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**The direct and immediate link test in EU VAT:  
A new set of criteria to clarify the right of deduction**

by

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HARN60 Master Thesis

Master's Programme in European and International Tax Law  
2022/2023

Spring semester 2023

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# Summary

Article 168 of the VAT Directive grants the right of deduction in EU VAT. Along with articles 168a and 169 it specifies the conditions that give rise to deduction rights. As EU VAT is harmonised, Member State discretion is meant to be reduced by the clarity of the VAT Directive and its transposition into national law. However, article 168 makes room for Member State discretion, as the requirements contained therein are ambiguous and inexhaustive. As an example, the direct and immediate link test which is a fundamental requirement for the right of deduction to exist, is not mentioned at all in the VAT Directive. Additionally, Member State transposition is not a harmonised process. This leads to divergences in how different EU Member States grant the right of deduction.

As a solution to this, the Court of Justice of the European Union allows Member States to request for preliminary rulings on national cases that are unclear. Accordingly, the rulings that are given are meant to relieve the lack of clarity and not worsen it. For some areas of tax law this may function effectively, and this thesis investigates whether the line of rulings has provided the sought after clarity within right of deduction cases. The collection of direct and immediate link case law is found to be a confusing and overwhelming mass of evolving criteria that obscures the right of deduction requirements.

In view of this, six criteria are developed in this study to pinpoint the requirements of the direct and immediate link test. This is done by analysing the most prominent and sometimes oldest CJEU case law to establish the prevailing questions and their answers. The indirect link test is also studied and findings demonstrate that it adds to the existing obscurity, increasing the need for the criteria developed in this study. The development of a set of criteria for the indirect link test is a recommendation for further studies.

The three principles of legal certainty, economic reality and fiscal neutrality can be intertwined and operate conjunctively in both tests and are considered as a foundation to the study. Economic reality is characterised as subjective, and fiscal neutrality differs across Member States even though it is not meant to. This explains why the principle of legal certainty shapes the motivation and results of the study. However, with the current lack of legal certainty of the direct link test, neither economic reality nor fiscal neutrality can be forsaken.

# Preface

When I came to Sweden to start the Masters in EU and International Tax Law at Lund University, I hardly knew what I was in for. Within less than a year I have come to call Sweden my indefinite home. It is within this time at Lund University that I met and married my husband, a greater joy than I expected from this Masters adventure.

Along the way there have also been many challenges. My mental resilience has been tested and sharpened this year. For a large part of the process I was also very sick. I am extremely grateful that none of these challenges were able to change the course that I was on. Many thanks to family, friends and classmates who supported and uplifted me throughout the course.

My sincere thanks to the excellent lecturers at LUSEM's Business Law department. You have each shaped me to be the best that I can be. In particular a thank you to my supervisor, Mariya Senyk, who showed me by her own writing and our feedback sessions how to continuously improve my ideas.

An applause to the VAT lecturers, who managed to intrigue me with this side of EU Tax Law. I came to Lund with a background in Direct Tax Law and I am leaving with a wider set of tools. I have developed a passion for EU Tax Law and I am excited to become a participant of this bright and brilliant field of work.

# Abbreviation list

AG	Advocate General
CJEU	Court of Justice of the European Union
EU	European Union
Direct Link Test	The direct and immediate link test
IBFD	International Bureau of Fiscal Documentation
IR	Implementing Regulation
para/s	paragraph/s
p.	p.
SA	South Africa
SARS	South African Revenue Services
Second Directive	Second Council Directive 67/228/EEC
Sixth Directive	Sixth Council Directive 77/388/EEC
TEU	Treaty on European Union
UK	United Kingdom
VAT	Value Added Tax
VD	VAT Directive

# 1. Introduction

## 1.1 Background

Value Added Tax (VAT) in the European Union (EU) can be viewed as a system that is governed by two poles. The poles are the consumption of a good or service, and the deduction of the costs to provide it. Consumption creates a VAT responsibility and deduction lessens that responsibility<sup>1</sup> in order to neutralise the burden on VAT vendors and to ensure that the charge falls upon the final consumer only.<sup>2</sup> If either of the poles are unclear or hard to achieve, its balance does not function as it is intended to.

This thesis focuses on the deduction pole. The right to VAT deduction is granted in article 168 of the VAT Directive.<sup>3</sup> Besides formal requirements, there are additional requirements from a plethora of Court of Justice of the European Union (CJEU) case law that determine whether the right to deduction is granted or not. This case law mainly centres around the direct and immediate link test. It tests whether there is a direct link between a specific input transaction and a specific output transaction.<sup>4</sup> These requirements apply to each and every VAT vendor, whether proof is requested or not.

The legal precedent created in the CJEU cases provides interpretation of EU legislation and guidelines for national legislation that Member States must adhere to.<sup>5</sup> However, the vast amount of case law and the variation between the rulings make the direct link test challenging to navigate and problematic to apply in practice. As an example, the United Kingdom (UK) requested the opinions of other Member States regarding the direct link test requirements, because they assessed a specific CJEU ruling to be incomprehensible and hard to reconcile with other case law.<sup>6</sup> Despite the EU VAT Committee's attempt to provide answers to the UK's questions, Member State National Courts remain uncertain as regards the direct link test. This is evidenced by their similar requests for preliminary rulings from the CJEU that keep resurfacing despite such a deep and wide legal precedent. As an academic counterpart to this practical problem, the non-deductibility of input VAT has been identified as a direct obstacle to the

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<sup>1</sup> C-98/98 *Midland Bank* [2000] ECR p. I-4177 para 29.

<sup>2</sup> C-140/17 *Gmina Ryjewo* [2018] Published in the Digital Digest ECLI:EU:C:2018:595 para 29.

<sup>3</sup> Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax, OJ L 347, further referred to as the VAT Directive and abbreviated to VD.

<sup>4</sup> C-98/98 *Midland Bank supra* note 1 para 24.

<sup>5</sup> Terra B.J.M., Kajus J. & Szatmári Z. *Introduction to European VAT* Global Topics IBFD [2023] Chapter 6.1.1 para 7.

<sup>6</sup> EU VAT Committee, 'Case C-26/12 *Fiscale eenheid PPG Holdings BV* : Direct and immediate link test' (2014), European Commission Brussels Working Paper no. 812 p. 7 paras 2 and 3.

functioning of the EU internal market. The lack of uniform criteria of non-deductible input VAT is a primary reason for this obstacle.<sup>7</sup>

Possible solutions to problems in EU tax law are found by comparing the law with that of other legal jurisdictions.<sup>8</sup> A country which has a large amount of case law that shapes the right of deduction is South Africa (SA). In South African income tax, the criteria for deduction is grouped within a definition based on the questions that keep resurfacing in the relevant case law. By doing so the SA legislation has made use of the legal precedent, but has formalised and assembled the case law into promulgated legislation.<sup>9</sup> By drawing inspiration from the South African example, this thesis will attempt to simulate such an application to EU VAT case law.

There are three main reasons why the EU should consider the South African example. Firstly, their legal system in essence is similar to that of the EU. SA makes use of a combination of Civil and Common law, whereas the EU employs Civil law but relies heavily on case law as within Common law.<sup>10</sup> Secondly, SA has an established Tax Court.<sup>11</sup> The CJEU does not deal exclusively with tax cases like the South African Tax Court does. Such exclusive focus on tax cases can be seen as a competitive advantage. Thirdly, the legal precedent in SA is sufficiently mature to take into consideration. The SA precedent on the right of deduction in income tax has stretched over the past 85 years.<sup>12</sup> The SA VAT precedent spans 30 years<sup>13</sup> and EU cases that build the right of deduction in VAT span 45 years.<sup>14</sup> Additionally, the South African Revenue Services (SARS) has also drafted various VAT guides that clarify what the requirements for VAT deductions are,<sup>15</sup> in a similar fashion to the papers that are issued by the EU VAT Committee.

## **1.2 Aim**

At the centre of the right of deduction requirements in EU VAT lies the direct and immediate link test.<sup>16</sup> The primary aim of this thesis is to formulate legally certain criteria that must be met to pass the test and in so doing gain the right of deduction. The purpose of this would be to encourage a more harmonised understanding of the direct link test across Member States. This could reduce the need for preliminary rulings.

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<sup>7</sup> Rita De La Feria, 'The EU VAT System and the Internal Market' [2009] 261 vol. 16 (IBFD Doctoral Series) Chapter 3, 2.2.1, p. 142.

<sup>8</sup> Douma S. *Legal Research in International and EU Tax Law*. Kluwer, Deventer [2014] Chapter 3.2.5.

<sup>9</sup> Income Tax Act. 1962. Act No. 58 of 1962, as amended. Government Gazette, Pretoria, sections 11(a) and 23(g) read concurrently.

<sup>10</sup> OpenStax. See Websites in the Bibliography.

<sup>11</sup> SARS. See Websites in the Bibliography.

<sup>12</sup> *Port Elizabeth Electric Tramway Co Ltd v CIR*, 1936 CPD 241, 8 SATC 13.

<sup>13</sup> The Constitutional Court of South Africa. See Websites in the Bibliography.

<sup>14</sup> 154/80 *Staatsecretaris van Financiën / Coöperatieve Aardappelenbelaarplaats* [1981] ECR p. 445.

<sup>15</sup> VAT 404 Guide for Vendors Issue 14, 29 June 2022, South African Revenue Service, Government Printer, Pretoria.

<sup>16</sup> Referred to as the 'direct link test' throughout this thesis.



The indirect link test (a derogation from the direct link test) will be reviewed in this thesis, mainly for the purpose of ascertaining its connection with the direct link test.

The secondary aim of this thesis is to comment on the influence of certain legal principles on the direct link test. These principles of EU VAT are economic reality, fiscal neutrality and legal certainty.

### **1.3 Method and Materials**

Each EU VAT vendor's obligation to pass the direct link test lies embedded within hundreds of CJEU cases. In this thesis, case law that determines the direct link test will be approached categorically through the identification of common elements in the cases. Six categories will be identified. Cases are grouped into these six categories according to the questions of the national courts that keep recurring. The grouping of case law serves as an administrative function to condense a wide precedent. Only the cases that first address an issue, or subsequently alter the outcome of that issue, will be selected. This method is referred to as a variation of legal engineering by the systemization of norms or colloquially, creating order out of chaos.<sup>17</sup>

Most writings on the right of deduction and the direct link test are industry or country analyses. The exception to this is an approach by Van Doesum and Van Norden which identifies three steps in the deduction process.<sup>18</sup> Dissimilarly, this thesis develops six different categorical criteria, all with equal standing but with a specific order of application that is in line with the structure of the VAT Directive (VD).

### **1.4 Delimitations**

This study does not present a solution to the obscurity of the indirect link test, but due to the current inextricable relationship between the direct and indirect link tests, points out that the weakness of the latter simultaneously weakens the former. This is demonstrated in Chapter 4. Additionally, Chapter 3.3 does not investigate a taxpayer's intention comprehensively due to the spatial limitations of this thesis and its focus on identifying six criteria. Taxpayer intentions in VAT is a potential area for future studies.

Cross border transactions are excluded from the study as well as agents and intermediaries, despite their inclusion in article 168 VD.<sup>19</sup> When looking at the broader legislation, formal requirements as contained in Title X Chapter 4 of the VD that regulates the right of deduction is outside the scope of this study.

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<sup>17</sup> Douma S. *supra* note 8 chapters 2.2.4, 2.2.7, 3.2.2 and 3.2.5.

<sup>18</sup> A.J. van Doesum & G-J. van Norden, 'The Right To Deduct under EU VAT' [2011] 22 Intl. VAT Monitor 5, Journal Articles & Opinion Pieces IBFD.

<sup>19</sup> The VD, article 168(b) - (e).

## **1.5 Outline**

Chapter 2 of this thesis will address Member State presumptions and the legal principles that affect the direct link test. Chapter 3 contains the study of the case law of the CJEU and develops the six criteria of the direct link test. Chapter 4 considers the influence and involvement of the direct link test on the indirect link test. Chapter 5 concludes with the results of the research aim. A table of the chosen cases will serve as an addendum to summarise the findings for ease of reference and understanding.

## 2. Presumptions and Principles

### 2.1 Presumptions

There are some risk factors that may jeopardise the successful usage of legally certain criteria of the direct link test. One of these risk factors is the presumptions that Member States are in the habit of making, either due to the prevention of tax evasion, the simplification of the VAT system, or the enabling of a balanced right of deduction system.<sup>20</sup> These examples indicate that presumptions are usually set up to benefit all EU stakeholders.

An example of this may be taken from the *Apple and Pear* case wherein the Dutch Supreme Court clarified that a direct link between a supply and its consideration is presumed to exist.<sup>21</sup> This is an aid to the deduction system in that vendors do not have to prove such a link before making a deduction, but may have to prove it at a later stage if asked to by authorities.<sup>22</sup> In essence, this is what is meant by ‘immediate’ in the direct and immediate link test. This type of presumption would qualify as a rebuttable presumption, which is able to be questioned by authorities or defended by vendors through providing proof of the contrary.<sup>23</sup> Rebuttable presumptions can only function if they are based on objective criteria, are sufficiently specific and do not restrict EU rights. Any required proof to establish or rebut a presumption should be reasonably accessible.<sup>24</sup>

The opposite can be said for irrebuttable presumptions, which assume the existence of facts that negatively affect the flow of the VAT system, without giving a taxable person an opportunity to prove that such assumptions are inappropriate.<sup>25</sup> An example of this occurred in the *Ampafrance and Sanofi* case<sup>26</sup> wherein France applied a systematic denial of the right of deduction of certain business expenditure to prevent tax evasion or avoidance. The taxable person was not permitted to provide evidence to contradict such a systematic denial. This was found to be against the proportionality and neutrality principles of the EU.<sup>27</sup>

National Courts of the Member States seem to consider legal presumptions as a means of proving a fact, but also that they could limit the uniform application of EU rules or ‘the full enjoyment of a certain right’.<sup>28</sup> The

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<sup>20</sup> Claudia Sanò, ‘National Tax Law Presumptions and EU Law’ [2014] 23 EC Tax Review Issue 4 p. 195 para 3.

<sup>21</sup> 102/86 *Apple and Pear Development Council / Commissioners of Customs and Excise* [1988] ECR p. 1443 para 12.

<sup>22</sup> The VD article 167.

<sup>23</sup> Rita De La Feria *supra* note 7 p. 200 section 5.2 para 4.

<sup>24</sup> *ibid* p. 206 para 6.

<sup>25</sup> *ibid* p. 200 section 5.2 para 4.

<sup>26</sup> Joined cases C-177/99 and C-181/99 *Ampafrance and Sanofi* [2000] ECR p. I-7013 paras 33 and 34.

<sup>27</sup> Rita De La Feria *supra* note 7 p. 201 section 5.2.3 paras 1-3.

<sup>28</sup> *ibid* p. 206 para 5.

CJEU has added that the appellant is responsible for providing proof when the non-fulfillment of obligations is being claimed and that presumptions may not be relied upon to replace such proof.<sup>29</sup>

In light of the above, in order for the criteria of the direct link test to be implemented fairly, it may function along with rebuttable presumptions, but not alongside irrebuttable presumptions.

## **2.2 Principles**

### **2.2.1 The three principles**

Three principles of law that are of relevance for this study are the principles of legal certainty, economic reality and fiscal neutrality. Each will be considered in order to create a foundation that will be referred to throughout this research.

The principle of legal certainty is commonly described as rules that are sufficiently accessible, foreseeable, precise and certain.<sup>30</sup> In taxation, the principle requires that tax law will be clear and precise enough for taxpayers to know their rights and obligations well enough to be able to take necessary steps.<sup>31</sup> When these rights and obligations entail financial consequences, the principle of legal certainty must be observed more strictly.<sup>32</sup> An exception to the application of legal certainty will be when there is an abuse of law.<sup>33</sup> As expressed in the chapter section on presumptions, such abuse may not be presumed by Member States and is thus not an excuse for lack of legal certainty or fiscal neutrality of EU legislation.<sup>34</sup>

The principle of economic reality works hand in hand with legal certainty to facilitate the application of VAT.<sup>35</sup> Economic reality in EU VAT has been described as all circumstances and actions of parties to a transaction, such as their intentions, contractual agreements and common commercial practice.<sup>36</sup> Economic reality therefore may be utilised to determine whether there is an abuse of the law. The CJEU employs the principle of economic reality<sup>37</sup> which allows courts to repackage the facts of a case to be relevant for VAT purposes. In this way it creates a ‘VAT reality’, which requires legal certainty.<sup>38</sup>

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<sup>29</sup> C-494/01 *Commission / Ireland* [2005] ECR p. I-3331 para 41.

<sup>30</sup> Case of *The Sunday Times v The United Kingdom*, Application number 6538/74 of 26. April 1979 para 49.

<sup>31</sup> 169/80 *Gondrand and Garancini* [1981] ECR p. 1931 para 17.

<sup>32</sup> C-255/02 *Halifax and others* [2006] ECR p. I-1609 para 72.

<sup>33</sup> *ibid* para 84.

<sup>34</sup> *ibid* para 92.

<sup>35</sup> *ibid* para 57.

<sup>36</sup> A.J. van Doesum & F.J.G. Nellen, ‘Economic Reality in EU VAT’ [2020] EC Tax Review 2020-05 section 2.1 para 2.

<sup>37</sup> *ibid*.

<sup>38</sup> *ibid* section 2.2 para 3 and section 5 para 3.

Economic reality is named so for EU VAT but may be found in other spheres of the law under different names. ‘Substance over form’, ubiquitous in direct tax, captures an element of economic reality. Chapter 4 of this research on the indirect link test refers to the wider business context prevailing over a strict application of a direct and immediate link criterion, which in a nutshell is the very same principle of economic reality.

At times economic reality and fiscal neutrality will serve the same purpose.<sup>39</sup> Fiscal neutrality or equal treatment is thought to be one of the two principles that create the foundation of the EU VAT system.<sup>40</sup> The principle of fiscal neutrality will ensure that a taxpayer acting in good faith may not lose the right of deduction that other taxpayers acting in a like fashion have acquired.<sup>41</sup> Good faith may be hard to prove and the principle of economic reality will undoubtedly have a role to play in the assessment thereof.<sup>42</sup> Verification requirements included in the Implementing Regulation (IR)<sup>43</sup> assist with reviewing all circumstances of a transaction, such as the requisition of certain documents. In the *Evita-K* case,<sup>44</sup> despite the request for various documentary proof to secure the legal relationship and actual sale of livestock between two parties, the original ownership and thereby right to sell such animals was ruled as an indeterminative factor to determining whether VAT fraud had occurred.<sup>45</sup> From this case one may note that the application of economic reality in VAT fraud can be subjective and may increase the complexity of right of deduction cases. Van Doesum and Nellen agree:

“Assessing the artificiality of a construct on the basis of economic reality is therefore a complicated affair that bears the risk that it relies on unverified presumptions”.<sup>46</sup>

This is one reason why it is questionable whether excluding irrebuttable presumptions is possible when courts make use of the principle of economic reality. The principle of fiscal neutrality will be analysed in more detail in the next section.

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<sup>39</sup> *ibid* section 3.3 para 4 with reference to C-165/86 *Intiem / Staatssecretaris van Financiën* [1988] ECR p. 1471.

<sup>40</sup> Rita De La Feria, Oxford University Centre for Business Taxation, Working Paper 16/03 “EU VAT principles as interpretative aids to EU VAT rules: the inherent paradox” II para 1.

<sup>41</sup> The VD article 273 and C-228/05 *Stradasfalti* [2006] ECR p. I-8391 para 50.

<sup>42</sup> C-653/11 *Newey* [2013] Published in the Digital Digest ECLI:EU:C:2013:409 para 46.

<sup>43</sup> Council Implementing Regulation (EU) No 282/2011 of 15 March 2011 article 51.

<sup>44</sup> C-78/12 *Evita-K* [2013] Published in the Digital Digest ECLI:EU:C:2013:486.

<sup>45</sup> *ibid* para 43.

<sup>46</sup> A.J. van Doesum & F.J.G. Nellen *supra* note 36 section 4.1.

### **2.2.2 Fiscal neutrality**

In EU VAT the principle of fiscal neutrality is included in the VD in article 1(2). It is not a general principle of law with constitutional status according to article 19 TEU,<sup>47</sup> but it requires that legislation such as the VD and VAT case law comply with it. This is perhaps why authors have questioned whether the principle should be treated as other EU principles of law or viewed as a construct of the EU VAT system.<sup>48</sup> Authors acknowledge that fiscal neutrality has autonomy in the function, structure and objectives of the EU systems,<sup>49</sup> but also question whether its inherent dependence on the system invalidates that so-called autonomy.<sup>50</sup> Nonetheless, it has played a significant role in the direct link test and has at times determined the outcome of the CJEU rulings.<sup>51</sup>

Fiscal neutrality exists to prevent tax competition and unfair burdens that fall on some but not all vendors that are in similar positions<sup>52</sup> or vendors that provide identical or similar goods or services.<sup>53</sup> However, legislation that enables the differential treatment of taxpayers does not breach the principle of fiscal neutrality when it is drafted in that way to establish the economic reality of a taxpayer's situation.<sup>54</sup> That creates a situation wherein the principles of legal certainty, economic reality and fiscal neutrality work together.

In the *Kügler*<sup>55</sup> and *Zimmerman*<sup>56</sup> cases, the principle of fiscal neutrality determined whether legal form or the type of a service would lead to exemption from VAT. Although these cases dealt with exemptions and not deductions, one may note the status that the principle of fiscal neutrality achieved within these cases. Provisions in the German Umsatzsteuergesetz regarding social and welfare services had to be interpreted in line with fiscal neutrality.<sup>57</sup> The specific wording (linguistic interpretation) and purpose of the EU provisions (teleological interpretation) also had to be performed in line with fiscal neutrality.<sup>58</sup>

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<sup>47</sup> Consolidated versions of the Treaty on European Union and the Treaty on the Functioning of the European Union of 7 June 2016, 2016/C 202 p. 171-172, article 19 TEU.

<sup>48</sup> Christian Amand, "VAT neutrality: a principle of EU law or a principle of the VAT system?" [2013] *World Journal of VAT/GST Law* 2.3: 163-18.

<sup>49</sup> C-367/96 *Kefalas and others / Elliniko Dimosio and Organismos Oikonomikis Anasygkrotisis Epicheiriseon* [1998] ECR p. I-2843, Opinion of AG Tesauro, para 23.

<sup>50</sup> Christian Amand *supra* note 48.

<sup>51</sup> Joined Cases C-259/10 and C-260/10 *The Rank Group* [2011] ECR p. I-10947 para 75.

<sup>52</sup> C-481/98 *Commission / France* [2001] ECR p. I-3369 para 22.

<sup>53</sup> Joined Cases C-259/10 and C-260/10 *The Rank Group supra* note 51 paras 32 and 42.

<sup>54</sup> A.J. van Doesum & F.J.G. Nellen *supra* note 36 section 3.3. para 2 with reference to C-162/07 *Ampliscentifica and Amplifin* [2008] ECR p. I-4019.

<sup>55</sup> C-141/00 *Kügler* [2002] ECR p. I-6833.

<sup>56</sup> C-174-11 *Zimmermann* [2012] Published in the Digital Digest ECLI:EU:C:2012:716.

<sup>57</sup> *ibid* para 33.

<sup>58</sup> *ibid* para 64.

Limitations on the right of deductions are to be executed uniformly by all Member States as it affects fiscal neutrality.<sup>59</sup> This is even demonstrated when Member State specific derogations must comply with fiscal neutrality.<sup>60</sup> In the *Metropol and Stadler* case, the court ruled that the Austrian derogations were equal to exclusions and so were prohibited by the VD's wording and intent.<sup>61</sup> At the time, the Austrian laws distinguishing between mini buses and cars and vehicles caused the dispute in the referred case. Those laws were faulted by their lack of fiscal neutrality<sup>62</sup> when they were tightened and the right of deduction became harder to attain for some than for others. Derogations which limit the right of deduction were said to be interpreted very strictly as fiscal neutrality was at stake.<sup>63</sup> From this case it is apparent that the principle of fiscal neutrality is not just mentioned in article 1(2) of the VD, but permeates other articles in the VD and guides the interpretation thereof.

In the *Rank Group* case<sup>64</sup> the British Court of Appeal asked whether tax competition needed to exist as an independent and additional condition for the principle of fiscal neutrality to be breached, on top of the pre-existing fiscal neutrality standards.<sup>65</sup> The answer to that question was no, if similar supplies met the needs of a consumer equally well.<sup>66</sup> Neither does the distortion of tax competition have to exist as an independent and additional condition for the principle of fiscal neutrality to be breached.<sup>67</sup>

However, it was demonstrated that when national legislation allows differential treatment between similar products, regardless of the standard practice of the national tax authority, the principle of fiscal neutrality can not be relied on to safeguard VAT rights.<sup>68</sup> Consequently, the *Rank Group* case expressed that the principle of fiscal neutrality does not supersede national legislation which does not comply with the principle, but that it may grant rights when national legislation is compliant with the principle of fiscal neutrality. This in itself may mean that the principle has the ability to grant rights in certain Member States and not in others, which seems contradictory to the harmonisation of EU VAT.

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<sup>59</sup> C-62/93 *BP Soupergaz / Greek State* [1995] ECR p. I-1883 para 18. Joined cases C-177/99 and C-181/99 *Ampafrance and Sanofi supra* note 26 para 34.

<sup>60</sup> Sixth Council Directive 77/388/EEC, OJ 1977 L 145, p. 1 ('the Sixth Directive) article 17(6) and the VD articles 176 and 168a (2).

<sup>61</sup> C-409/99 *Metropol and Stadler* [2002] ECR p. I-81 paras 49 and 51.

<sup>62</sup> *ibid* para 42.

<sup>63</sup> *ibid* para 59.

<sup>64</sup> Joined Cases C-259/10 and C-260/10 *The Rank Group supra* note 51.

<sup>65</sup> *ibid* para 31.

<sup>66</sup> *ibid* para 34.

<sup>67</sup> *ibid* para 35.

<sup>68</sup> *ibid* para 64.

### **2.2.3 Conclusion**

The legal certainty of the direct link test is the issue at stake in this thesis. Economic reality has been shown to rely on legal certainty.<sup>69</sup> Economic reality is complex, but fiscal neutrality has been shown to rely on it.<sup>70</sup> Thereby, these three principles are interdependent.

Doubts about fiscal neutrality exist.<sup>71</sup> Despite that, this principle has the power to determine how national legislation must be interpreted and how the VD must be interpreted.<sup>72</sup> Unharmonised national legislation will not breach the principle, because the principle influences how legislation is interpreted but not necessarily how it is written.<sup>73</sup>

From this brief analysis, both economic reality and fiscal neutrality appear to be sensitive in one way or another. Legal certainty appears to be the most resilient of the principles and that increases the need for it within the direct link test.

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<sup>69</sup> See *supra* p. 6 para 5.

<sup>70</sup> See *supra* p. 7 para 2.

<sup>71</sup> See *supra* p. 8 para 1.

<sup>72</sup> See *supra* p. 9 para 1.

<sup>73</sup> See *supra* p. 9 para 3.



# 3. The Direct Link Test

## 3.1 Introduction

The direct link test assists in the interpretation of article 168(a) of the VD.<sup>74</sup> Due to the multiplicity of factors that influence this test, this chapter will now group the CJEU case law into the six suggested criteria of the direct link test. The purpose of this is to form robust components of a legally certain and comprehensive definition of a direct link, which as the law stands today does not yet exist.

The South African right of deduction legislation,<sup>75</sup> which inspired this thesis, relies on a rolling list of key cases and their contributions.<sup>76</sup> The list remains open to new key cases. The balance between the legal certainty of the SA cases that are incorporated into their legislation, and the openness of a rolling list of cases, is a balance that the EU simulation in this thesis should not exist without. Therefore, the addendum attached to this thesis represents a rolling list of case law that builds a definition of the direct link test, but remains open to new key cases.

## 3.2 Economic activity

Before the right of deduction according to article 168 of the VD can be established, the scope, person, transaction, place, amounts and exemptions must first be considered. The scope of EU VAT is wide as it is a general tax on consumption.<sup>77</sup> Article 168 specifically grants rights to taxable persons. The taxable person definition as in article 9(1) paragraph 1 of the VD requires that the person be conducting ‘economic activity’. Thus, one of the elements that has kept resurfacing in the direct link test, is whether or not the person in question is undergoing ‘economic activity’.

The first case to take note of is the *Hong Kong Trade* case.<sup>78</sup> The Dutch Government ascertained that traders that provide all of their goods or services free of charge cannot be considered to be taxable persons due to a lack of economic activity, which precludes such traders from claiming input VAT deductions.<sup>79</sup> This ruling remained intact even though the traders were acting as a branch of a taxable undertaking that received consideration for their goods and services. However, the Dutch Government submitted that traders who provide goods or services free of charge, but mainly or occasionally provide chargeable and taxable services, would be considered taxable persons conducting economic activity. Further, traders who charge consideration but make no profit were found to conduct economic activity,

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<sup>74</sup> The VD article 1(2) para 2.

<sup>75</sup> Income Tax Act *supra* note 9.

<sup>76</sup> SA Tax Cases. See Websites in the Bibliography.

<sup>77</sup> Rita De La Feria *supra* note 40, Chapter II para 1 with reference to C-215/94 *Mohr / Finanzamt Bad Segeberg* [1996] ECR p. I-959.

<sup>78</sup> 89/81 *Hong-Kong Trade* [1982] ECR p. 1277.

<sup>79</sup> *ibid* p.1279.

as profit is not a requirement within article 9's definition of taxable person.<sup>80</sup> It is worth mentioning that this case also addresses the scope element contained in article 1(2) of the VD, as 'price' is a requirement for the consumption tax to take place. Later cases clarified that the presence of a 'price' does not guarantee that the 'economic activity' within the taxable person requirement will be met.<sup>81</sup>

On the same consideration of 'price', the *Commission v Finland* case dealt with public offices providing legal aid services in legal proceedings, partly free of charge and partly for a fee.<sup>82</sup> The Commission asked whether that activity constituted economic activity and the answer was no.<sup>83</sup> The Commission also asked whether a person who does not normally have taxable person status can acquire taxing capacity due to employing a third party taxable person to conduct activities which are wholly in the employing party's power.<sup>84</sup> A few requirements from prior case law were considered. Importantly, whether tangible or intangible property was exploited on a permanent and continuing basis for the purpose of obtaining income, income which was to remunerate the person performing the service.<sup>85</sup> Because the part payment by clients was based on their income level and not on the level of service provided, the income was not based on the public office's exploitation of their advisers' skills. The part payment was not considered economic activity, because the link between the payment and the service was not sufficiently direct.<sup>86</sup>

The next case to consider is *Fini H* which deals with the timeline of economic activity.<sup>87</sup> Danish restaurateurs took out a 10-year property lease. After five years they were no longer able to continue business, but the lease was non-terminatable. They continued to carry costs connected to the leased property, which VAT was levied on. Despite trying to sublease the premises, the actual subletting did not take place and the premises remained vacant for the residual five years of the lease.<sup>88</sup> The Danish Supreme Court questioned the validity of the right of deduction during the five years of vacancy.<sup>89</sup> The CJEU ruled that the continued claims of economic activity could be permitted if the direct link between the input and output was unbroken and the absence of fraud and/or abuse was established.<sup>90</sup> Prior case law permitted the continued right of deduction after liquidation commenced.<sup>91</sup> The court's decision was in line with such treatment even though *Fini H*'s business was

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<sup>80</sup> *ibid* p.1280 and 154/80 *Staatsecretaris van Financiën / Coöperatieve Aardappelenbewaarplaats supra* note 14.

<sup>81</sup> C-369/04 *Hutchison 3G and others* [2007] ECR p. I-5247 para 39.

<sup>82</sup> C-246/08 *Commission / Finland* [2009] ECR p. I-10605 para 24.

<sup>83</sup> *ibid* para 53.

<sup>84</sup> *ibid* para 30.

<sup>85</sup> *ibid* para 36 and 37.

<sup>86</sup> *ibid* paras 48-51.

<sup>87</sup> C-32/03 *Fini H* [2005] ECR p. I-1599.

<sup>88</sup> *ibid* paras 8-10.

<sup>89</sup> *ibid* para 15.

<sup>90</sup> *ibid* para 35.

<sup>91</sup> *ibid* para 22 and C-110/94 *INZO / Belgische Staat* [1996] ECR p. I-857 para 20.

not in liquidation, only on account of the inextinguishable legal contract. Thereby the legal contract in effect secured the direct and immediate link.

Despite the existence of clear legal relationships, the following cases deal with the terms of those legal relationships and how they affect economic activity. Firstly, in the *Floridienne and Berginvest* case<sup>92</sup> the Belgian Court of First Instance asked whether the holding of shares and extension of loans could qualify as economic activity.<sup>93</sup> The case relied heavily on legal precedent, but presented an additional element when the defendants provided management services to their subsidiaries in exchange for dividends and interest.<sup>94</sup> From prior case law it was clear that the mere holding of shares could not constitute economic activity, but that management activities by shareholders could.<sup>95</sup> Such management activities included administrative, financial, commercial and technical services to its subsidiaries.<sup>96</sup> The remuneration of those shareholders is what determined the outcome of this case. Since there was no additional remuneration or larger dividend extended for such management activities, and dividends were exactly the same for other shareholders, no direct link between the dividend and their management services could be found.<sup>97</sup> On the other hand, interest income on loans extended may constitute economic activity where the trader's main economic activity is the continuous granting of capital in order to maximise the return on capital investment.<sup>98</sup> This was not the case with *Floridienne* or *Berginvest* as the loans granted to their subsidiaries were only the reinvestment of their unpaid dividends which had no link to economic activity. The right to VAT deduction was not afforded.<sup>99</sup>

Secondly, the *SKF* case presented the situation in which the holding company wanted to sell shareholding in its subsidiaries and employed professional services towards those share sales.<sup>100</sup> These were not normal share sales, as the holding company had an active management role in its subsidiaries and was invoiced for those services which VAT was levied upon.<sup>101</sup> The share sales by SKF were to occur in stages and not as a once-off event. The *Fini H* case presented above indicated that economic activity does not have to occur once 'but may consist of a series of consecutive acts'.<sup>102</sup> An additional factor of the *SKF* case is that the Commission claimed that a full share sale constitutes a transfer of a totality of assets or part thereof and is deemed to be an economic activity according to article 5(8) of the Sixth Directive.<sup>103</sup> However, the optional article 19 of

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<sup>92</sup> C-142/99 *Floridienne and Berginvest* [2000] ECR p. I-9567.

<sup>93</sup> *ibid* para 6.

<sup>94</sup> *ibid*.

<sup>95</sup> *ibid* paras 17 and 18 and C-60/90 *Polysar Investments Netherlands / Inspecteur der Invoerrechten en Accijnzen* [1991] ECR p. I-3111.

<sup>96</sup> C-16/00 *Cibo Participations* [2001] ECR p. I-6663 para 21.

<sup>97</sup> C-142/99 *Floridienne and Berginvest supra* note 92 para 23.

<sup>98</sup> *ibid* para 28.

<sup>99</sup> *ibid* para 30.

<sup>100</sup> C-29/08 *SKF* [2009] ECR p. I-10413 para 21.

<sup>101</sup> C-142/99 *Floridienne and Berginvest supra* note 92 para 16.

<sup>102</sup> C-32/03 *Fini H supra* note 87 paras 8-10.

<sup>103</sup> The Sixth Directive *supra* note 60 article 5(8).

the VD would put such activities outside the scope of VAT and the Kingdom of Sweden had exercised the option of article 19 within their national VAT law.<sup>104</sup> If this were not the case and the transaction had remained within the scope of VAT, the economic activity would be exempt by article 135(1)(f) of the VD, leading to no right of VAT deduction.<sup>105</sup> In conclusion, SKF could not access the right to input VAT deduction by means of the direct link test, but could do so by way of the indirect link that will be analysed in Chapter 4.

From these cases economic activity can be understood to exist when a trader aims to make income, no matter whether profit is made and no matter whether such activity occurs briefly or over time, as long as cost components continue to be linked to some or other taxable production. Economic activity cannot be transferred from a taxable person to a non-taxable person by virtue of employment. Share sales do not constitute economic activity unless active involvement in the management of the company occurs and is remunerated according to a competitive market and can be proved. Full share sales will be deemed economic activity but may lose that status depending on the Member States' application of optional EU VAT provisions. From the above, the definitive character of economic activity is:

*The attempt to continuously produce income with related cost components and proof of active remunerated involvement, subject to optional deeming provisions selected by Member States.*

### **3.3 Intention with the economic activity**

Article 9(1) para 1's definition of taxable person in the VD states that the purpose or result of the economic activity is irrelevant. The common system of EU VAT ensures that all economic activity, regardless of its purpose or result, should be treated in a VAT neutral way, but presupposes that the activity is itself subject to VAT.<sup>106</sup> The VD's article 9(1) paragraph 2 further stipulates the specific inclusion in 'economic activity' when assets are exploited for the purposes of obtaining income therefrom on a continuing basis. In order to make sense of these seemingly contradictory paragraphs, it is assumed that paragraph 2 specifically deals with the exploitation of an asset where paragraph 1 speaks to the general purpose of a taxpayer's trade. As purpose and intentions are subjective concepts, finding legal standards to measure such purpose or intention objectively, is the aim of this section.

The *INZO* case provided the precedent for taxable persons whose purpose is to obtain income, but due to a variety of factors beyond their control are not able to produce such income.<sup>107</sup> The Court 'ruled that the right to deduct stands, even if planned activities do not take place<sup>108</sup> and that government

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<sup>104</sup> C-142/99 *Floridienne and Berginvest supra* note 92 paras 35, 36 and 40.

<sup>105</sup> *ibid* para 53.

<sup>106</sup> 268/83 *Rompelman / Minister van Financiën* [1985] ECR p. 655 para 19.

<sup>107</sup> C-110/94 *INZO / Belgische Staat supra* note 91 paras 20 and 21.

<sup>108</sup> *ibid* para 21.

authorities should accept the declared intention of the taxpayer<sup>109</sup> even though that does not prohibit the authorities from requiring documentary proof of the declared intention.<sup>110</sup> Also, “the tax authority may claim repayment of the sums retroactively on the ground that those deductions were made on the basis of false declarations.”<sup>111</sup>

Contrarily in the *Skellefteå Industrihus* case, the CJEU determined that when planned activities giving the right to input deduction are no longer planned and do not occur, the right to deduction may be extinguished.<sup>112</sup> This must be differentiated from a situation in which factors beyond the control of a taxable person prohibits the activity from continuing. In this case, their plans for construction were supported mainly by architectural services already acquired, but construction never commenced.<sup>113</sup> Due to the above, architectural services acquired were not VAT deductible and input VAT claims had to be adjusted down to nil.<sup>114</sup>

From the above two cases the general intention to produce income is seen as less important than the actual outcome of a taxpayer’s trade. The right to deduction is upheld when uncontrollable factors change the flow of business plans, but it is lost when those plans never commence. This assists in the clarification of article 9(1) para 1 of the VD. The specific intention with an asset according to article 9(1) para 2 of the VD will be explored in the following section. The cases considered dealt with the exploitation of capital goods, but the individual case facts are not discussed as the comparison instead aims to highlight the different ratio decidendis.

The often quoted *Rompelman* case<sup>115</sup> established that objective evidence must exist to prove that there was a real intention to exploit tangible or intangible assets, before the ultimate aim of a transaction can be disregarded.<sup>116</sup> Thereby the intentions of taxable persons in paras 1 and 2 of article 9(1) of the VD are linked. The assets in question consisted of immovable property. Besides declared intention, other facts and circumstances must confirm the intention and its commercial viability.<sup>117</sup> Active steps must be taken before a declared intention will be considered legitimate, and the nature of an asset is not sufficient to prove intention.<sup>118</sup>

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<sup>109</sup> *ibid* para 17.

<sup>110</sup> *ibid* para 23.

<sup>111</sup> C-110/94 *INZO / Belgische Staat* para 24, as seen in D. De Gouveia Pinto, “Fiscal Neutrality and Unjust Enrichment as principles to govern voluntary tax liability on letting and leasing of immovable property in Sweden and the European Union” p. 11 para 2.

<sup>112</sup> C-248/20 *Skellefteå Industrihus* [2021] Published in the Digital Digest ECLI:EU:C:2021:394 para 50.

<sup>113</sup> *ibid* para 24.

<sup>114</sup> *ibid* para 50.

<sup>115</sup> 268/83 *Rompelman / Minister van Financiën supra* note 106.

<sup>116</sup> *ibid* para 12.

<sup>117</sup> *ibid* paras 12 and 25.

<sup>118</sup> C-230/94 *Enkler / Finanzamt Homburg* [1996] ECR p. I-4517 paras 27 and 29.

In the *Gran Via Moinești* case<sup>119</sup> the use or intended use of capital goods purchased determined the right of deduction and the purpose in that specific situation was proved by the issuing of a building permit, planning certificate and actual demolition of a building.<sup>120</sup> When the intended use of a cost component is declared soon after its purchase, that intention is more secure.<sup>121</sup> When taxable goods are purchased but not used immediately, the timing element does not deter the right of deduction.<sup>122</sup>

In the *Gmina Ryjewo* case, it was decided that the initial use of a product does not determine the future use of a product<sup>123</sup> even if the secondary intention was not stated at the beginning of the purchase of capital goods; instead it is the taxable nature of the goods that affects both the initial and subsequent deductions.<sup>124</sup> The Court also stated that factual evidence determines whether a person is acting as a taxable person, by referring to the nature of the goods and time lapsed between the purchase of goods and taxable use thereof.<sup>125</sup> Further, prior registration for VAT strengthens the ability to deduct<sup>126</sup> and completion of the original intention strengthens the ability to deduct.<sup>127</sup>

The *Vittamed Technologijos* case<sup>128</sup> reiterated that the purpose of the transactions do not alter the economic nature of the transactions, but if there is no further intention to utilise products, the direct link is broken and adjustments become necessary.<sup>129</sup> The case relied on prior case law that stated ‘it is not for the tax authorities to assess the soundness of the taxable person’s reasons for abandoning the economic activity initially planned’.<sup>130</sup> Finally, if economic activities take place that were not necessarily planned, such as the sale of assets due to liquidation, the lack of initial planning towards such activity does not disqualify it from being classified as economic activity.<sup>131</sup>

In summary of the above four cases: For the asset-specific intention of an economic activity, declared plans at the time of commencement and at later stages must be accepted by tax authorities, but proof of the plans may be requested. Various factors should be considered to determine intentions to

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<sup>119</sup> C-257/11 *Gran Via Moinești* [2012] Published in the Digital Digest ECLI:EU:C:2012:759.

<sup>120</sup> *ibid* para 33.

<sup>121</sup> Terra B.J.M., Kajus J. & Szatmári Z. *Commentary on European VAT* Alarcón Díaz L. (ed.), Global Topics IBFD [2022] Chapter 4.

<sup>122</sup> C-257/11 *Gran Via Moinești supra* note 119 para 25 and C-97/90 *Lennartz / Finanzamt München III* [1991] ECR p. I-3795 para 14.

<sup>123</sup> C-140/17 *Gmina Ryjewo supra* note 2 para 20.

<sup>124</sup> *ibid* para 48.

<sup>125</sup> *ibid* para 38.

<sup>126</sup> *ibid* para 43.

<sup>127</sup> *ibid* para 48.

<sup>128</sup> C-293/21 *Vittamed Technologijos* [2022] Published in the Digital Digest ECLI:EU:C:2022:763.

<sup>129</sup> *ibid* paras 51 and 29.

<sup>130</sup> *ibid* para 33 and C-734/19 *ITH Comercial Timișoara* [2020] Published in the Digital Digest EU:C:2020:919 para 35.

<sup>131</sup> *ibid* para 50.

exploit, such as the nature of an asset, the time taken to start using the asset, and the taxable person's prior use of assets. This is not an exhaustive list as circumstances will determine the exploitative purpose of resources, in line with the principle of economic reality. From the above it is probable that a trader's intention with his or her assets does matter and may determine if the direct link exists or not. Economic reality is an aid to each of these types of cases, but at the same time creates more and more 'precedent', which in reality is just situational detailing.

Considering the above, the criteria contained in article 9(1) para 1 and 2 may be described as:

*Declared plans and unplanned additions to trade and exploit assets, which actually commences and is supportable by proof. Such plans may change during trade due to uncontrollable circumstances and are of less significance than the actual outcome of the trade.*

### **3.4 Legal Relationship**

Article 2 of the VD subjects the supply of goods and services for consideration to VAT. The case law in this section establishes that without a legal relationship between a supplier and a customer, such supply may no longer be subjected to VAT. This is not a legislative requirement, but has been established by the CJEU in its case law. However, some provisions in the VD that pertain to legal relationships do exist. Article 25 of the VD contains examples of the supply of services which are each based on assignment, obligation or performance. As these activities are hazardedly vulnerable without legal relationship, the article may imply a legal relationship to exist when services are supplied for consideration. Due to the lack of precise legislation on legal relationship, the CJEU's relevant case law is now considered.

In the *Tolsma* case Mr Tolsma was a musician who performed on a public highway and received donations from people passing by.<sup>132</sup> The question arose whether such donations constituted 'consideration' and whether Mr Tolsma's musical performances could meet the requirements of the supply of a service.<sup>133</sup> As the subjective amounts voluntarily given to Mr Tolsma were not quantifiable and not obligatory, the answer to that question was no, due to the requirement of 'consideration' not being met and due to the lack of legal relationship between Mr Tolsma and the passers-by. Consideration and legal relationship are linked and interdependent.<sup>134</sup> Lastly, Mr Tolsma's performance, purpose to make money and actual receipt of monies were irrelevant in determining the existence of a supply of services for consideration.<sup>135</sup> This indicates that the findings of Chapters 3.2 and 3.3 of this thesis do not comprehensively cover the requirements of the direct link test and that further criteria must be established.

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<sup>132</sup> C-16/93 *Tolsma / Inspecteur der Omzetbelasting* [1994] ECR p. I-743 para 16.

<sup>133</sup> *ibid* para 8.

<sup>134</sup> *ibid* para 14.

<sup>135</sup> *ibid* para 18.

Subsequently in the *Town & County Factors* case the legal relationship requirements were made clearer.<sup>136</sup> Town & County arranged a weekly competition which entrants gained access to by paying an entry fee and sending in an entry form. The entry form contained the rules which stipulated that the obligations created for Town & County were ‘binding in honour only’.<sup>137</sup> All obligations were met by Town & County.<sup>138</sup> The question was whether such a phrase as ‘binding in honour only’ could negate the legality of the agreement between the competition entrants and Town & County.<sup>139</sup> The answer to that question was no. The entry form constituted a sufficiently legal agreement and could not affect Town & County’s obligation to pay VAT on all entry fees received.<sup>140</sup> This case demonstrates that the concept of legal relationship is robust and cannot simply or easily be rendered void by specific wording of the agreement, where that wording could create arbitrary doubt when the economic reality of the situation proves such doubt to be needless.

Likewise, in the *Zita Modes* case,<sup>141</sup> Zita Modes transferred a part of its totality of assets to Milady in return for consideration, but Milady did not have the required authorisation to trade in such goods in its Member State of trade.<sup>142</sup> Such lack of authorisation, not forming a part of the legality of their agreement, could not deter the normal VAT application.<sup>143</sup> Again, the robustness of legal relationship is demonstrated in this case and the lack of legality on behalf of either parties to a transaction did not break the direct link. This case also demonstrates that legal relationship criteria pertain to the supply of both goods and services.

In the *Posnania Investment* case the relationship between a debtor and its creditor qualified as a legal relationship.<sup>144</sup> However, the specifics of this case meant that the debtor and creditor relationship was not enough to fulfil the requirements of ‘consideration’. Posnania Investment owed the Polish government tax monies. They made a deal with the tax authorities to provide the municipality with vacant land in lieu of their tax debt, as the provision of immovable property was their usual line of business.<sup>145</sup> After agreeing on the terms, they disagreed whether VAT should be levied on the provision of the land. Because taxes are statutory and are unilateral in nature, tax debts cannot be viewed as consideration for goods or services, which by their nature are bilateral.<sup>146</sup> Legal relationship which was originally

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<sup>136</sup> C-498/99 *Town and County Factors* [2002] ECR p. I-7173.

<sup>137</sup> *ibid* paras 7 and 8.

<sup>138</sup> *ibid* para 9.

<sup>139</sup> *ibid* para 16.

<sup>140</sup> *ibid* paras 24 and 31.

<sup>141</sup> C-497/01 *Zita Modes* [2003] ECR p. I-14393.

<sup>142</sup> *ibid* para 18.

<sup>143</sup> *ibid* para 54.

<sup>144</sup> C-36/16 *Posnania Investment* [2017] Published in the Digital Digest ECLI:EU:C:2017:361 para 32.

<sup>145</sup> *ibid* paras 13 and 14.

<sup>146</sup> *ibid* para 34.



acknowledged, was extinguished due to the unilaterality of taxes.<sup>147</sup> Due to this analysis, the CJEU ruled that no VAT in principle should be levied on the transaction, although it was clear that input VAT deductions had been claimed by Posnania Investment on the vacant land.<sup>148</sup>

The order of importance of various principles in the above case, is firstly the nature of the consideration (economic reality) secondly legal relationship (legal certainty) and thirdly the balanced system of VAT inputs and outputs (fiscal neutrality). The credibility of these principles differ, which may be a reason for the specific order of importance applied in this case.

In conclusion to this section: Robust legal relationship is required in order for the direct link to exist. Legal relationship and consideration requirements are interconnected. The economic reality of a relationship is of more significance than that of face value and an exchange between parties does not guarantee legal relationship. The wording of a legal agreement cannot render it void and neither can the presence of other unmet legal requirements. The nature of consideration may render a legal relationship void. Due to the above, the requirement for legal relationship may be formulated as follows:

*Robust agreement between parties that includes the provision of a form of valid consideration and does not undermine the actual terms of the relationship.*

### **3.5 Supply for consideration**

As expressed above, legal relationship and consideration requirements are interconnected. Whereas the focus in the prior section was on the parties involved, the focus in the following section is on the quid pro quo nature of a supply for consideration. A link must exist between the supply and its consideration. This is a different link to the direct link between one trader's input and output transactions, as the link in this section refers to the supply by one trader in return for a consideration provided by a consumer.

Firstly, in the *Coöperatieve Aardappelenbewaarplaats* case the supply in question was the storage of potatoes and the consideration was the reduction in shareholder's stocks.<sup>149</sup> 'Consideration' has a subjective character, but the interpretation thereof should be guided by community legislation.<sup>150</sup> The definition reads as follows:

‘...everything received in return for ... the provision of services, including incidental expenses...that is to say not only the cash amounts charged, but also, for example, the value of the goods received in exchange or, in the

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<sup>147</sup> *ibid* para 35.

<sup>148</sup> *ibid* paras 36 and 38.

<sup>149</sup> 154/80 *Staatsecretaris van Financiën / Coöperatieve Aardappelenbewaarplaats supra* note 14 para 6.

<sup>150</sup> *ibid* paras 4 and 9.

case of goods or services supplied by order of a public authority, the amount of the compensation received.<sup>151</sup>

However subjective this definition, a direct link between the consideration and the supply must exist, which the court found did not exist in the current case as the reduction of stocks with an uncertain monetary effect could not constitute payment.<sup>152</sup>

Secondly, in the *Apple and Pear Development Council* case<sup>153</sup> the supply in question was advertising and promotional services for the benefit of commercial apple and pear growers in England and Wales. The consideration received by the Council was mandatory charges based on the amount of hectares or sometimes trees.<sup>154</sup> The UK's House of Lords asked, as the Dutch Supreme Court in the prior case did, whether a direct link between the supply and the consideration existed.<sup>155</sup> As the advertising and promotional services benefitted some growers but not others, to an unquantifiable degree and beyond the control of either of the parties, this direct link was not established. The mandatory charges were levied regardless of the benefit or lack thereof of the services provided, supporting the absence of this direct link.<sup>156</sup> The mandatory industry charges were not found to be 'consideration' and so, neither were the advertising and promotional benefits found to be 'services'.<sup>157</sup> Consequently, the above two cases demonstrate that any element of uncertainty, from the supply or consideration's side, breaks the link between them and forfeits the right of deduction. It also demonstrates that supply for consideration is an indivisible unit, and when either of the elements fail the whole does too.<sup>158</sup>

As a secondary requirement for this link to exist, the *Mohr* case determined that consumption is required for VAT to be chargeable.<sup>159</sup> A Council Regulation at the time encouraged the discontinuation of milk farming, in return for compensation. Mr Mohr chose to discontinue his milk farming. Article 25 (b) of the VD includes 'the obligation to refrain from an act, or to tolerate an act or situation' within 'supply of services'. Due to this article Mr Mohr supplied a service.<sup>160</sup> However, as Advocate General (AG) Jacobs pointed out in his Opinion, no benefit or service was consumed by the German Bundesamt, as the Council Regulation was set up for the benefit of the (European) Community as a whole.<sup>161</sup> This case also highlights that the economic reality of a transaction will take precedence over its legal form,

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<sup>151</sup> *ibid* para 10 with reference to the Second Council Directive 67/228/EEC OJ 71 p.16 (The Second Directive) article 8(a) and Annex A point 13.

<sup>152</sup> 154/80 *Staatsecretaris van Financiën / Coöperatieve Aardappelenbewaarpplaats supra* note 14 para 12.

<sup>153</sup> 102/86 *Apple and Pear Development Council / Commissioners of Customs and Excise supra* note 21.

<sup>154</sup> *ibid* paras 4 and 5.

<sup>155</sup> *ibid* para 11.

<sup>156</sup> *ibid* paras 14 and 15.

<sup>157</sup> *ibid* para 16.

<sup>158</sup> *ibid* para 14.

<sup>159</sup> C-215/94 *Mohr / Finanzamt Bad Segeberg* [1996] ECR p. I-959 para 20.

<sup>160</sup> *ibid* paras 3 and 4.

<sup>161</sup> *ibid* paras 21-23.

and that interpretation of the VD should follow that. In reality, Mr Mohr's compensation received was unilateral.

The next case departs from the previous findings - the *Iberdrola* case.<sup>162</sup> Iberdrola was a private investor that purchased land in a holiday village in order to construct 300 holiday homes that, without a replacement of the water-waste system on the land, would not have sufficient access to sewage systems and because of this would not be purchasable.<sup>163</sup> The municipality had a permit to reconstruct the water-waste system, but Iberdrola offered to take up the work themselves, at no cost to the municipality, and the municipality agreed to the offer.<sup>164</sup> Subsequently, the tax deductibility of the cost components of the water-waste system's reconstruction was denied.<sup>165</sup> Based on the service for consideration requirements, there was no consideration provided, and according to prior case law the right to tax deduction of those costs should not have been granted. The reason for the granting can be pinned on the integral function of the deduction system which may in principle not be limited.<sup>166</sup> However, the right of deduction was only allowed to the extent that the construction costs did not exceed the minimum costs necessary to secure the output transactions and where the costs incurred were factored into the prices of the holiday homes. In a sense, there was a barter transaction between Iberdrola and the relevant Bulgarian Municipality. The Municipality acquired the water-waste system, and Iberdrola acquired the necessary facilities to be able to trade. Barter contracts and monetary contracts are two identical situations from an economic and a commercial perspective.<sup>167</sup>

In brief, to gain access to the right of deduction in VAT, a supply must be provided for consideration and a direct link must exist between them. Uncertainty will break that direct link, such as uncertain consideration or a service to many recipients without certain results. Consumption must occur in order for this link to exist. If consideration is not provided but a benefit is derived by the supplier, that benefit may be seen as consideration in kind. By the above, supply for consideration is:

*Certain consideration of any kind, directly linked and in return for supplies that will achieve a reasonably certain goal which will lead to consumption of a good or service.*

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<sup>162</sup> Joined Cases C-566/11, C-567/11, C-580/11, C-591/11, C-620/11 and C-640/11 *Iberdrola and others* [2013] Published in the Digital Digest ECLI:EU:C:2013:660.

<sup>163</sup> *ibid* paras 9-12.

<sup>164</sup> *ibid* para 11.

<sup>165</sup> *ibid* para 14.

<sup>166</sup> *ibid* para 25.

<sup>167</sup> C-283/12 *Serebryannay vek* [2013] Published in the Digital Digest ECLI:EU:C:2013:599 para 39.

### **3.6 The concept of consideration**

Certain circumstances may arise when the consideration provided for a supply does not meet specific requirements to secure a direct link between the supply and the consideration. The VD has changed various times over the past 35 years on the matter of ‘consideration’. The following section determines what the current requirements are. Article 73 in the VD states that the taxable amount shall include everything which constitutes consideration and case law has shown that a broad approach is taken.<sup>168</sup>

Firstly, in the *Naturally Yours Cosmetics* (NYC) case<sup>169</sup> beauty consultants working for NYC received products at largely discounted prices in order to remunerate their sub-consultants with free cream. However, VAT was charged on the retail prices of the cream due to the British VAT Law at the time.<sup>170</sup> The CJEU rephrased NYC’s question and asked ‘whether there is a direct link between the goods supplied for a price lower than the normal price and the value of the service which must be provided by the beauty consultant’.<sup>171</sup> The court recalled that consideration must be capable of being expressed in monetary terms, and that consideration is determined with subjective criteria, not objective criteria, due to the subjective value that such consideration may add.<sup>172</sup> In this case, the subjective value of the goods received by the beauty consultants was made up of two components: The discounted price that they paid NYC, as well as the price of the service that they delivered to NYC when they arranged for such sub-consultants. The value of that service was ascertained as the difference between the retail price and the discounted price. When those two components were put together, the subjective value of the goods was the same as the retail price. Subsequently, the British law did not contradict the VD.<sup>173</sup>

In another UK case, *Empire Stores Ltd*, the company sold goods by catalogue.<sup>174</sup> Sometimes customers would receive goods free of charge if they fulfilled certain requirements. The VAT treatment of those free of charge goods was questioned by the Manchester VAT tribunal.<sup>175</sup> A potential direct link was pointed out between the goods provided free of charge and promotional services provided by the customer in exchange for those goods.<sup>176</sup> Moreover, the consideration could in monetary terms be expressed as the cost price of the free good.<sup>177</sup> The ‘consideration’ was not affected by the existence of additional conditions that would determine whether the

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<sup>168</sup> C-380/99 *Bertelsmann* [2001] ECR p. I-5163 para 25.

<sup>169</sup> 230/87 *Naturally Yours Cosmetics Ltd / Commissioners of Customs and Excise* [1988] ECR p. 6365.

<sup>170</sup> *ibid* paras 5 and 6.

<sup>171</sup> *ibid* para 13.

<sup>172</sup> *ibid* para 16.

<sup>173</sup> *ibid* paras 17 and 18.

<sup>174</sup> C-33/93 *Empire Stores / Commissioners of Customs and Excise* [1994] ECR p. I-2329.

<sup>175</sup> *ibid* paras 7 and 10.

<sup>176</sup> *ibid* para 16.

<sup>177</sup> *ibid* para 17.

transaction took place or not.<sup>178</sup> Specific performance and contingency clauses do thus not alter established consideration.

Consideration for supplies between employers and their employees was questioned again in the *Hotel Scandic Gåsabäck* case.<sup>179</sup> The hotel offered their staff lunch in their canteen at a fixed price which was going to be lower than the cost price.<sup>180</sup> According to the Swedish Skatterättsnämnden the provision of those meals constituted a supply of a service.<sup>181</sup> That would mean that the difference between the staff cost and the company cost could be seen as a ‘free of charge’ component. The Commission and the Danish Government submitted that ‘the taxable amount is the consideration actually paid by the employee to the employer, even if that consideration is less than the cost price of the meals provided’, in line with article 11A(1)(a).<sup>182</sup> Article 11A(1)(a) of the Sixth Directive at the time specifically included subsidies directly linked to the price of the supply in the taxable amount.<sup>183</sup> However, the consideration received by the hotel from its staff was not understood to be an amount subject to a subsidy, as the transaction was between two parties and not three. The Court agreed with the Commission and the Danish Government that the VATable amount was to be the price paid by the staff to the hotel.<sup>184</sup> This case is important for the differentiation between self supplies (articles 16 and 26 of the VD) and a normal supply of goods or services for consideration (article 73 of the VD), which affects the taxable amount differently.

Lastly, the Hungarian case *Lajvér*<sup>185</sup> contained a full analysis of whether non-profit agricultural engineers had a direct link between their services and the consideration to be received for such services. The modesty of the fee made the referring court to question whether it would suffice as consideration. The CJEU’s ruling assisted with each element, but it was up to the national referring court to determine whether the modest fees to be received would qualify as consideration, taking into account all factors and if such fees would only be a partial remuneration.<sup>186</sup> Whether a price paid for an economic activity is higher or lower than market value and to be paid over a period of 8 years, is irrelevant in determining its sufficiency as consideration.<sup>187</sup> The ancillary character of their services could also not render it non-consideration,<sup>188</sup> but all factors had to be considered to ensure that it did not interfere with their economic activities.<sup>189</sup>

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<sup>178</sup> *ibid* para 15.

<sup>179</sup> C-412/03 *Hotel Scandic Gåsabäck* [2005] ECR p. I-743.

<sup>180</sup> *ibid* paras 12 and 13.

<sup>181</sup> *ibid* para 14.

<sup>182</sup> *ibid* para 20.

<sup>183</sup> The VD article 73.

<sup>184</sup> C-412/03 *Hotel Scandic Gåsabäck* *supra* note 179 para 29.

<sup>185</sup> C-263/15 *Lajvér* [2016] Published in the Digital Digest ECLI:EU:C:2016:392.

<sup>186</sup> *ibid* para 51(2).

<sup>187</sup> *ibid* paras 45-47.

<sup>188</sup> *ibid* para 34.

<sup>189</sup> *ibid* paras 16 and 35.

Taking the above cases into account, consideration must be: ascertainable in monetary terms, whether paid in cash or kind. It is determined with subjective criteria and may consist of services delivered. Contingencies do not undermine consideration. The consideration is the amount actually paid and includes subsidies directly linked to the price of the supply. For subsidies to be included in consideration, three parties are required for it to qualify as a subsidy. Neither the amount nor the length of time over which fees are paid will determine whether the amount qualifies as consideration. In summary, consideration is:

*An ascertainable value of any size, actually paid or payable, which may consist of cash, kind or services. It includes subsidies directly linked to the price of the supply and is not altered by contingencies.*

### **3.7 Third party involvement**

Sometimes the recipient of a supply is not the same person who provides the consideration. Does this break the direct link required for input VAT deduction? Sometimes the provider of a supply is not the same person who receives the consideration. Likewise the question must be asked, does this break the direct link required for input VAT deduction? This section considers relevant cases to find the limits that apply to these situations, that will simultaneously keep the direct link intact.

In the *First Choice Holidays case* a tour operator employed travel agents to sell holiday packages to customers.<sup>190</sup> The prices were set by the tour operator, but if the travel agent wanted to give the customer a discount they had to do so at the cost of their own commission. Article 26(2) of the Sixth Directive included both costs of a supply by the taxable person and costs of a service by another taxable person in the taxable amount, as long as both had direct benefit to a traveller.<sup>191</sup> Article 26(2) had specific provisions for certain transactions of travel agents and tour operators.<sup>192</sup> Concurrently, article 73 of the VD determines the general rule that the taxable amount of a supply shall consist of everything obtainable by the supplier from the customer or a third party. Both articles have the same effect that the taxable amount should be the total price paid by the traveller and do not contradict each other. Further, 'paid by the traveller' should not be interpreted so literally as to exclude payments by third parties on behalf of the traveller.<sup>193</sup> The commission foregone by the travel agent turned out to be part of the consideration provided for the holiday package and that is why the travel agent was a third party as in article 73 of the VD. The commission forgone cannot be considered a service provided to the tour operator, as the travel agent did not act as the representative of the customer, causing the old article 26(2) to not apply in this situation.<sup>194</sup> In this case, it was demonstrated that 'third parties' should not be limited unduly.

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<sup>190</sup> C-149/01 *First Choice Holidays* [2003] ECR p. I-6289.

<sup>191</sup> *ibid* para 18.

<sup>192</sup> *ibid* para 21.

<sup>193</sup> *ibid* paras 27 and 28.

<sup>194</sup> *ibid* para 19.

In the *AES-3C* case AES and AES Services were two companies with mutual interests.<sup>195</sup> AES Services provided staff to AES and remunerated the staff according to employment contracts between them and the staff. AES on the other hand, ran a power station and provided necessary goods and services free of charge to AES Services' staff, in order to conduct their business. AES remunerated AES Services for recruiting services.<sup>196</sup> Normally, articles 16 and 26 of the VD would apply to AES when making supplies to their staff for their private usage free of charge, but as the employment contracts are not made between AES and the staff, the correct VAT treatment was questioned. Further, whether the use of the supplies were private or not was also questioned.<sup>197</sup> In order to answer this question, the direct link test was conducted. It was found that all supplies made to the staff were strictly for business purposes, due to the specific circumstances of the case, and any personal benefit derived therefrom was secondary to this business purpose.<sup>198</sup> Despite the lack of a legal contract between AES and its 'staff', the economic reality of the set up was that the staff worked for AES. The Bulgarian law that would have limited the right of deduction was precluded by the VD.<sup>199</sup> The principle of fiscal neutrality would prohibit treatment of the set up that is different to other employee-employer situations.<sup>200</sup> An order of priorities can be taken from this case in descending order: economic reality, fiscal neutrality and legal certainty.

The *Vos Aannemingen* case<sup>201</sup> resembles the *AES-3C* case above with regards to benefits to third parties that are ancillary to the main business. Vos Aannemingen constructed and sold buildings that were built on land belonging to third parties. Advertising, administration and agent's services were all included in their service offering to their clients and therefore all billed with the accompanying output and input VAT.<sup>202</sup> The Belgian State asked whether the right of deduction was influenced when a taxable person had the ability to pass on a cost to a third party, but did not do so.<sup>203</sup> In response it was decided that the ability to pass on a cost to a third party who also benefits from it, is not in itself enough to break the direct link, but may contribute to such breakage when looking at all the facts of the situation.<sup>204</sup> The direct link was kept between the full range of Vos Aannemingen's services and the consideration provided to them by the third party landowners, but it was up to the referring Belgian national court to test that direct link.<sup>205</sup>

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<sup>195</sup> C-124/12 *AES-3C Maritza East I* [2013] Published in the Digital Digest ECLI:EU:C:2013:488.

<sup>196</sup> *ibid* paras 11-17.

<sup>197</sup> *ibid* paras 23 and 29.

<sup>198</sup> *ibid* paras 30-33.

<sup>199</sup> *ibid* para 39.

<sup>200</sup> *ibid* paras 34-38.

<sup>201</sup> C-405/19 *Vos Aannemingen* [2020] Published in the Digital Digest ECLI:EU:C:2020:785.

<sup>202</sup> *ibid* paras 6 and 7.

<sup>203</sup> *ibid* para 44.

<sup>204</sup> *ibid* para 47.

<sup>205</sup> *ibid* para 49(1) and (2).

The last case for this section is *Le Rayon D'or*.<sup>206</sup> The RCHE (French residence for the sick or elderly) received health care lump sums from the sickness insurance fund as a subsidy to provide healthcare to the residents. The provision of health care in RCHEs was obligated by law, even though such care did not need to be personalised and was not expressly paid for by the residents.<sup>207</sup> As has been demonstrated in this section, article 73 of the VD also makes inclusion for payments from third parties on behalf of consumers. Third party involvement does not break the direct link.<sup>208</sup> Importantly, the direct link does not require that a service be personalised when the service is permanently available.<sup>209</sup> The link is also not affected by the type of payment, being premiums or lump sums, nor by the fact that healthcare services were not defined in advance.<sup>210</sup>

To summarise the above line of case law: Third parties may pay for services supplied even though they don't benefit from it, and third parties may benefit from services even if they are not responsible for payment. Legislation must not be interpreted so strictly that payments on behalf of beneficiaries are excluded from 'consideration'. Any personal benefit that arises during the provision of a supply or consideration will not invalidate either of them as long as the main benefit is the business benefit. If a service is permanently available, the fact that it is not personalised or defined in advance, does not remove a third-party payment from the inclusion in consideration. The ability to pass on a cost to a third party who would also benefit from the service, is not enough as an independent factor, to break the direct link between the service and consideration therefor. In light of the above, third party involvement may be allowed as follows:

*The unenforceable choice by a third party to pay consideration, provide or receive supplies, regardless of minor personal benefit when the benefit to business supersedes it, even when a supply is undefined and impersonalised.*

### **3.8 Conclusion**

In this chapter six factors have been analysed to establish what the direct link test requires. That was done by looking at the most relevant CJEU case law per category of frequent legal issues. The following are the findings of the analysis.

Three factors are inherent elements of a direct and immediate link, namely economic activity, which carries a specific intention and is conducted within legal relationships between suppliers and customers. Those elements form three criteria for the right to input tax deductions to exist:

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<sup>206</sup> C-151/13 *Le Rayon d'Or* [2014] Published in the Digital Digest ECLI:EU:C:2014:185.

<sup>207</sup> *ibid* paras 19 and 22.

<sup>208</sup> *ibid* para 35.

<sup>209</sup> *ibid* paras 36 and 37.

<sup>210</sup> *ibid*.



- *The attempt to continuously produce income with related cost components and proof of active remunerated involvement, subject to optional deeming provisions selected by Member States.*
- *Declared plans and unplanned additions to trade and exploit assets, which actually commences and is supportable by proof. Such plans may change during trade due to uncontrollable circumstances and are of less significance than the actual outcome of the trade.*
- *Robust agreement between parties that includes the provision of a form of valid consideration and does not undermine the actual terms of the relationship.*

One may note that economic reality is key in each of the first three requirements. Further elements exist that may break that link if their criteria are not met. Those elements are the provision of a supply for a consideration, consideration which meets a standard and permissible third party involvement. The criteria developed by these three elements are:

- *Certain consideration of any kind, directly linked and in return for supplies that will achieve a reasonably certain goal which will lead to consumption of a good or service.*
- *An ascertainable value of any size, actually paid or payable, which may consist of cash, kind or services. It includes subsidies directly linked to the price of the supply and is not altered by contingencies.*
- *The unenforceable choice by a third party to pay consideration, provide or receive supplies, regardless of minor personal benefit when the benefit to business supersedes it, even when a service is undefined and impersonalised.*

From the above six criteria, it is clear that the direct link test contains more than what is usually referred to. Transparency and legal certainty of the criteria are necessary for the proper functioning of the EU VAT system. In order for transparency and legal certainty to exist, the criteria should be formulated, acknowledged and easily accessible by all affected parties. The maze of case law which is the current point of reference, does not sufficiently provide transparency and legal certainty to bolster the VAT deduction system. This list of criteria may create awareness of why confusion exists, confusion which increases the number of requests for preliminary rulings. This in turn may place excessive pressure on the EU legal system.

Chapter 3's analysis of the case law also identifies that economic reality often overrides both legal certainty and fiscal neutrality. Bearing that in mind, the study now proceeds to investigate the indirect link test.

## 4. The Indirect Link Test

Once the above test has been satisfied, in principle, the right to deduction may not be limited.<sup>211</sup> The following chapter considers a derogation<sup>212</sup> from the direct link test, which also leads to the granting of the right of deduction. The derogation will for simplicity sake be consolidated under the name of an indirect link test. A passed direct link test grants deduction rights due to a direct link between specific input costs and specific VAT outputs.<sup>213</sup> Contrarily, the indirect link test grants deduction rights of either overhead costs that link to a clearly defined part of economic activity or general costs that link to economic activity as a whole.<sup>214</sup> The overhead cost derogation will be considered first, wherafter the general cost derogation will be analysed.

When a vendor's trade consists of a mixture of taxable and non-taxable goods or services, a pro-rata deduction of the cost components towards the taxable supplies will be allowed.<sup>215</sup> However, the supply of non-taxable goods or services as part of a vendor's general business may utilise overhead costs that do have a direct link with taxable supplies.<sup>216</sup> In such a situation, the full deduction right may be granted. The following explores when this may be the case.

In two cases from the United Kingdom, *BLP Group* and *Abbey National*,<sup>217</sup> group companies transacting, amongst other things, in the sale of assets which qualified as exempt transactions, the British tax authorities challenged the deductibility of certain cost components of their trades.<sup>218</sup> In the *BLP Group* case the company sold 95% of its shares in a subsidiary in order to cover its debts and considered the costs of the sale to be deductible due to the principle of fiscal neutrality.<sup>219</sup> BLP claimed that accounting services employed towards liquidity requirements would have been tax deductible in other like situations.<sup>220</sup> However, the CJEU disagreed, as the alternative situation would include a direct link between accounting services on bank loans as an overhead cost to general taxable business, whereas the current use of accounting services did not link to general taxable business.<sup>221</sup> The CJEU pointed out that links between overhead costs and taxable

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<sup>211</sup> C-437/06 *Securenta* [2008] ECR p. I-1597 para 24.

<sup>212</sup> A.J. van Doesum & G-J. van Norden *supra* note 18.

<sup>213</sup> C-62/93 *BP Soupergaz / Greek State* *supra* note 59 para 18.

<sup>214</sup> A.J. van Doesum & G-J. van Norden *supra* note 18 sections 4.1 and 4.2.

<sup>215</sup> The VD article 174.

<sup>216</sup> C-98/98 *Midland Bank* *supra* note 1 paras 27 and 32.

<sup>217</sup> C-4/94 *BLP Group / Commissioners of Customs & Excise* [1995] ECR p. I-983 and C-408/98 *Abbey National* [2001] ECR p. I-1361.

<sup>218</sup> *ibid* both cases para 16.

<sup>219</sup> C-4/94 *BLP Group / Commissioners of Customs & Excise* *supra* note 217 paras 3, 12 and 13.

<sup>220</sup> *ibid* paras 14 and 15.

<sup>221</sup> *ibid* para 26.

transactions should be objective and that the lack of objectivity would contradict the principle of legal certainty.<sup>222</sup>

The *Abbey National* case was based on the same criteria for overhead costs but the taxpayers were now able to prove the direct link between overhead costs and taxable transactions of the business as a whole.<sup>223</sup> Professional fees on the transfer of a going concern were tax deductible when those fees were directly linked to a sufficiently large part of the business that was considered economic activity.<sup>224</sup>

In the *Investrand* case,<sup>225</sup> which also dealt with the sale of shares and related management activities, the sale of part of their share assets was ruled insufficient to form a direct link between Investrand's costs incurred in the sale and their economic activity as a whole.<sup>226</sup> At this point one may note that the same criteria in the direct link test play a role in the indirect link test and that legal certainty and fiscal neutrality play a role too.

Conversely, as seen in the *Kretztechnik* case,<sup>227</sup> the direct link criteria may be omitted in the indirect link test. In that case neither economic activity, supply or consideration were identified in the transaction in question, but because the input costs of the transaction could be seen as general costs directly linked to their business as a whole, input VAT deduction was allowed.<sup>228</sup> If the direct link sometimes plays a role in the indirect link test, and sometimes not, is the indirect link legally certain? When does it play a role and when does it not?

The trajectory of the case law at this point in time referred interchangeably to overhead costs and general costs. This perhaps created the impression that they are synonymous. The general cost derogation will now be investigated, which illustrates the difference between overhead and general cost deductions.

When a direct link can be established between general costs of the entire business and specific VAT inputs, the general costs may qualify for input VAT deduction, but will only be deductible in part relative to those VAT inputs.<sup>229</sup> Due to its part-nature it is less advantageous than the overhead cost derogation above. Articles 173 - 175 of the VD deal with proportional deductions. Articles 174 (2) a - c exclude amounts from deduction and bear significance in the following cases.

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<sup>222</sup> *ibid* para 24.

<sup>223</sup> C-408/98 *Abbey National supra* note 217 paras 35 and 36.

<sup>224</sup> *ibid* paras 18 and 40.

<sup>225</sup> C-435/05 *Investrand* [2007] ECR p. I-1315 para 38.

<sup>226</sup> IBFD. See Websites in the Bibliography.

<sup>227</sup> C-465/03 *Kretztechnik* [2005] ECR p. I-4357.

<sup>228</sup> *ibid* paras 19, 22, 26 and 36.

<sup>229</sup> C-98/98 *Midland Bank supra* note 1 para 28.

2. (a) “the amount of turnover attributable to supplies of capital goods used by the taxable person for the purposes of his business;”

In the *Sveda* case<sup>230</sup> a Lithuanian events company spent funds on capital goods that would only after 5 years of economic activity start to produce taxable income.<sup>231</sup> The deductibility of those capital goods was questioned by the Lithuanian tax authority.<sup>232</sup> The CJEU answered by referring to the direct link criteria such as economic activity and the vendor’s intentions.<sup>233</sup> Additionally, they utilised the broad measure of all the circumstances of *Sveda*’s transactions, supported by objective evidence.<sup>234</sup> Despite it not being said expressly, this broad approach is based on the principle of economic reality. Due to that an indirect link between the cost of the capital goods and the business activities as a whole was observed to exist by the CJEU, but was for the referring court to establish.<sup>235</sup> This was done in a similar fashion to the *PPG Holdings* case below. Both the direct and indirect link tests were conducted in a single case and used interchangeably in *Sveda*. Even though the provision in article 174 (2)(a) could have applied to the situation, the broad approach of a direct link between general costs and capital goods circumvented such application.

2. (b) “the amount of turnover attributable to incidental real estate and financial transactions;”

In the *NCC Construction Danmark* case,<sup>236</sup> NCC’s business was mainly the construction and secondarily the sale of real estate. Since the Danish law considered the sale of real estate to be an exempt activity NCC was called a hybrid taxable person, with general costs to be split between taxable and exempt activities.<sup>237</sup> In support of this the Danish tax authority interpreted article 174(2)(b) as a reason to exclude a portion of NCC’s general costs of property sales from their right of deduction.<sup>238</sup> The CJEU clarified the purpose of that provision which was to exclude transactions that were unrepresentative of the taxable person’s business activities, which if included would deprive the calculation of its materiality.<sup>239</sup> NCC’s real estate sales were however not considered to be incidental, but rather as direct, permanent and necessary part of their business objectives which carry commercial purpose and input costs could be deducted in full.<sup>240</sup> In light of this overview, NCC’s costs resemble the overhead cost cases in section 4.1, but purely due to the specific national legislation were threatened to be treated as partially deductible general costs. This indicates that the degree of deduction in the indirect link test is determined by national legislation and is

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<sup>230</sup> C-126/14 *Sveda* [2015] Published in the Digital Digest ECLI:EU:C:2015:712.

<sup>231</sup> *ibid* paras 8 and 24.

<sup>232</sup> *ibid* para 13.

<sup>233</sup> *ibid* paras 19-21.

<sup>234</sup> *ibid* para 22.

<sup>235</sup> *ibid* para 35.

<sup>236</sup> C-174/08 *NCC Construction Danmark* [2009] ECR p. I-10567.

<sup>237</sup> *ibid* paras 15-17.

<sup>238</sup> *ibid* para 19.

<sup>239</sup> *ibid* para 30.

<sup>240</sup> *ibid* paras 33 and 35.

therefore not a harmonised matter. In conclusion, the derogation contained in article 174(2)(b) was found to not apply.

2. (c) “the amount of turnover attributable to the transactions specified in points (b) to (g) of Article 135(1) in so far as those transactions are incidental.”

Article 135(1)(g) “the management of special investment funds as defined by Member States;”

In *PPG Holdings*, PPG set up a separate legal entity as their employees’ pension fund due to national legal requirements as employers.<sup>241</sup> PPG’s input VAT deduction of the administration and management costs of the fund were contested by the Dutch tax authority. PPG’s view was that the costs constituted general costs directly related to all of their taxable activities and should not have been limited. The Dutch authority questioned the direct link test requirements, in particular the consideration element per Chapter 3.6 of this research, as well as national and EU law on exemptions.<sup>242</sup> The CJEU answered the preliminary ruling with a broad measure of all the circumstances of PPG’s transactions and established a direct link between the pension fund costs and their business activities as a whole. In particular they highlighted the economic activity of PPG as well as the intention with the setting up of the pension fund,<sup>243</sup> which stems from the direct link test criteria, however this was not said explicitly by the CJEU. The UK government highlighted that it was still up to the national court to determine whether costs of running a third party pension fund were to be defined as general costs of a business and that the CJEU had not provided guidance thereto.<sup>244</sup> In conclusion, the derogation contained in article 174(2)(c) was found to not apply.

The above three cases indicate that the principle of economic reality is a main driver of the general cost component of the indirect link test. However, it is not common knowledge and that is why it is not legally certain.<sup>245</sup> The legislation on pro-rata deductions may be contested by the general cost derogation, despite its lack of legal certainty. The cases also indicate that the degree of deduction in the indirect link test is largely influenced by national legislation and consequently is not harmonised. The trend in the cases contained in Chapter 4 is one of a relaxation of the direct link test, but that is not expressly stated. The overhead cost derogation contains exceptions to the general rules of the direct link test. The general cost derogation is based on a broad approach to all circumstantial facts. These reasons are why the indirect link test may be formulated as a different test in entirety, instead of a derogation of the direct link test. This is a promising area for future research.

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<sup>241</sup> C-26/12 *PPG Holdings* [2013] Published in the Digital Digest ECLI:EU:C:2013:526 para 11.

<sup>242</sup> *ibid* paras 13, 16 and 17.

<sup>243</sup> *ibid* paras 24 and 26.

<sup>244</sup> EU VAT Committee Working Paper no. 812 *supra* note 6 p. 6 paras 6 and 7.

<sup>245</sup> Case of *The Sunday Times v The United Kingdom* *supra* note 30 para 49.

## 5. Conclusion

Six criteria for the direct and immediate link test were identified to determine requirements for VAT vendors to gain the right of deduction. Condensed, they are the presence of economic activity and a specific intention with that activity, conducted within a legal relationship that entails the provision of supplies in return for a particular consideration. Third parties may be involved in the transactions. The principle of economic reality was identified as a key factor in each of the first three criteria.

As with the South African example that inspired this criteria, the underlying cases that have fortified the criteria are a fluid list. This means that its legal certainty may remain concrete, but not inflexible. When new cases arise that will change the criteria, those cases must be added to the list. If any of the original cases on the list are obsoleted by a new case, they should be removed from the list. The cases are listed in tabular form at the end of this research.

If such criteria is communicated effectively to all Member States along with the EU's confidence, the harmonisation of the right of deduction could be a reality. However, this would require Member States to only make use of rebuttable and not irrebuttable presumptions. This would also require the national courts to make use of the criteria while maintaining their own confidence. The desired effect of this process would be the reduction in redundant requests for preliminary rulings which would lighten the legislative load of the CJEU.

After this the indirect link test was found to be a relaxation of the direct link test, but that obscurities exist within the connection between the two. The difference between an overhead cost derogation and a general cost derogation was discussed. The overhead cost derogation leans largely on the direct link test criteria but is treated inconsistently by the CJEU. The general cost derogation relies on a broad approach to all circumstances of a case, otherwise known as economic reality. There is also a need for the drafting of legally certain indirect link test criteria.

The current application of both the direct and indirect link tests rely on the principle of economic reality, but depend on national legislation and are thus not harmonised. When the principle of legal certainty is secured there is a case for the principle of economic reality to play a softer role.

Harmonised criteria for the direct link test will strengthen the deduction pole of EU VAT. With a strong deduction pole, the strong consumption pole may be fairly balanced. As consumption is a daily and universal event, real pressure exists for deduction to be as commonplace, while upholding precise and certain standards for all stakeholders to adhere to.

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# Addendum A:

## Direct Link Test Principle Cases

Case Name	Case No.	CJEU date	National Court	Summary
<b>1.Economic Activity</b>				
<u>Hong-Kong Trade</u>	89/81	1 April 1982	The Netherlands	If all goods or services are free of charge it is not economic activity. A 'price' is required.
<u>Commission / Finland</u>	C-246/08	29 October 2009	Finland	The goods or services must be directly linked to the price.
<u>Fini H</u>	C-32/03	3 March 2005	Denmark	Continued VAT claims over a period of time are permitted if the direct link is intact.
<u>Floridienne and Berginvest</u>	C-142/99	14 November 2000	Belgium	Management by shareholders is economic activity if their remuneration accurately reflects the activities.
<u>SKE</u>	C-29/08	29 October 2009	Sweden	Member State options and VAT exemptions may forfeit economic activity.
<b>2. Intention</b>				
<u>INZO</u>	C-110/94	29 February 1996	Belgium	The right to deduction is upheld when uncontrollable factors change the

<b>Case Name</b>	<b>Case No.</b>	<b>CJEU date</b>	<b>National Court</b>	<b>Summary</b>
				flow of business plans.
<u>Skellefteå Industrihus</u>	C-248/20	18 May 2021	Sweden	The right of deduction is lost when business plans never commence.
<u>Rompelman</u>	268/83	14 February 1985	The Netherlands	Objective evidence must exist to prove that there was a real intention to exploit tangible or intangible assets.
<u>Gran Via Moinești</u>	C-257/11	29 November 2012	Romania	Declared intentions serve as proof of intentions regardless of the timing of initial use, but:
<u>Gmina Ryjewo</u>	C-140/17	25 July 2018	Poland	The taxable nature of the goods affect both the initial and subsequent deductions.
<u>Vittamed Technologijos</u>	C-293/21	6 October 2022	Lithuania	If there is no further intention to utilise products the direct link is broken.
<b>3. Legal Relationship</b>				
<u>Tolsma</u>	C-16/93	3 March 1994	The Netherlands	Legal relationship validates consideration given in return for goods or services.
<u>Town and County Factors</u>	C-498/99	17 September 2002	The United Kingdom	The concept of legal relationship is robust and cannot simply or easily be rendered void by

Case Name	Case No.	CJEU date	National Court	Summary
				specific wording of an agreement.
<u>Zita Modes</u>	C-497/01	17 November 2003	Luxembourg	Lack of national authorisation, does not affect the legality of their agreement.
<u>Posnania Investment</u>	C-36/16	11 May 2017	Poland	Legal relationship on paper is extinguished when transactions are unilateral in reality.
<b>4. Supply for consideration</b>				
<u>Coöperatieve Aardappelenbe waarplaats</u>	154/80	5 February 1981	The Netherlands	A direct link between the consideration and the supply must exist.
<u>Apple and Pear Development Council</u>	102/86	8 March 1988	The United Kingdom	Any element of uncertainty from the supply or consideration's side breaks the link between them.
<u>Mohr</u>	C-215/94	29 February 1996	Germany	Unilaterality or the lack of consumption within a transaction will break the link.
<u>Iberdrola</u>	C-132/16	14 September 2017	Bulgaria	Barter may replace the traditional supply for consideration. Then the input costs may not exceed the minimum costs necessary to secure output transactions and must be factored into the

Case Name	Case No.	CJEU date	National Court	Summary
				prices of the output goods or services.
<b>5.Consideration</b>				
<u>Naturally Yours Cosmetics</u>	230/87	23 November 1988	The United Kingdom	Consideration must be capable of being expressed in monetary terms and is determined with subjective criteria.
<u>Empire Stores</u>	C-33/93	2 June 1994	The United Kingdom	Specific performance and contingency clauses do not alter established consideration.
<u>Hotel Scandic Gåsabäck</u>	C-412/03	20 January 2005	Sweden	The consideration is what was actually paid, even if that consideration is less than the cost price.
<u>Lajvér</u>	C-263/15	2 June 2016	Hungary	Whether a price paid is higher or lower than market value and to be paid over a period of time is irrelevant in determining its sufficiency as consideration.
<b>6.Third Party Involvement</b>				
<u>First Choice Holidays</u>	C-149/01	19 June 2003	The United Kingdom	The taxable amount of a supply shall consist of everything obtainable by the supplier from the customer or a third party and who that



<b>Case Name</b>	<b>Case No.</b>	<b>CJEU date</b>	<b>National Court</b>	<b>Summary</b>
				third party is may not be unduly limited.
<u>AES-3C</u>	C-124/12	18 July 2013	Bulgaria	The validity of a legal agreement and VAT treatment are unaffected when third parties hold the legal agreement on behalf of a taxpayer.
<u>Vos Aannemingen</u>	C-405/19	1 October 2020	Belgium	The ability to pass on a cost to a third party who also benefits from it, is not enough to break the direct link.
<u>Le Rayon D'or</u>	C-151/13	27 March 2014	France	Third party payments are not invalidated by their frequency or whether services are defined in advance and personalised or not.