JUDGMENT OF THE COURT (Fourth Chamber)

23 April 2009 *

In Case C-74/08,

REFERENCE for a preliminary ruling under Article 234 EC from the Nógrád Megyei Bíróság (Hungary), made by decision of 16 July 2007, received at the Court on 30 January 2008, in the proceedings

PARAT Automotive Cabrio Textiltetőket Gyártó kft

v

Adó- és Pénzügyi Ellenőrzési Hivatal Hatósági Főosztály Észak-magyarországi Kihelyezett Hatósági Osztály,

THE COURT (Fourth Chamber),

composed of K. Lenaerts, President of the Chamber, R. Silva de Lapuerta (Rapporteur) and J. Malenovský, Judges,

* Language of the case: Hungarian.

Advocate General: J. Kokott,
Registrar: B. Fülöp, Administrator,

having regard to the written procedure and further to the hearing on 4 March 2009,

after considering the observations submitted on behalf of:

— the Hungarian Government, by R. Somssich, J. Fazekas, K. Borvölgyi and M. Fehér, acting as Agents,

— the Commission of the European Communities, by D. Triantafyllou and K. Talabér-Ritz, acting as Agents,

having decided, after hearing the Advocate General, to proceed to judgment without an Opinion,

gives the following

Judgment

1 This reference for a preliminary ruling concerns the interpretation of Article 17(2) and (6) of Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonisation of the

laws of the Member States relating to turnover taxes — Common system of value added tax: uniform basis of assessment (OJ 1977 L 145, p. 1) ('the Sixth Directive').

2 The reference was made in the course of proceedings between PARAT Automotive Cabrio Textiltetöket Gyártó kft ('PARAT') and Adó- és Pénzügyi Ellenőrzési Hivatal Hatósági Főosztály Észak-magyarországi Kihelyezett Hatósági Osztály (local branch of tax office responsible for the north of Hungary, branch of the Central Tax Office; 'APEH'), concerning the determination of the ambit of national tax law concerning the right to deduct value added tax ('VAT') pertaining to the purchase of subsidised goods.

Legal context

Community legislation

3 Article 2 of First Council Directive 67/227/EEC of 11 April 1967 on the harmonisation of legislation of Member States concerning turnover taxes (OJ, English Special Edition 1967, p. 14) is worded as follows:

'The principle of the common system of [VAT] involves the application to goods and services of a general tax on consumption exactly proportional to the price of the goods and services, whatever the number of transactions which take place in the production and distribution process before the stage at which tax is charged.

On each transaction, [VAT], calculated on the price of the goods or services at the rate applicable to such goods or services, shall be chargeable after deduction of the amount of [VAT] borne directly by the various cost components.

…'

4 Article 17(2), (6) and (7) of the Sixth Directive, as amended by Council Directive 95/7/EC of 10 April 1995 (OJ 1995 L 102, p. 18), provides:

'2. In so far as the goods and services are used for the purposes of his taxable transactions, the taxable person shall be entitled to deduct from the tax which he is liable to pay:

(a) [VAT] due or paid within the territory of the country in respect of goods or services supplied or to be supplied to him by another taxable person;

…

6. 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 [VAT]. [VAT] shall in no circumstances be deductible on expenditure which is not strictly business expenditure, such as that on luxuries, amusements or entertainment.

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.

7. Subject to the consultation provided for in Article 29, each Member State may, for cyclical economic reasons, totally or partly exclude all or some capital goods or other goods from the system of deductions. To maintain identical conditions of competition, Member States may, instead of refusing deduction, tax the goods manufactured by the taxable person himself or which he has purchased in the country or imported, in such a way that the tax does not exceed the [VAT] which would have been charged on the acquisition of similar goods.'

National legislation

5 Chapter VIII of Hungarian Law No LXXIV of 1992 relating to value added tax ('VAT Law') which entered into force on 1 May 2004 — the date of accession of the Republic of Hungary to the European Union — contained, at the time of the facts in the main proceedings, in Article 38(1)(a), concerning the division of input tax, under the title 'Deduction of the tax' the following provision:

'Division of value added tax

Taxable persons shall record the amounts of [VAT] separately as deductible and non-deductible … A taxable person receiving any subsidies charged to public funds … not subject to taxation shall, unless otherwise prescribed by the act on the annual budget,

(a) be entitled to exercise his right of tax deduction only up to the amount not subsidised in the purchases of individual goods for which any subsidy is received;

…'

6 The abovementioned provision was repealed with effect from 1 January 2006. However that measure was not retroactive. Therefore, the application of the pro rata calculation of the subsidies financed by public funds applied for every purchase of goods made before 31 December 2005.

The dispute in the main proceedings and the questions referred for a preliminary ruling

7 Pursuant to a subsidy contract of 11 May 2005 concluded with the Magyar Fejlesztési Bank (the Hungarian Development Bank), on behalf of the Gazdasági és Közlekedési Minisztérium (the Ministry of the Economy and Transport), PARAT made an investment for the purpose of enlarging its production capacity for convertible tops for cars in the year 2005. That contract had granted PARAT a non-repayable subsidy of 47% of the total amount of the investment costs.

8 For that investment, PARAT entered four invoices issued for the purchase of the machinery totalling HUF 43 882 853, deducting all the VAT indicated on those invoices, that is to say, HUF 10 971 718, in its tax return for the month of September 2005.

9 Subsequently, the Nógrád Megyei Igazgatóság Kiutalás Előtti Ellenőrzési Osztálya (Inspection Division of the Directorate for Tax Administration of the county of Nógrád) carried out an audit of the aforementioned tax return which concluded that PARAT, because of the non-repayable subsidy which it had received, had to reduce that amount of VAT deducted with regard to the purchase of machinery in the context of the investment made.

10 APEH then calculated the amount of deductible VAT on the basis of the proportion of the finance received (47%), finding that, instead of the amount of HUF 10 971 718 which PARAT had deducted as VAT on the machinery purchased, PARAT was entitled to a deduction of HUF 5 748 000. APEH then determined the amount of non-deductible VAT, which after the calculation of the remaining portion, was HUF 5 223 718, and that amount was charged to PARAT as a tax debt. In addition, that amount was increased by a fine and a penalty for delay.

11 In its complaint against that decision, PARAT applied to have the tax debt, the fine and the penalty for delay annulled. In particular, it pointed out that the national legislation applicable at the material time constituted a restriction of the right to deduct VAT contrary to the provisions of the Sixth Directive. PARAT's complaint was dismissed by APEH.

12 PARAT then brought an action for annulment of the decision ordering the recovery of the tax debt, and a fine and a penalty for delay. It stressed, in particular, that Article 17(2) of the Sixth Directive allowed it to deduct the total amount of VAT shown in the invoices corresponding to the machinery acquired.

13 In those circumstances, the Nógrád Megyei Bíróság (Nógrád County Court) decided to stay the proceedings and to refer the following questions to the Court for a preliminary ruling:

'(1) On 1 May 2004, the date of accession of the Republic of Hungary to the European Union, were the rules laid down in Article 38(1)(a) of the [VAT Law] compatible with Article 17 of Sixth Council Directive …?

(2) If the answer is in the negative, may the applicant rely directly on Article 17 of the Sixth Directive when exercising the right to deduct, rather than on Article 38(1)(a) of the [VAT Law]?'

The questions referred

First question

14 By its first question, the referring court essentially asks whether it is not contrary to the provisions set out in Article 17 of the Sixth Directive for a Member State to exclude the right to deduct VAT for the part of the purchase price of goods which comes from a subsidy financed by public funds.

15 In order to answer that question, it is to be recalled first of all that the right to deduct VAT, as an integral part of the VAT scheme, is a fundamental principle underlying the

common system of VAT, and in principle may not be limited (see Joined Cases C-110/98 to C-147/98 *Gabalfrisa and Others* [2000] ECR I-1577, paragraph 43; Case C-409/99 *Metropol and Stadler* [2002] ECR I-81, paragraph 42; and Case C-465/03 *Kretztechnik* [2005] ECR I-4357, paragraph 33).

16 The Court has also ruled, in the paragraphs of the case-law cited above, that, according to the principles governing the common system of VAT, that tax applies to each transaction by way of production or distribution, after deduction has been made of the VAT which has been levied directly on transactions relating to inputs. The right of deduction must be exercised immediately in respect of all the taxes charged on input transactions. It follows that any limitation on the right of deduction of VAT affects the level of the tax burden and must be applied in a similar manner in all Member States.

17 In addition, it should be pointed out that Article 17(2) of the Sixth Directive sets out, in explicit and precise terms, the principle of the taxable person's right to deduct the amounts invoiced as VAT for goods supplied or services rendered to him, in so far as such goods or services are used for the purposes of his taxable transactions (see *Metropol and Stadler*, paragraph 43; Case C-371/07 *Danfoss and AstraZeneca* [2008] ECR I-9549, paragraph 27; and Case C-414/07 *Magoora* [2008] ECR I-10921, paragraph 29).

18 In those circumstances, derogations are permitted only in the cases expressly provided for in the Sixth Directive (see Joined Cases C-177/99 and C-181/99 *Ampafrance and Sanofi* [2000] ECR I-7013, paragraph 34; *Danfoss and AstraZeneca*, paragraph 26; and *Magoora*, paragraph 28).

19 As regards national legislation such as that at issue in the main proceedings, entitled 'Deduction of the tax', it should be noted that it contains a general limitation of the right to deduct VAT which applies to every acquisition of goods benefiting from a subsidy financed from public funds.

20 Such national legislation introduces, with regard to the purchase of goods or services financed by a subsidy, a restriction of the right to deduct which is not permissible under Article 17(2) of the Sixth Directive (see, to that effect, Case C-204/03 *Commission* v *Spain* [2005] ECR I-8389, paragraphs 26 and 27, and Case C-243/03 *Commission* v *France* [2005] ECR I-8411, paragraph 32).

21 The principle of the right to deduct VAT is none the less subject to the derogation set out in the second subparagraph of Article 17(6) of the Sixth Directive. In accordance with that provision, Member States are authorised to retain their existing legislation as at the date of entry into force of that directive in regard to exclusion from the right of deduction of VAT until such time as the Council has determined the costs not covered by that right (see *Metropol and Stadler*, paragraph 44, and *Danfoss and AstraZeneca*, paragraph 28).

22 The second subparagraph of Article 17(6) of the Sixth Directive contains a standstill clause which provides for the retention of national exclusions from the right to deduct VAT which were applicable before the Sixth Directive entered into force for the Member State concerned. The objective of that provision is to allow Member States, pending the establishment by the Council of the Community system of exclusions from the right to deduct VAT, to maintain any rules of national law excluding that right to deduct which were actually applied by their public authorities at the date of entry into force of the Sixth Directive (see *Metropol and Stadler*, paragraph 48; *Danfoss and AstraZeneca*, paragraphs 30 and 31; and *Magoora*, paragraph 35).

23 However, arrangements providing for a derogation from the principle of the right to deduct VAT, which are laid down in a general manner in Article 17(2) of the Sixth Directive and which ensure the neutrality of that tax, are to be interpreted strictly (see *Metropol and Stadler*, paragraph 59, and *Magoora*, paragraph 28).

24 As far as a situation such as that in the main proceedings and the applicability of the derogating rules are concerned, it should first be noted that the Sixth Directive entered into force in Hungary on the date of its accession to the European Union, that is 1 May

2004. Therefore, that is the material date for the purposes of the application of Article 17(6) of that directive as regards that Member State (see, to that effect, *Magoora*, papragraph 27).

25 In order to assess national legislation such as that at issue in the main proceedings in the light of those Community derogating rules, it must be noted that, as is apparent from paragraph 19 above, it constitutes a measure of a general nature restricting the right to full deduction of input VAT relating to the acquisition of goods financed by a subsidy from public funds.

26 That legislation entails a restriction of the right to deduct which goes beyond what is authorised by Article 17(6) of the Sixth Directive.

27 The second subparagraph of Article 17(6) of the Sixth Directive must be read in the light of the first subparagraph of the same provision, which confers on the Council the power to determine, on a proposal from the Commission, what expenditure is not to be eligible for a deduction of VAT, and which specifies that, in no circumstances, is expenditure to be deductible which is not strictly business expenditure, such as that on luxuries, amusements or entertainment.

28 Consequently, and in view of the strict interpretation which it must be given as a derogation, the second subparagraph of Article 17(6) of the Sixth Directive cannot be regarded as permitting a Member State to maintain a restriction of the right to deduct VAT which may also apply in a general manner to any expenditure related to the acquisition of goods, irrespective of its nature or purpose.

29 That interpretation is also obvious in the light of the history of that provision, which demonstrates a continuing intention on the part of the Community legislature to authorise only the exclusion of certain goods or services from the deduction system, and not to authorise general exclusions from that system (see, to that effect, Case C-305/97 *Royscot and Others* [1999] ECR I-6671, paragraph 22, and Case C-434/03 *Charles and Charles-Tijmens* [2005] ECR I-7037, paragraphs 32 and 35).

30 The answer to the first question is therefore that Article 17(2) and (6) of the Sixth Directive must be interpreted to the effect that it precludes national legislation which, in the case of acquisition of goods subsidised by public funds, allows the deduction of related VAT only up to the limit of the non-subsidised part of the costs of that acquisition.

Second question

31 By its second question, the referring court asks, essentially, if a taxable person may rely on Article 17 of the Sixth Directive in order to challenge national legislation which restricts the right to deduct VAT in a manner not compatible with Article 17(2) and (6).

32 In order to answer that question, it should be recalled that the Court held in Case C-62/93 *BP Soupergaz* [1995] ECR I-1883, paragraph 35, that Article 17(2) of the Sixth Directive clearly specifies the conditions giving rise to the right to deduct and the extent of that right, and does not leave the Member States any discretion as regards implementation.

33 The Court therefore held at paragraphs 35 and 36 of that judgment that Article 17(2) of the Sixth Directive confers rights on individuals which they may invoke before a

national court in order to challenge national rules that are incompatible with that provision.

34 The Court also stressed that, in so far as an exception from the system of deductions has not been established in accordance with the provisions of the Sixth Directive, the national tax authorities may not rely as against a taxable person on a provision derogating from the principle of the right to deduct VAT (see Case C-228/05 *Stradasfalti* [2006] ECR I-8391, paragraph 66).

35 A taxable person having been subject to such a measure must therefore be able to recalculate his VAT debt in accordance with Article 17(2) of the Sixth Directive, in so far as the goods and services have been used for the purposes of taxable transactions (see *Stradasfalti*, paragraph 68).

36 Consequently, the answer to the second question is that Article 17(2) of the Sixth Directive confers on taxable persons rights on which they may rely before a national court to contest national rules that are incompatible with that provision.

Costs

37 Since these proceedings are, for the parties to the main proceedings, a step in the action pending before the national court, the decision on costs is a matter for that court. Costs incurred in submitting observations to the Court, other than the costs of those parties, are not recoverable.

On those grounds, the Court (Fourth Chamber) hereby rules:

1. **Article 17(2) and (6) of Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes — Common system of value added tax: uniform basis of assessment must be interpreted to the effect that it precludes national legislation which, in the case of acquisition of goods subsidised by public funds, allows the deduction of related VAT only up to the limit of the non-subsidised part of the costs of that acquisition.**

2. **Article 17(2) of Sixth Directive 77/388 confers on taxable persons rights on which they may rely before a national court to contest national rules that are incompatible with that provision.**

[Signatures]