economic approach remains unsettled for now.

To conclude, this section illustrates that not all terms associated with economic reality are synonyms. Nonetheless, it appears that economic reality and commercial reality have been developed in conjunction and are applied as benchmarks for the abuse of law doctrine and purposeful interpretation of the facts and circumstances to ensure VAT reality.¹⁵² This seems to be confirmed by the fact that these are often referred to jointly.¹⁵³ However, this is not true for the real and actual economic situation. As opposed to the two modern applications of economic and commercial reality, the CJEU refers to the real or actual economic situation when justifying either their comparison in a non-discrimination analysis¹⁵⁴ or legislative choices in VAT law¹⁵⁵. In this regard, the CJEU seems to apply the terms in their justifications. Their divergence might be explained by the fact that the real and actual economic situation were referred to in the early stages, before the Court embraced the economic and commercial reality. The CJEU has mentioned the real and economic situation only twice, dating back more than 25 years ago.¹⁵⁶ Hence, the terms do not seem to be relevant anymore. The economic approach forms a complete contrast. It has been developed quite recently over the past four years, in conjunction with the economic and commercial reality.¹⁵⁷ Although the economic approach might form a *lex specialis* of the economic and commercial reality, it is more likely to be a linguistic inconsistency. Hopefully, the CJEU abandons the economic approach, since a further subdivision within the economic and commercial reality would reduce legal certainty even further.

3.5 Economic Reality and Legal Certainty

According to the CJEU, legal certainty is a fundamental principle of Community law.¹⁵⁸ It ‘requires, in particular, that rules should be clear and

¹⁵¹ The words used are *perspetiva económica* and *abordagem económica* respectively.

¹⁵² As identified by Ad van Doesum and Frank Nellen, ‘Economic Reality in EU VAT’ (2020) 29 EC Tax Review 213, 214.

¹⁵³ Case C-405/19 *Vos Aannemingen* [2020] EU:C:2020:785, para 42; Case C-734/19 *ITH Comercial Timișoara* [2020] EU:C:2020:919, para 48; and Case C-801/19 *Franck* [2020] EU:C:2020:1049, para 44.

¹⁵⁴ Case 42/83 *Dansk Denkavit* [1984] EU:C:1984:254, para 3.4.3.

¹⁵⁵ Case C-260/95 *Commissioners of Customs and Excise v DFDS* [1997] EU:C:1997:20, para 23.

¹⁵⁶ *ibid.*

¹⁵⁷ Case C-295/17 *MEO - Serviços de Comunicações e Multimédia* [2018] EU:C:2018:942, para 61; and Case C-43/19 *Vodafone Portugal* [2020] EU:C:2020:465, para 49.

¹⁵⁸ Case C-143/93 *Gebroeders van Es Douane Agenten v Inspecteur der Invoerrechten en Accijnzen* [1996] EU:C:1996:45, para 27; Case C-354/95 *The Queen v Minister for Agriculture, Fisheries and Food, ex parte: National Farmers' Union and Others* [1997] EU:C:1997:379, para 57; and Case C-177/96 *Belgische Staat v Banque Indosuez and Others* [1997] EU:C:1997:494, para 27.

precise, so that individuals may be able to ascertain unequivocally what their rights and obligations are and can take steps accordingly'.¹⁵⁹ Although not specified to EU VAT, it is still referred to frequently.¹⁶⁰ It is essential to this field since taxable persons act as unpaid tax collectors, bearing the risk of being confronted with a higher tax burden if their initial recovery from consumers is not high enough. To prevent this, VAT legislation should be clear and precise. Nonetheless, economic reality seems to infringe this principle of legal certainty in two ways.

First, as identified throughout this research, there is still considerable doubt regarding economic reality. This relates to the principle's origin, legal status, function and terminology. Although extensively covered in case law, neither the CJEU nor the AGs have taken the opportunity to elaborate on this principle clearly. There is still considerable doubt about economic reality, despite clarifications in academic literature.¹⁶¹ Therefore, it seems to conflict with the principle of legal certainty.

Second, both principles point in the opposite direction. Whilst, on one hand, legal certainty allows taxpayers to rely on the contractual provisions agreed upon, on the other hand, economic reality deviates from this if it is not reflected in the contract.¹⁶² Although this has always been clear in cases dealing with abuse of law or fraud, it is more sensitive in regular business. Abusive and fraudulent practices require the underlying transactions to be redefined to re-establish the situation that would have prevailed without abuse or fraud.¹⁶³ Ignoring the contractual provisions or transactions is justified by the fact that abusive and fraudulent practices are subject to strict conditions, as identified in section 3.3.1. However, as illustrated throughout this research, economic reality has not been clearly defined yet. Consequently, the implications of neglecting the contractual provisions are less foreseeable, and hence, might be at odds with the principle of legal certainty.

Van Doesum and Nellen have expressed their concerns about this relationship.¹⁶⁴ They are afraid that applying the principle of economic reality might result in motivated reasoning by courts whenever they are unwilling to accept the VAT implications as maintained by the parties involved in the proceedings. Although sharing this view, it must be noted that, as section 3.3.1 illustrates, abusive practices represent a considerable number of instances of economic reality. Moreover, not all cases falling outside the

¹⁵⁹ Case C-344/04 *IATA and ELFAA* [2006] EU:C:2006:10, para 68; Case C-72/15 *Rosneft* [2017] EU:C:2017:236, para 161; and Case C-570/19 *Irish Ferries* [2021] EU:C:2021:664, para 164.

¹⁶⁰ Case C-424/12 *Fatorie* [2014] EU:C:2014:50, paras 45-51; Case C-81/17 *Zabrus Siret* [2018] EU:C:2018:283, paras 38-39; and Case C-661/18 *CTT - Correios de Portugal* [2020] EU:C:2020:335, paras 41-42.

¹⁶¹ Ad van Doesum and Frank Nellen, 'Economic Reality in EU VAT' (2020) 29 *EC Tax Review* 213.

¹⁶² Case C-276/18 *KrakVet Marek Batko* [2020] EU:C:2020:485, paras 61-70.

¹⁶³ For abuse, Case C-255/02 *Halifax and Others* [2006] EU:C:2006:121, para 98; and Case C-251/16 *Cussens and Others* [2017] EU:C:2017:881, para 46. For fraud, Case C-648/16 *Fontana* [2018] EU:C:2018:932, para 34; and Case C-576/15 *Maya Marinova* [2016] EU:C:2016:740, para 42.

¹⁶⁴ Ad van Doesum and Frank Nellen, 'Economic Reality in EU VAT' (2020) 29 *EC Tax Review* 213, 225.

abuse of law doctrine result in negative corrections for the taxable persons. Often, the CJEU makes some sort of reservation.¹⁶⁵ Nonetheless, there are enough examples where economic reality redefines contractual provisions without testing for abusive practices¹⁶⁶, signalling an abuse of law ‘light’¹⁶⁷ or ‘by default’¹⁶⁸. In this regard, this research agrees with Van Doesum and Nellen that this is a worrisome development.

There is no simple solution to the issues mentioned above. Nonetheless, small steps might be taken to align economic reality closer with the principle of legal certainty. Regarding the first uncertainty identified, i.e., the uncertainty of economic reality’s origin, legal status, function and terminology, the CJEU should provide more guidance in the upcoming case law. Whereas the issue of lack of referral in the earlier decades of the principle’s existence seems to be solved, clarity in the Court’s case law is the next step. Concerning the second issue, there is no clear solution since the nature of both principles simply contradict each other. Nonetheless, this study recognises Van Doesum’s and Nellen’s concerns for economic reality to develop into an abuse of law ‘light’ or ‘by default’. However, as long as the CJEU adopts a careful case-by-case approach, the principles’ contradicting natures should pose no further issues.

¹⁶⁵ Case C-547/18 *Dong Yang Electronics* [2020] EU:C:2020:350, paras 29-38. Although economic reality permits the existence of a fixed establishment in the Member State where the taxable person has a subsidiary, it is not up to the counterparty in the transaction to inquire into contractual relationships between the parent and its subsidiary.

¹⁶⁶ Joined Cases C-53/09 and C-55/09 *Loyalty Management UK and Baxi Group* [2010] EU:C:2010:590, paras 38-42. Another example is Case C-653/11 *Newey* [2013] EU:C:2013:409, as there is no universal agreement whether disregarding the contractual provisions is based on abuse of law or only economic reality in itself. See Case C-5/17 *DPAS* [2018] EU:C:2018:592, Opinion of AG Saugmandsgaard Øe, para 70, where he states that the application of VAT must be based on the economic reality and refers to *Newey*, without mentioning abuse of law.

¹⁶⁷ Ad van Doesum and Frank Nellen, ‘Economic Reality in EU VAT’ (2020) 29 *EC Tax Review* 213, 225-226.

¹⁶⁸ Ad van Doesum, ‘Capital Contributions: VAT Neutrality, Economic Reality and Legal Certainty’ in *EU Value Added Tax and Beyond – Essays in honour of Ben Terra* (IBFD 2022 forthcoming) para 10.

4 Comparison: Principle of Fiscal Neutrality vs Economic Reality

Whereas the principles of fiscal neutrality and economic reality have been studied in isolation in chapters 2 and 3, this research continues with a comparison, examining to what extent the two might overlap. Academic literature has established that economic reality aims for a neutral VAT outcome, in line with fiscal neutrality.¹⁶⁹ As illustrated in chapter 2, this latter principle can be dissected in various components: external, legal and system neutrality. Moreover, section 3.3 has identified that economic reality primarily serves as two functions, as a benchmark in abuse of law and as an interpretive method of facts and circumstances to ensure VAT reality. Section 4.1 concerns an in-depth analysis of the claim about the similarities between fiscal neutrality and economic reality, linking the neutrality components and functions of economic reality as illustrated in chapters 2 and 3. In contrast, section 4.2 identifies several differences between the principles.

4.1 Similarities: Principle of Fiscal Neutrality vs Economic Reality

4.1.1 Benchmark Abuse of Law and System Neutrality

As the upcoming two sections illustrate, the similarities between the principle of fiscal neutrality and economic reality primarily relate to the latter's function as an interpretive method to ensure VAT reality. Nonetheless, a comparison between system neutrality and economic reality as a benchmark in abuse of law can be made as well. Although section 3.3.1 illustrates that the principle of economic reality is primarily important in establishing the subjective criterion for abusive practices, the similarity with system neutrality relates to the objective condition.

As the CJEU ruled on numerous occasions, abuse of law requires that, despite the formal conditions being met, a tax advantage is granted in contrast to the purpose of the law.¹⁷⁰ As discussed in section 3.3.1, in *Weald Leasing* this was deemed to be the case if lease rentals were set unusually low, not reflecting the economic reality.¹⁷¹ If the price was not to be set at arm's length, the non-deductible VAT in case of lease arrangements is lower than in case of direct purchase. This financial incentive would distort economic decision-making, in conflict with the principle of system neutrality. Consequently, both economic reality as a benchmark for the objective condition in the abuse

¹⁶⁹ Ad van Doesum and Frank Nellen, 'Economic Reality in EU VAT' (2020) 29 EC Tax Review 213, 220-221; and Ad van Doesum, 'Capital Contributions: VAT Neutrality, Economic Reality and Legal Certainty' in *EU Value Added Tax and Beyond – Essays in honour of Ben Terra* (IBFD 2022 forthcoming) para 3.

¹⁷⁰ Case C-589/12 *GMAC UK* [2014] EU:C:2014:2131, para 45; Case C-273/18 *Kuršu zeme* [2019] EU:C:2019:588, para 35; and Case C-281/20 *Ferimet* [2021] EU:C:2021:910, para 54.

¹⁷¹ Case C-103/09 *Weald Leasing* [2010] EU:C:2010:804, para 39.

of law doctrine and system neutrality aim for non-distortion of economic decision-making.

4.1.2 Benchmark VAT Reality and Legal Neutrality

Whilst the link between fiscal neutrality and economic reality is somewhat weak where the latter is used as standard in abusive practices, the same cannot be said regarding its function as a benchmark of VAT reality. This relates to legal, as well as system neutrality. As referred to in section 3.1, the academic literature suggests that economic reality might have its legal base in ensuring equal treatment, in line with the principle of legal neutrality.¹⁷² This is clearly identified when the CJEU ignores contractual provisions, favouring the factual circumstances to determine the VAT treatment. This ensures that similar situations from an economic reality point of view are treated equally, in line with the principle of legal neutrality.

Several cases confirm this relationship. In *Temco Europe*, AG Ruiz-Jarabo Colomer disregards the legal classification and favours the economic reality as a basis for the VAT treatment, to avoid ‘undermining its neutrality by allowing operations which were substantially the same to be treated differently’.¹⁷³ Another example is *MEO*.¹⁷⁴ In order to assess whether cancellation payments are ‘for consideration’ for telecommunication services, the Court determines that contractual termination leaves the economic reality of the relationship between the provider and its customer unaltered¹⁷⁵. If the penalty payment for cancellation were to be excluded from VAT, this would cause a different treatment between customers who benefited from services for the entire commitment period and terminating early.¹⁷⁶ This jurisprudence proves that ignoring contractual provisions and favouring the economic reality ensures equal treatment, in line with the principle of legal neutrality.

Whereas the cases mentioned above take an economic reality perspective first and eventually reach equal treatment, the other way around is possible too. On three occasions relating to VAT grouping schemes, the Court and AGs evaluated the national systems to check for legal neutrality, with differing results. In *Ampliscientifica and Amplifin*, where access to the VAT group depended on the temporal length of the shareholding, the CJEU ruled that this distinction was objectively justified so that the economic reality underlying a legal transaction may be established.¹⁷⁷ However, in *Larentia + Minerva* and *Norddeutsche Gesellschaft für Diakonie*, the AGs concluded that a distinction based on legal form infringes the principle of fiscal neutrality. They ruled that ‘The VAT group mechanism must promote fiscal neutrality whilst reflecting

¹⁷² Albert Bomer, *Unierechtelijke beginselen en BTW* (Wolters Kluwer 2013) 25. Also recognised in Ad van Doesum and Frank Nellen, ‘Economic Reality in EU VAT’ (2020) 29 EC Tax Review 213, 214-215.

¹⁷³ Case C-284/03 *Temco Europe* [2004] EU:C:2004:287, Opinion of AG Ruiz-Jarabo Colomer, para 25.

¹⁷⁴ Case C-295/17 *MEO - Serviços de Comunicações e Multimédia* [2018] EU:C:2018:942.

¹⁷⁵ *ibid* para 44.

¹⁷⁶ *ibid* para 47.

¹⁷⁷ Case C-162/07 *Ampliscientifica and Amplifin* [2008] EU:C:2008:301, para 26.

economic reality.’¹⁷⁸ These three cases seem to point to the fact that the principle of legal neutrality requires similar situations from an ‘economic reality’ perspective.¹⁷⁹ This might even constitute a new function of economic reality, as a benchmark of similarity in matters of legal neutrality.

According to Van Doesum, this is a troublesome development.¹⁸⁰ Using the cases *MEO*¹⁸¹, *Vodafone Portugal*¹⁸² and *Société thermale d’Eugénie-Les-Bains*¹⁸³, he argues that situations can be comparable from an economic point of view, yet differ from a legal perspective, or vice versa. The question might arise what takes precedence: the economic or legal comparability. In a sense, this comes down to a choice between economic reality or legal certainty.¹⁸⁴ To conclude, it has become apparent that the benchmark of VAT reality and the principle of legal neutrality bear a special relationship. In a sense, they almost seem to merge.

4.1.3 Benchmark VAT Reality and System Neutrality

Besides legal neutrality, system neutrality is heavily connected to economic reality as a benchmark of VAT reality. Although differing in functioning¹⁸⁵, both system neutrality and economic reality serve as a method of interpretation and strive for a neutral VAT outcome. Although the CJEU does not explicitly refer to economic reality, Van Doesum¹⁸⁶ identified this relationship in *Faxworld*¹⁸⁷ and *Polski Trawertyn*¹⁸⁸. Nonetheless, as stressed in section 1.4, this study is limited to cases where the principle is specifically mentioned. The relationship between economic reality’s function as a benchmark of VAT reality and system neutrality can be identified in numerous AG opinions.

In this regard, *Glawe* forms an excellent example.¹⁸⁹ German law required particular gaming machines to contain a built-in reserve department filled

¹⁷⁸ Case C-108/14 *Larentia + Minerva* [2015] EU:C:2015:212, Opinion of AG Mengozzi, para 83; and Case C-141/20 *Norddeutsche Gesellschaft für Diakonie* [2022] EU:C:2022:11, Opinion of AG Medina, para 89.

¹⁷⁹ In *Weald Leasing*, the UK and Greek governments made a similar argument, that from a true underlying commercial and economic reality perspective the group acquired the goods, and hence, should be comparable to other purchasers without full right of VAT deduction when applying the principle of legal neutrality. See Case C-103/09 *Weald Leasing* [2010] EU:C:2010:633, Opinion of AG Mazák, para 18.

¹⁸⁰ Ad van Doesum, ‘Capital Contributions: VAT Neutrality, Economic Reality and Legal Certainty’ in *EU Value Added Tax and Beyond – Essays in honour of Ben Terra* (IBFD 2022 forthcoming) para 3.

¹⁸¹ Case C-295/17 *MEO - Serviços de Comunicações e Multimédia* [2018] EU:C:2018:942.

¹⁸² Case C-43/19 *Vodafone Portugal* [2020] EU:C:2020:465.

¹⁸³ Case C-277/05 *Société thermale d’Eugénie-Les-Bains* [2007] EU:C:2007:440.

¹⁸⁴ See section 3.5

¹⁸⁵ See the next section.

¹⁸⁶ Ad van Doesum, ‘Capital Contributions: VAT Neutrality, Economic Reality and Legal Certainty’ in *EU Value Added Tax and Beyond – Essays in honour of Ben Terra* (IBFD 2022 forthcoming) para 3.

¹⁸⁷ Case C-137/02 *Faxworld* [2004] EU:C:2004:267.

¹⁸⁸ Case C-280/10 *Polski Trawertyn* [2012] EU:C:2012:107.

¹⁸⁹ Case C-38/93 *Glawe v Finanzamt Hamburg-Barmbek-Uhlenhorst* [1994] EU:C:1994:188, Opinion of AG Jacobs.

with coins used to pay out winnings. The question arose of what constitutes the taxable amount of the underlying gaming services: the total coins inserted by consumers (as claimed by the German government) or those left in reserve after pay-out (as advocated by Glawe and the UK government). According to AG Jacobs, the former ‘view is inconsistent with the commercial reality of the transaction and with the aims and basic principles of the directive’.¹⁹⁰ Without explicitly mentioning system neutrality, his argumentation clearly resembles this principle, in the sense that VAT should be proportional to prices. Consequently, economic reality as an interpretive method ensures system neutrality in this case.

The same holds true in several other AG opinions, dealing with the right of input VAT deduction incurred on the supply of fuels. In *Intiem*, whereas the invoice was directed to, and paid by, the employer, the petrol was pumped directly into the employee’s own car.¹⁹¹ Nonetheless, AG Da Cruz Vilaça ruled that this fact ‘in no way affects the legal and economic reality of the transaction’.¹⁹² Consequently, he interpreted the facts and circumstances so that the employer, and not the employee, is designated as the recipient of the supply. Hence, this allowed the taxable person a right of deduction, ensuring system neutrality as identified in section 2.4.3. However, in *Commission v Netherlands*¹⁹³ and *Commission v United Kingdom*, AG Stix-Hackl did not extend that analysis to cases where the employer wanted to deduct VAT after reimbursement of fuel costs to employees. Although a similar argumentation based on economic reality in conjunction with system neutrality was brought up¹⁹⁴, the national legislation was deemed to be applied *contra legem*. Subsequently, the CJEU confirmed this.¹⁹⁵ Hence, although economic reality as a benchmark of VAT reality and system neutrality both strive for input VAT deduction to ensure a neutral VAT outcome, these principles’ reach is not absolute.

Whilst the aforementioned cases date back from decades ago, a recently delivered AG opinion reconfirms the cooperation between the interpretive function of economic reality and system neutrality. In *GE Aircraft Engine Services*, an employer purchased and subsequently rewarded employees with a retail voucher, on which the input VAT was deducted.¹⁹⁶ The preliminary questions relate to whether there is a self-supply in the sense of Article 26 paragraph 1 sub b of the VAT Directive. After discussing the doctrine of vouchers implemented in 2019¹⁹⁷, AG Čápeta concludes that taking into

¹⁹⁰ *ibid* para 18.

¹⁹¹ Case 165/86 *Intiem v Staatssecretaris van Financiën* [1988] EU:C:1988:122, Opinion of AG Da Cruz Vilaça.

¹⁹² *ibid* para 23.

¹⁹³ Case C-338/98 *Commission v Netherlands* [2001] EU:C:2001:300, Opinion of AG Stix-Hackl, paras 20-24.

¹⁹⁴ Case C-33/03 *Commission v United Kingdom* [2005] EU:C:2004:801, Opinion of AG Stix-Hackl, paras 20-24.

¹⁹⁵ Case C-338/98 *Commission v Netherlands* [2001] EU:C:2001:596, para 77; and Case C-33/03 *Commission v United Kingdom* [2005] EU:C:2004:801, para 31.

¹⁹⁶ Case C-607/20 *GE Aircraft Engine Services* [2022] EU:C:2022:63, Opinion of AG Čápeta, paras 8-18.

¹⁹⁷ Council Directive 2016/1065 of 27 June 2016 amending Directive 2006/112/EC as regards the treatment of vouchers [2016] OJ L177/9. For extensive research on treatment of vouchers,

consideration the economic reality and respecting system neutrality, VAT should be levied on the final application of the retail voucher, rather than the intermediate self-supply.¹⁹⁸ Hence, the consideration of economic reality prevented double taxation, in line with system neutrality. To conclude, the close relationship between economic reality as a benchmark of VAT reality and the principle of system neutrality seems to have been upheld in recent jurisprudence.

4.2 Differences: Principle of Fiscal Neutrality vs Economic Reality

As identified in the last section, the principle of fiscal neutrality and economic reality seem to overlap significantly, especially regarding the latter's function as a benchmark of VAT reality. Nonetheless, three apparent differences can be observed too. These relate to the legal status, observance with legal certainty and method of interpretation.

First, whereas the principle of fiscal neutrality is widely recognised among the CJEU¹⁹⁹, AGs²⁰⁰ and academics²⁰¹ as a fundamental principle underlying the common system of VAT, economic reality enjoys significantly less attention. Although referred to as a fundamental 'criterion' of the common system of VAT²⁰², the question arises whether the notion forms a principle or a rule. In section 3.2, this research answers in the positive. Nonetheless, there are compelling arguments to deny the status of economic reality as a fundamental principle. Fiscal neutrality enjoys more recognition.

Second, economic reality and fiscal neutrality do not adhere to the principle of legal certainty in similar proportions. This latter requires that EU law and rules are clear and precise. As illustrated in section 3.5, economic reality deviates from the legal status quo insofar as it might overrule contractual provisions.²⁰³ Whereas the principle of fiscal neutrality also requires a neutral

see Jeroen Bijl, *The EU VAT treatment of vouchers in the context of promotional activities* (Tilburg University 2019).

¹⁹⁸ Case C-607/20 *GE Aircraft Engine Services* [2022] EU:C:2022:63, Opinion of AG Ćapeta, paras 66-73.

¹⁹⁹ Case C-454/98 *Schmeink & Cofreth and Strobel* [2000] EU:C:2000:469, para 59; Case C-188/09 *Profaktor Kulesza, Frankowski, Józwiak, Orłowski* [2010] EU:C:2010:454, para 2; and Case C-587/10 *VSTR* [2012] EU:C:2012:592, para 44.

²⁰⁰ Case C-592/15 *British Film Institute* [2017] EU:C:2016:733, para 32; Case C-664/16 *Vădan* [2018] EU:C:2018:346, para 35; and Case C-495/17 *Cartrans Spedition* [2018] EU:C:2018:573, paras 37-38.

²⁰¹ Marta Papis, 'The Principle of Neutrality in EU VAT' in Cécile Brokelind (ed), *Principles of Law: Function, Status and Impact in EU Tax Law* (IBFD 2014) ch 16.7; Ad van Doesum and others, *Fundamentals of EU VAT Law* (2nd edn, Kluwer Law International 2020) 40; and Christian Amand, 'VAT Neutrality: A Principle of EU Law or a Principle of the VAT System?' (2013) 2 *World Journal of VAT/GST Law* 163, 181.

²⁰² C-544/16 *Marcandi* [2018] EU:C:2018:540, para 45; Case C-801/19 *Franck* [2020] EU:C:2020:1049, para 44; and Case C-90/20 *Apcoa Parking Danmark* [2022] EU:C:2022:37, para 38.

²⁰³ Joined Cases C-53/09 and C-55/09 *Loyalty Management UK and Baxi Group* [2010] EU:C:2010:590, paras 38-42; ; Case C-295/17 *MEO - Serviços de Comunicações e Multimédia* [2018] EU:C:2018:942, para 42-43; and Case C-276/18 *KrakVet Marek Batko* [2020] EU:C:2020:485, paras 61-70.

VAT outcome, the end result is usually more favourable for the taxable person, often extending the right of deduction.²⁰⁴ Although, in itself, it does not make EU law and rules clearer and more precise, a positive decision is more acceptable to taxable persons. Moreover, the almost excessive reference to fiscal neutrality makes the application of VAT legislation more predictable. Hence, legal certainty is better preserved by the principle of fiscal neutrality than economic reality.

Third, both principles differ in their interpretive methodology. Whilst fiscal neutrality serves as interpretation of VAT legislation²⁰⁵, economic reality interprets the facts and circumstances surrounding a case. In a sense, they can be seen as two halves, complementing each other. The CJEU has two remedies to ensure a neutral VAT outcome: either purposefully interpreting the facts according to economic reality, or interpretation of legislation in line with fiscal neutrality. However, if the CJEU starts making its own *de facto* assessment of the facts as suggested in by AG Kokott in *DuoDecad*²⁰⁶, this difference might disappear as well. The different interpretation between economic reality and fiscal neutrality might also explain why Van Doesum and Nellen could not fit economic reality in the framework of hermeneutic methods.²⁰⁷ Besides not allowing for teleological interpretation such as the principle of fiscal neutrality, it does not allow for textual nor contextual understanding. Indeed, Van Doesum concludes that it complements the standard interpretation methods.²⁰⁸ In a sense, the CJEU has enriched itself with a fourth interpretive method.

²⁰⁴ Case C-465/03 *Kretztechnik* [2005] EU:C:2005:320, paras 33-38; Case C-126/14 *Sveda* [2015] EU:C:2015:712, paras 17-20; and Case C-132/16 *Iberdrola Inmobiliaria Real Estate Investments* [2017] EU:C:2017:683, paras 26-35.

²⁰⁵ For instance, the direct and immediate link for input VAT deduction. See Case C-437/06 *Securenta* [2008] EU:C:2008:166, paras 25-31; Case C-249/17 *Ryanair* [2018] EU:C:2018:834, paras 24-32; and Case C-528/19 *Mitteldeutsche Hartstein-Industrie* [2020] EU:C:2020:712, paras 24-35.

²⁰⁶ Case C-596/20 *DuoDecad* [2022] EU:C:2022:91 Opinion of AG Kokott, para 79.

²⁰⁷ Ad van Doesum and Frank Nellen, 'Economic Reality in EU VAT' (2020) 29 *EC Tax Review* 213, 215-216.

²⁰⁸ Ad van Doesum, 'Capital Contributions: VAT Neutrality, Economic Reality and Legal Certainty' in *EU Value Added Tax and Beyond – Essays in honour of Ben Terra* (IBFD 2022 forthcoming) para 3.

5 Conclusion

This research attempted to identify to what extent economic reality is (in)comparable to the principle of fiscal neutrality in EU VAT. In this regard, these two elements were studied in isolation in the legal framework. First, chapter 2 distinguished between three different components of fiscal neutrality. Subsequently, several elements of economic reality were individually covered under chapter 3, relating to its legal status, function, terminology and adherence to legal certainty. Finally, chapter 4 compared them to identify potential overlap.

5.1 The Principle of Fiscal Neutrality

In addition to Article 1 paragraph 2, the principle of fiscal neutrality has been codified in Recitals 4, 5, 7, 13, 30 and 34 in the Preamble to the VAT Directive. As referred to by the CJEU, it is a fundamental principle underlying the common system of VAT. As illustrated in section 2.1, three primary elements can be identified.

First, a distinction is made between internal and external neutrality. Whereas internal neutrality relates to domestic transactions, the external component captures cross-border situations. Within the latter, a further distinction can be made. Whilst intra-external neutrality refers to transactions between the Member States, the regular external component concerns trade with Third Countries. Although not referred to by the CJEU too often, it is represented in the place of supply rules in the VAT Directive. Simply put, the principle of external neutrality requires exports to be freed of VAT, and imports to be taxed. In a sense, it serves as an equaliser of the VAT burden in cross-border trade.

In contrast to external neutrality, the principle of legal neutrality is not represented in the VAT Directive. Nonetheless, it has been referred to by the CJEU on numerous occasions. Legal neutrality was intended by the EU legislature to reflect the general principle of equal treatment in matters relating to VAT. However, whilst the latter entails a prohibition on treating similar situations differently and treating different situations in the same way unless there are objective reasons for such treatment, legal neutrality requires an additional condition. Besides the similarity of situations, taxable persons should be in competition. Although this seems to have been downplayed in the *Rank* case²⁰⁹, there is still significant uncertainty. Nonetheless, should the principle of fiscal neutrality be inapplicable, the CJEU and AGs seem to have accepted the application of the general EU law principle of equal treatment as an alternative, as identified in section 2.3. This extends taxpayers' rights to similar situations, yet not in competition.

Finally, the principle of fiscal neutrality entails a systematic component too. In this regard, it requires proportionality between VAT and the underlying

²⁰⁹ Joined Cases C-259/10 and C-260/10 *The Rank Group* [2011] EU:C:2011:719, paras 33-36.

price, based on the economic theory that economic decision-making should not be distorted. In CJEU case law, four separate norms preserve system neutrality. First, the length of the supply chain should be irrelevant to the eventual tax burden. Second, the right of deduction should be granted broadly, to ensure that businesses are freed of VAT. Third, double non-taxation should be prevented. Fourth, as VAT is a general tax on private consumption, all forms should be taxed, including self-supplies. The Court has applied these four norms regularly to ensure the principle of system neutrality in EU VAT.

5.2 Economic Reality

Whereas the principle of fiscal neutrality has been heavily discussed in academic literature, economic reality has been barely touched upon.²¹⁰ Nonetheless, its reference by the CJEU and AGs has been steadily increasing over the past decades. Despite this development, the origins of economic reality have never been clarified. However, three theories have emerged in academic literature: economic reality as an aid to the uniform application of EU VAT law, as protection of legal neutrality and as preservation of VAT's nature as transaction tax.²¹¹ The latter two seem plausible.

Similar to economic reality's origin, its legal status is also covered in uncertainty. Despite suggestions by several academics²¹², there is no universally accepted condition separating fundamental principles from general rules. Relating to economic reality, there is no collective agreement either. Nonetheless, the CJEU refers to 'a fundamental criterion for the application of the common system of VAT'.²¹³ Due to its increased importance, this research refers to the principle of economic reality.

As identified in academic literature²¹⁴, section 3.3 distinguished two functions of economic reality. First, it is used as a benchmark of normality in the abuse of law doctrine. Whereas referred to only once in the objective condition establishing a tax benefit contrary to the purpose of EU VAT law, economic reality plays a significant role in the second criterion. This subjective condition requires the transaction's essential aim to be the obtention of the tax advantage. In this regard, the CJEU targets 'wholly artificial arrangements

²¹⁰ Except for Ad van Doesum and Frank Nellen, 'Economic Reality in EU VAT' (2020) 29 EC Tax Review 213; and Ad van Doesum, 'Capital Contributions: VAT Neutrality, Economic Reality and Legal Certainty' in *EU Value Added Tax and Beyond – Essays in honour of Ben Terra* (IBFD 2022 forthcoming).

²¹¹ See Ad van Doesum and Frank Nellen, 'Economic Reality in EU VAT' (2020) 29 EC Tax Review 213, 214-215. The first and second ideas were originally developed by Albert Bomer, *Unierechtelijke beginselen en BTW* (Wolters Kluwer 2013) 25.

²¹² Cécile Brokelind, 'Introduction' in Cécile Brokelind (ed), *Principles of Law: Function, Status and Impact in EU Tax Law* (IBFD 2014) ch 1.2; and Ronald Dworkin, *Taking Rights Seriously* (Harvard University Press 1978) 29.

²¹³ Case C-53/09 *Loyalty Management UK and Baxi Group* [2010] EU:C:2010:590, para 39; Case C-544/16 *Marcandi* [2018] EU:C:2018:540, para 45; and Case C-410/17 *A* [2019] EU:C:2019:12, para 60.

²¹⁴ Ad van Doesum and Frank Nellen, 'Economic Reality in EU VAT' (2020) 29 EC Tax Review 213 214; and Ad van Doesum, 'Capital Contributions: VAT Neutrality, Economic Reality and Legal Certainty' in *EU Value Added Tax and Beyond – Essays in honour of Ben Terra* (IBFD 2022 forthcoming) para 3.

which do not reflect economic reality and are set up with the sole aim of obtaining a tax advantage'.²¹⁵ Consequently, the principle plays a significant role in the abuse of law doctrine, particularly in its second subjective condition.

Second, besides this function, economic reality serves as a benchmark of VAT reality. In this regard, the CJEU adopts a two-step approach. First, it picks the facts and circumstances relevant to the analysis. Subsequently, these are interpreted to ensure purposeful interpretation of VAT law, preserving neutrality. As identified in section 3.3.2, the Court commits to this neutral result significantly, possibly disregarding contractual provisions²¹⁶, reviewing national judgments *res judicata*²¹⁷ and taking account of sectoral practices²¹⁸. According to this second function, the VAT rules should apply to the economic reality of transactions, regardless of their legal classification.²¹⁹

Throughout the years, the CJEU has referred to a multitude of terms. The question arises whether these all capture the same theory, or whether subtle differences might exist. As illustrated in section 3.4, three groups can be identified. First and foremost, the CJEU and AGs referred to the economic, commercial or economic and commercial realities. These three have been developed in conjunction, and capture the modern application theories discussed in 3.3, as standard of normality in abusive practices and as benchmark of VAT reality. Second, the CJEU has referred twice to the real and actual economic situation, in *Dansk Denkavit*²²⁰ and *DFDS*²²¹. These did not involve the modern application methods but served as justification for legislative choices. Third, the CJEU has recently referred to the economic approach. In this regard, it might function as a *lex specialis* of the economic and commercial reality. Nonetheless, it is more likely to form a linguistic inconsistency. Since the economic approach has only been referred to twice²²², future case law might provide more clarity.

As illustrated throughout this study, legal certainty is at risk when the Court applies economic reality. Although not specific to EU VAT, the principle is of significant importance in this field since businesses act as unpaid tax collectors. Therefore, legal neutrality prescribes that rules should be clear and precise. However, this principle seems to be infringed by economic reality in two ways.

First, uncertainty exists regarding its origin, legal status, function and terminology. Although several of these elements have been covered in

²¹⁵ Case C-653/11 *Newey* [2013] EU:C:2013:409, para 46; Case C-419/14 *WebMindLicenses* [2015] EU:C:2015:832, para 35; and Case C-276/18 *KrakVet Marek Batko* [2020] EU:C:2020:485, para 84.

²¹⁶ Case C-410/17 *A* [2019] EU:C:2019:12, paras 48, 60.

²¹⁷ Case C-396/16 *T - 2* [2018] EU:C:2018:109, paras 42-44.

²¹⁸ Case C-224/18 *Budimex* [2019] EU:C:2019:347, para 29.

²¹⁹ Case C-284/03 *Temco Europe* [2004] EU:C:2004:287, Opinion of AG Ruiz-Jarabo Colomer, para 25.

²²⁰ Case 42/83 *Dansk Denkavit* [1984] EU:C:1984:254, para 3.4.3.

²²¹ Case C-260/95 *Commissioners of Customs and Excise v DFDS* [1997] EU:C:1997:20, para 23.

²²² Case C-295/17 *MEO - Serviços de Comunicações e Multimédia* [2018] EU:C:2018:942, para 61; and Case C-43/19 *Vodafone Portugal* [2020] EU:C:2020:465, para 49.

academic literature, considerable doubt remains until the Court provides more clarity. Secondly, both functions of economic reality might entail deviations from the contractual provisions agreed between the parties involved. This creates legal uncertainty for taxpayers, especially given the fact that the CJEU does not clearly define the conditions of economic reality. Van Doesum and Nellen are particularly afraid that the benchmark of VAT reality might evolve in an abuse of law ‘light’ or ‘by default’, not safeguarded by the objective and subjective criterion. Although this has not occurred yet, it is true that the CJEU should apply the benchmark of VAT reality carefully, on a case-by-case basis.

5.3 Comparison: Principle of Fiscal Neutrality vs Economic Reality

This research attempts to identify to what extent economic reality is (in)comparable to the principle of fiscal neutrality in EU VAT. Whereas these have been studied in isolation, a comparison has not been made yet. This research identified three similarities.

The first comparison is made between economic reality as a benchmark of normality in abusive practices and system neutrality. As illustrated in *Weald Leasing*²²³, if lease terms are set unusually low and do not reflect economic reality, a tax benefit is granted contrary to the purpose of the law, meeting the second condition in the abuse of law doctrine. Like system neutrality, the objective criterion demands the law to be applied in a neutral manner, preventing distortion of economic decision-making.

The second and third similarities relate to economic reality as a benchmark of VAT reality. If compared to legal neutrality, several cases identify a cause-effect relationship.²²⁴ By disregarding contractual provisions and favouring the economic reality, the resulting VAT treatment is equal to other economically similar situations, in line with legal neutrality. In a similar fashion, three other cases reviewing national VAT grouping schemes for legal neutrality compare similar situations from an economic reality perspective.²²⁵ In short, the principle of legal neutrality and economic reality as a benchmark of VAT reality seem to merge to a certain extent in cases mentioned above.²²⁶

The third similarity involves system neutrality. This requires VAT to be proportional to the prices of goods and services. Besides system neutrality,

²²³ Case C-103/09 *Weald Leasing* [2010] EU:C:2010:804, para 39.

²²⁴ Case C-284/03 *Temco Europe* [2004] EU:C:2004:287, Opinion of AG Ruiz-Jarabo Colomer, para 25; and Case C-295/17 *MEO - Serviços de Comunicações e Multimédia* [2018] EU:C:2018:942, paras 44-47.

²²⁵ Case C-162/07 *Amplisientifica and Amplifin* [2008] EU:C:2008:301, para 26; Case C-108/14 *Larentia + Minerva* [2015] EU:C:2015:212, Opinion of AG Mengozzi, para 83; and Case C-141/20 *Norddeutsche Gesellschaft für Diakonie* [2022] EU:C:2022:11, Opinion of AG Medina, para 89.

²²⁶ The question arises whether economically or legally similar situations take precedence in the comparison analysis of the principle of legal neutrality. See Ad van Doesum, ‘Capital Contributions: VAT Neutrality, Economic Reality and Legal Certainty’ in *EU Value Added Tax and Beyond – Essays in honour of Ben Terra* (IBFD 2022 forthcoming) para 3.

this goal is achieved by economic reality as a benchmark of VAT reality.²²⁷ Several other AG opinions show a similar effect by the principle of economic reality, ensuring fiscal neutrality's norm of input VAT deduction²²⁸ and taxation of self-supplies²²⁹. To conclude, besides legal neutrality, economic reality as a benchmark of VAT reality ensures the principle of system neutrality.

Nonetheless, in addition to the similarities, three differences can be identified. First, whilst fiscal neutrality is widely recognised and forms a fundamental principle underlying the EU VAT system, economic reality does not enjoy similar levels of recognition. Second, they relate differently to the principle of legal certainty. Whilst fiscal neutrality usually extends taxpayers' rights, economic reality often works to their detriment. Third, the principles differ in their interpretive methodology. Where economic reality as a benchmark of VAT reality interprets a case's facts and circumstances, fiscal neutrality serves as a teleological interpretation method of EU VAT legislation.

So, to what extent is economic reality comparable to the principle of fiscal neutrality in EU VAT? Whereas its function as a standard of normality in abusive practices shares limited similarities, sections 4.1.2 and 4.1.3 demonstrate that its role as a benchmark of VAT reality ensures legal and system neutrality. If a proportion should be established, approximately half of the principle of economic reality would be allocated to fiscal neutrality. The other fifty percent is devoted to abusive practices. Hence, economic reality and the principle of fiscal neutrality are not two peas in a pod. Rather, economic reality in EU VAT might be regarded as a two-sided coin, with fiscal neutrality on one side, and abuse of law on the other.

²²⁷ Case C-38/93 *Glawe v Finanzamt Hamburg-Barmbek-Uhlenhorst* [1994] EU:C:1994:188, Opinion of AG Jacobs, para 18.

²²⁸ Case 165/86 *Intiem v Staatssecretaris van Financiën* [1988] EU:C:1988:122, Opinion of AG Da Cruz Vilaça, para 23.

²²⁹ Case C-607/20 *GE Aircraft Engine Services* [2022] EU:C:2022:63, Opinion of AG Ćapeta, paras 66-73.

Appendix A: CJEU's Case Law on Economic Reality

Table 1 on the next page lists the occasions on which the CJEU, AG or both mention the concept of economic reality, or one of its synonyms identified in academic literature. This research was conducted on 27 May 2022 by searching for economic reality, commercial reality, economic and commercial realities, actual economic situation, real economic situation or economic approach mentioned in the text of judgments issued by the CJEU or AG opinions within the field of VAT. The following data entries were made in the Curia search form:

Documents: Documents published in the ECR: Judgments – Opinion
Text: "economic realit*", "commercial realit*", "economic and commercial realit*", "commercial and economic realit*", "actual economic situation", "real economic situation", "economic approach"
Subject-matter: "Value added tax"

Case C-290/05 *Nádasdi* [2006] EU:C:2006:477, Opinion of AG Sharpston, fn 25 is excluded from the table on next page. For whatever reason, it somehow showed up in the search results, despite not dealing with VAT but rather with national registration duties on motor cars.

Table 1: Reference CJEU and AGs to 'economic reality' and supposed synonyms.

Case	Name	Authority	Economic reality	Commercial reality	Economic and commercial realities/commercial and economic realities	Actual economic situation	Real economic situation	Economic approach
C-250/21	O. Fundusz Inwestycyjny Zamknięty reprezentowany przez O		-	-	-	-	-	-
		AG	-	-	Para 54	-	-	-
C-607/20	GE Aircraft Engine Services		-	-	-	-	-	-
		AG	Para 73	-	Para 58	-	-	-
C-333/20	Berlin Chemie A. Menarini	CJEU	-	-	Paras 38, 39, 41	-	-	-
			-	-	-	-	-	-
C-141/20	Norddeutsche Gesellschaft für Diakonie		-	-	-	-	-	-
		AG	Para 89	-	-	-	-	-
C-90/20	Apcoa Parking Danmark	CJEU	-	-	Paras 34, 38	-	-	-
		AG	Paras 35, 42, 56, 59, 61	-	Paras 36, 61	-	-	-
C-4/20	ALTI	CJEU	Para 35	-	-	-	-	-
			-	-	-	-	-	-
C-846/19			-	-	-	-	-	-

	Administration de l'Enregistrement, des Domaines and de la TVA	AG	-	-	Para 95	-	-	-
C-801/19	Franck	CJEU	-	-	Para 44	-	-	-
			-	-	-	-	-	-
C-734/19	ITH Comercial Timișoara	CJEU	-	-	Para 48	-	-	-
			-	-	-	-	-	-
C-521/19	Tribunal Económico Administrativo Regional de Galicia	AG	Fn 19	-	Para 54	-	-	-
C-405/19	Vos Aannemingen	CJEU	-	-	Para 42	-	-	-
			-	-	-	-	-	-
C-43/19	Vodafone Portugal	CJEU	Paras 40, 48	-	-	-	-	Para 49
			-	-	-	-	-	-
C-547/18	Dong Yang Electronics	CJEU	-	-	Paras 31, 32	-	-	-
		AG	Para 50	-		-	-	-
C-276/18	KrakVet Marek Batko	CJEU	Para 84	-	Paras 61, 62, 66, 67, 68, 80	-	-	-
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