OPINION OF ADVOCATE GENERAL RUIZ-JARABO COLOMER
delivered on 10 December 1996 *

1. In this action the Commission alleges that the Italian Republic has failed to fulfil the obligation to bring part of its tax law into conformity with Council Directive 77/388/EEC of 17 May 1977, Sixth Directive on the harmonization of the laws of the Member States relating to turnover taxes — Common system of value added tax: uniform basis of assessment [1] ('the Sixth Directive' and 'VAT').

2. The Commission asks the Court to rule that by enacting and maintaining in force a provision concerning value added tax which does not exempt supplies of goods used wholly for an activity which is exempted, or supplies of goods excluded from the right of deduction, the Italian Republic has failed to fulfil its obligations under Article 13B(c) of the Sixth Directive.

Procedure

3. The Commission initiated the procedure laid down in Article 169 of the EC Treaty by a letter of 24 November 1992 giving formal notice to the Italian Republic to submit its observations on the alleged failure. No reply was received within the period allowed.

4. Nevertheless, the Italian Government sent the Commission a letter dated 31 March 1993 admitting, with regard to the first part of the allegation, that 'the said Community provision has been only partly incorporated into national law'. With regard to the second part of the allegation, the Italian Government admitted that it was justified and added, 'the Italian tax authorities intend very shortly [...] to draw up the necessary provisions for incorporating the exemption to the system laid down by the Sixth Directive'.

5. In view of the continuing failure to fulfil the abovementioned obligations, on 19 July 1994 the Commission sent the Italian Government a reasoned opinion to which no reply was received.

6. An application was lodged with the Court on 13 February 1995. The defence lodged by

* Original language: Spanish.

1 — OJ 1977 L 145, p. 1.

the Italian Government opposed the claims in the application.

7. The Commission's reply drew attention, among other points, to the document of 31 March 1993 originating from the Italian Government itself, which admitted the existence of the failure. However, the Italian Government did not reply to those contentions as it did not lodge a rejoinder.

The contested provisions

8. Article 13B(c) of the Sixth Directive, which in the Commission's opinion has not been correctly implemented by the Italian legislature, provides as follows:

'Without prejudice to other Community provisions, Member States shall exempt the following under conditions which they shall lay down for the purpose of ensuring the correct and straightforward application of the exemption and of preventing any possible evasion, avoidance or abuse:

[...]

(c) supplies of goods used wholly [2] for an activity exempted under this Article or under Article 28(3)(b) when these goods have not given rise to the right to deduction, or of goods on the acquisition or production of which, by virtue of Article 17(6), value added tax did not become deductible;

[...]'

9. Article 17(6) in turn provides as follows:

'Before a period of four years at the latest has elapsed from the date of entry into force of this Directive, the Council, acting unanimously on a proposal from the Commission, shall decide what expenditure shall not be eligible for a deduction of value added tax. Value added tax shall in no circumstances be deductible on expenditure which is not strictly business expenditure, such as that on luxuries, amusements or entertainment.

2 — The Spanish translation of this part of the Sixth Directive, as published in the Special Spanish Edition of the Official Journal, omitted the adverb 'wholly' which appears in the other language versions.

Until the above rules come into force, Member States may retain all the exclusions provided for under their national laws when this Directive comes into force'. [3]

10. Article 10 of the Decree of the President of the Italian Republic of 26 October 1972, No 633 ('the Presidential Decree') [4] concerning VAT, does not include among the exempt transactions the supplies of goods referred to by the Community rules set out above.

11. Article 2(3)(h) of the Presidential Decree provides that 'supplies of goods purchased or imported by the supplier without a right of deduction, pursuant to Article 19(2)' are not deemed to be supplies of goods.

12. Article 19 of the Presidential Decree in turn regulates the right of deduction. A taxable person may deduct from the VAT payable on the transactions carried out by him the VAT he has paid to purchase goods or obtain services, in both cases in the context of carrying on a business or pursuing a profession or occupation.

13. Article 19(2) of the Presidential Decree excludes a right to deduct the VAT paid on purchasing certain types of goods, such as motor vehicles, other self-propelled vehicles and pleasure boats in terms which I shall examine below.

Exemption of supplies of goods previously used for an exempted activity

14. The deduction of VAT regulated by Article 17 of the Sixth Directive is a key element of the VAT system. The deduction rule ensures that the VAT amounts paid by traders do not give rise to any tax charge for them, thus upholding the principle of neutrality on which the system of VAT, which is a tax on the final consumer and not on the previous economic stages, is based. If there were no right to deduct the amounts of VAT paid, they would become one more tax charge on traders, thus distorting the principle of neutrality.

3 — On 25 January 1983 the Commission submitted to the Council a proposal for a Twelfth Directive on the harmonization of the laws of the Member States relating to turnover taxes — Common system of value added tax: expenditure which is not eligible for deduction (OJ 1983 C 37), which was subsequently amended by a further proposal of 20 February 1984 (OJ 1984 C 56). The Council did not achieve the unanimity necessary to approve it.

4 — The Presidential Decree regulates the legal system of VAT and was issued under a prior delegated legislative power. It was published in the *Gazzeta Ufficiale della Repubblica Italiana* (GURI) 292, 11 November 1972, and has been amended on numerous occasions.

15. VAT previously paid may be deducted in so far as the goods or services in question (i. e. those the purchase or use of which determines the right of deduction) are purchased and used by the taxable person in turn to carry out transactions in the course of his economic activity.

16. This principle must be modified where the taxable person purchases such goods or services and uses them solely for exempt transactions because in that case a right to deduction does not arise and he becomes, so to speak, the 'final consumer' and is not entitled to deduct the amount of tax.

17. In this situation the taxable person must pay the whole of the VAT passed on to him by previous producers, traders and persons supplying services (i. e. those who supplied him with the goods or services) and, in strictly legal terms, [5] he cannot deduct it. He is therefore in the same position as the final consumers, who are the true payers of VAT.

18. However, it may happen that a taxable person purchases a particular product under such conditions (i. e. paying VAT but unable to deduct it subsequently) and decides to transfer it at a later date.

19. This would give rise to double taxation if the Sixth Directive had not, in order to avoid this, provided for the exemption laid down by the first indent of Article 13B(c). The Member States must exempt supplies of goods used wholly for an exempted activity 'when these goods have not given rise to the right of deduction'.

20. The reason for this exemption is merely technical. It avoids the double tax charge which arises where tax is charged on the transfer by a trader who resells goods on which he has already made a final VAT payment, without having been able in turn to deduct the amount paid. [6]

21. The Italian Government has not incorporated this exemption into its tax system.

5 — It is a different matter where, by way of an increase in prices, a trader engaging in exempt transactions, for example an insurance company in relation to most of its services, or a doctor in relation to certain health services supplied to patients, shifts the tax burden on to customers.

6 — See the judgment in Case C-50/88 *Kühne* v *Finanzamt München III* [1989] ECR I-1925, which reaches the same conclusion in a case similar in some respects to the present case, in finding that 'such taxation of business goods on which the residual tax was not deductible would lead to double taxation contrary to the principle of fiscal neutrality which is inherent in the common system of value added tax, of which the Sixth Directive forms part'. In that case, the taxable person was not entitled to deduct the residual tax because he had purchased the goods second-hand from a non-taxable person.

This fact alone constitutes failure in respect of its obligation under Article 13 of the Sixth Directive because this provision requires the Member States to provide precisely for such a tax 'exemption' with the features described above.

22. The explanation for this situation given by the Italian tax authorities differs, depending on whether one reads the statement to the Commission of 31 March 1993 [7] or the defence.

23. According to the first statement, the Italian legislature considered that it should not introduce an exemption for supplies of goods intended exclusively for an exempt activity because of the existing difficulties of verification. Taxable persons engaged in exempt activities normally carry out taxable transactions at the same time and this enables them to recover, by means of the deductible proportion rules, part of the VAT paid for the purchase of those goods. In any case, according to the statement, the double taxation arising from the Italian provision is 'only marginal'.

7 — Delivered by the Permanent Representation of Italy to the European Communities (letter No 2868). I referred to it in my account of the pre-litigation procedure.

24. The defence changes this approach and now attempts to justify the absence of the exemption by claiming that Article 2(3) of the Italian Presidential Decree, instead of adopting the exemption, preferred to declare that supplies of goods of that kind are 'outside the ambit' of VAT, which, in its opinion, would lead to the same result as that desired by the Sixth Directive.

25. However, somewhat confusedly, the defence manages to admit that the later supply of goods 'must be deemed taxable' where it has not been possible to deduct the tax previously paid (because the goods were purchased or used for exempt transactions). It adds that such supplies must be deemed 'hypothetical because normally an exempt person purchases the goods for his own use and not with a view to selling them immediately'. Consequently, the defence concludes that the amount of double taxation must be limited because of the difference in value between goods purchased at market prices and those sold second-hand.

26. I am not persuaded by these arguments. On the contrary, I consider that the Commission is right to claim that the Italian Government should simply fulfil its obligation under Article 13 of the Sixth Directive. The nature of the obligation is quite specific: to

grant an exemption, not to exclude a particular transaction from the ambit of the tax. [8]

27. Furthermore the Italian legislation differs on this point from the case-law of the Court of Justice, according to which, the purpose of the Sixth Directive is 'to base the common system of VAT on a uniform definition of taxable transactions. This objective might be jeopardized if the preconditions for a supply of goods — which is one of the three taxable transactions — varied from one Member State to another (see the judgment in Case C-320/88 *Staatssecretaris van Financiën* v *Shipping and Forwarding Enterprise Safe BV* [1990] ECR I-285)'. [9]

28. Both explanations (which, moreover, are contradictory) given by the Italian authorities are unsatisfactory:

— the first (difficulty of verifying the actual use of the goods) because it distorts the VAT tax system and gives rise to double taxation;

— the second (deeming to be 'non-supplies of goods' transactions which, in the terms of the Sixth Directive, are as a matter of law 'supplies of goods' but are exempt) because this means that the Italian provision differs from the uniform definition which the Community legislature wished to give to transactions which are subject to the tax.

29. This alone would be a sufficient reason for granting the Commission's application in this first respect. In addition, it is not certain that the legal and financial consequences of the Italian provision (in so far as it formulates as a case of non-taxation what should be a case of exemption) are the same as those ensuing from the correct incorporation of the Sixth Directive.

30. In its reply, the Commission correctly points out that, if the Italian Government accepts the existence of double taxation as an actual effect of its legislation on the matter, it is irrelevant that, financially, it is more or less 'insignificant', as claimed in the defence (although no figures whatever are produced in support).

31. Even if the financial repercussions were negligible, the *de minimis* rule does not apply in relation to the failure of Member

8 — Strictly speaking, a tax exemption can be said to exist only where there is an act which was previously chargeable, i. e. subject to tax. By definition, an exemption presupposes an initial obligation to pay tax which, on various grounds, is waived by the legislature. Consequently there must be a right arising from a mandatory positive reference in the law in order to provide for exemption from the duty to pay the tax. Before ascertaining whether a particular transaction meets the requirements for the exemption, it is necessary to ensure that it falls within the ambit of the tax.

9 — Case C-291/92 *Armbrecht* [1995] ECR I-2775, paragraph 13.

States to fulfil their obligations with regard to legislation. The decisive factor is that double taxation is inconsistent with the scheme of the VAT system and precisely for that reason Article 13 of the Sixth Directive requires the Member States to exempt supplies of goods used wholly for an exempted activity.

Exemption of supplies of other goods the purchase or use of which has not given rise to a right of deduction

32. The second ground of the application relates to the last part of Article 13B(c) which, as cited above, requires the Member States to exempt from VAT the later supply of goods 'on the acquisition or production of which [by the taxable person], by virtue of Article 17(6), value added tax did not become deductible'.

33. Article 17(6) refers to certain expenditure described in general terms as 'that on luxuries, amusements or entertainment', [10] which is not strictly business expenditure and which is not eligible for the deduction of VAT by the taxable person. As in relation to the first ground of the application, the taxable person purchasing items of this kind acts as the final consumer, who is the true taxpayer.

34. The counterpart of this restriction of the right of deduction should be, as with the first ground of the application, exemption from VAT when the taxable person resells — or, in general, transfers — goods of this kind. Otherwise, there would again be double taxation, which is contrary to the principles of the Sixth Directive and which Article 13 tries to avoid by means of the contested exemption.

35. On the other hand, as there is generally no right to deduct VAT on the purchase of goods of that kind (subject to the qualification which I shall consider below), the Italian Presidential Decree does not grant an exemption on their subsequent transfer.

36. Article 19(2) of the Presidential Decree regulates the deduction of VAT on the purchase of goods of that kind, whether aircraft and motor vehicles referred to in Table B(e), irrespective of cylinder capacity, [11] or 'the

10 — Further details or a list should have been given by the Council, as I mentioned in footnote 3, but successive attempts at doing so were unsuccessful.

11 — These are referred to by Article 19(2)(a), which extends this system not only to purchase or importation, but also to supplies of services and maintenance relating to those goods.

other goods included in the said table B, seagoing vessels and pleasure craft'. [12] The deduction is provided for as follows:

(a) The purchase of such goods gives a right to deduction only where they are the subject matter of the trader's activity itself; in the case of aircraft and motor vehicles, deduction is also possible where they are intended for use in the trader's own business. [13]

(b) Deduction is excluded in the other cases of the purchase of such goods, and 'in any case for persons engaged in a trade [14] or profession'.

37. In these latter cases of exclusion of the right of deduction, the later transfer of the purchased goods is not exempt, as required by the Sixth Directive. Instead of granting the exemption, the Italian legislature provided, by means of Article 2(3)(h) of the Presidential Decree, that such transfers would not be deemed supplies of goods (i. e. would not be deemed subject to VAT).

38. To justify this action, the Italian Government states that classifying such supplies as non-taxable is 'consistent with the presumption that the purchase [of goods of that kind] is not connected with carrying on a business', citing for this purposes Article 17(3) of the Sixth Directive and Article 11(2) of the Second VAT Directive.

39. I am not convinced by this argument, which concerns a different problem from that in the present case. The Commission is not complaining in this case that Article

12 — These are referred to by Article 19(2)(b) of the Presidential Decree.

13 — It is logical that a trader providing a driving tuition service, or tuition for pilots, should be able to deduct the VAT paid on the purchase of the vehicles or aircraft which it intends to use solely for that purpose.

14 — The term 'trade' appears to be used to mean an occupation which requires a skill and special knowledge on the part of the person concerned. The Italian provision refers to 'gli esercenti arti o professioni'.

17(6) of the Sixth Directive has not been fulfilled by reason of the fact that the right of deduction for professional persons or artists is excluded in any case under the Italian provisions cited above, when they purchase the goods in question. It would be debatable whether this general exclusion meets the requirements of the Sixth Directive. [15]

40. The failure of which the Commission complains in this case refers, on the contrary, to the fact that the Italian Republic does not consider as exempt subsequent sales or supplies of goods which, when originally purchased, did not give rise to a right to deduct VAT, regardless of whether the taxable person is a professional person, artist or any other economic agent.

41. May exemption be replaced by non-liability to tax? At first sight, it might appear that the practical effect is the same. In its defence, the Italian Government's defence contends that non-liability depends on establishing the 'objective impossibility of deduction', whereas exemption means the 'subjective impossibility of deduction [...] depending on calculation of the deductible proportion'. [16]

42. However, the legal effects of the two concepts are not absolutely identical. It is precisely in the effect on the calculation of the deductible proportion [17] that the consequences of the Italian rule appear, with the difference in effect entailed by choosing one principle or the other.

43. If the supply of the contested goods were excluded from the ambit of VAT, which is what the Presidential Decree does, the taxable person's total turnover used in calculating the deductible proportion would be

15 — In paragraph 3 of the operative part of the judgment in Case C-97/90 *Lennartz* v *Finanzamt München* [1991] ECR I-3795, the Court held that 'a rule or administrative practice imposing a general restriction on the right of deduction in cases where there is a limited, but none the less, business use constitutes a derogation from Article 17 of the Directive and is valid only if the requirements of Article 27(1) or Article 27(5) of the Directive are met.'

16 — In the opinion of P. Filippi, in his work *Le cessioni di beni nell'imposta sul valore aggiunto* (Padua 1984), there is some confusion in the Italian VAT legislation with regard to the concepts of exclusion and exemption. Certain situations described as exemptions should be regarded as exclusions and vice versa. According to this author, the excessive number of exclusions makes it difficult to understand the criteria used when opting for one concept or the other.

17 — Regulated by Article 19 of the Sixth Directive. The deductible proportion arises where the taxable person simultaneously carries out transactions in respect of which VAT is deductible and transactions for which it is not deductible. In such a case, it is necessary to determine the degree of use of the goods and services purchased in relation to each category of transaction, establishing the percentage (of all the taxable person's transactions) which is attributable to those giving a right of deduction. Article 17(5) of the Sixth Directive permits the Member States certain alternatives to the deductible proportion rule. In the case of Italy, this is regulated by Article 19(3) of the abovementioned Presidential Decree.

reduced. [18] The reduction in this figure, which is the denominator of the fraction, increases the final result or percentage by reference to which the deductible proportion is calculated.

44. Such increase in the percentage of the deductible proportion also results in increasing the amount which may be deducted from the VAT previously paid by a taxable person who carries out transactions with and without a right of deduction, without distinction.

45. Even apart from the effect on the deductible proportion rule, I consider that the legal system applied by the Presidential Decree to these supplies of goods is contrary to the Sixth Directive.

46. However wide 'the legal scope for the States' discretion in implementing this Directive' to which the defendant Government refers, I consider that there is a clear, specific and unconditional obligation to classify as exempt a subsequent supply of the goods in question. Therefore exemption cannot be replaced by a different principle, particularly where the legal and practical consequences of the two options differ.

47. In this connection I must repeat what I have already said with regard to the definition of taxable transactions given in the Sixth Directive. If it is desired to ensure the uniform application of VAT, such definition does not allow a 'supply of goods' to be converted, by a decision of the national legislature, into a 'non-supply of goods'.

48. Furthermore, the same position was adopted by the Italian authorities in the letter to the Commission to which I have already referred. The Italian *Avvocato dello Stato* has not offered any argument, even in the course of the oral procedure, to justify the change, as against the preceding official argument, made by the defence.

49. I therefore find that the application should be granted in full. The defendant should pay the costs in accordance with Article 69(2) of the Rules of Procedure.

18 — To calculate the deductible proportion, it is necessary to determine the percentage of the total turnover which is attributable to transactions giving rise to a right of deduction. The result of multiplying by one hundred the turnover with a right of deduction and dividing it by the total amount of taxable transactions is precisely the percentage which determines the deductible proportion.

Conclusion

50. Consequently I propose that the Court grant the Commission's application by:

(1) declaring that, by enacting and maintaining in force a provision concerning value added tax which does not exempt supplies of goods used wholly for an activity which is exempted, or supplies of goods excluded from the right of deduction, the Italian Republic has failed to fulfil its obligations under Article 13B(c) of Council Directive 77/388/EEC of 17 May 1977, Sixth Directive on the harmonization of the laws of the Member States relating to turnover taxes — Common system of value added tax: uniform basis of assessment;

(2) ordering the Italian Republic to pay the costs.