JUDGMENT OF THE COURT (Fifth Chamber)

22 February 2001 *

In Case C-408/98,

REFERENCE to the Court under Article 177 of the EC Treaty (now Article 234 EC) by the High Court of Justice of England and Wales, Queen's Bench Division (Divisional Court), for a preliminary ruling in the proceedings pending before that court between

Abbey National plc

and

Commissioners of Customs and Excise,

on the interpretation of Articles 5(8) and 17(2)(a) of the 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),

* Language of the case: English.

THE COURT (Fifth Chamber),

composed of: D.A.O. Edward, acting as President of the Fifth Chamber, P. Jann and L. Sevón (Rapporteur), Judges,

Advocate General: F.G. Jacobs,
Registrar: L. Hewlett, Administrator,

after considering the written observations submitted on behalf of:

— Abbey National plc, by R. Cordara QC and D. Southern, Barrister, instructed by S. Rose, Solicitor,

— the United Kingdom Government, by R. Magrill, acting as Agent, and K. Parker QC and M. Hall, Barrister,

— the Netherlands Government, by M.A. Fierstra, acting as Agent,

— the Commission of the European Communities, by E. Traversa and F. Riddy, acting as Agents,

having regard to the Report for the Hearing,

after hearing the oral observations of Abbey National plc, the United Kingdom Government and the Commission, represented by R. Lyal, acting as Agent, at the hearing on 23 February 2000,

after hearing the Opinion of the Advocate General at the sitting on 13 April 2000,

gives the following

Judgment

1 By order of 2 November 1998, received at the Court on 17 November 1998, the High Court of Justice of England and Wales, Queen's Bench Division (Divisional Court), referred to the Court for a preliminary ruling under Article 177 of the EC Treaty (now Article 234 EC) three questions on the interpretation of Articles 5(8) and 17(2)(a) of the 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 Those questions were raised in proceedings between Abbey National plc ('Abbey National') and the Commissioners of Customs and Excise ('the Commissioners') concerning the right to deduct the value added tax (VAT) paid on the fees for various services acquired in order to effect the transfer of a property as a going concern.

Legal background

Community legislation

3 The second paragraph of Article 2 of the 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, 'the First Directive') prescribes that '[o]n each transaction, value added tax, 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 value added tax borne directly by the various cost components'.

4 Article 2(1) of the Sixth Directive prescribes that the supply of goods or services effected for consideration within the territory of the country by a taxable person acting as such is to be subject to VAT.

5 Under Article 5(8) of the Sixth Directive:

'In the event of a transfer, whether for consideration or not or as a contribution to a company, of a totality of assets or part thereof, Member States may consider that no supply of goods has taken place and in that event the recipient shall be treated as the successor to the transferor. Where appropriate, Member States may take the necessary measures to prevent distortion of competition in cases where the recipient is not wholly liable to tax.'

6 Under Article 13C(a), 'Member States may allow taxpayers a right of option for taxation in cases of ... letting and leasing of immovable property'.

7 Article 17(2)(a) of the Sixth Directive states:

'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) value added tax due or paid in respect of goods or services supplied or to be supplied to him by another taxable person'.

8 As regards goods and services used by a taxable person both for transactions in respect of which VAT is deductible and for transactions in respect of which VAT is not deductible, the first subparagraph of Article 17(5) of the Sixth Directive states that 'only such proportion of the value added tax shall be deductible as is attributable to the former transactions'. The second subparagraph of Article 17(5) states that '[t]his proportion shall be determined, in accordance with Article 19, for all the transactions carried out by the taxable person'.

National legislation

9 It appears from the order for reference that the United Kingdom, making use of the option provided for in Article 5(8) of the Sixth Directive, adopted *inter alia* Regulation 5(1) of the Value Added Tax (Special Provisions) Order (SI 1995 No 1268, 'the VAT Order'), which replaced Regulation 5(1) of the Value Added Tax (Special Provisions) Order (SI 1992 No 3129). Under that provision, where a person transfers a business or part of a business as a going concern, the transfer is neither regarded as a supply of goods nor as a supply of services. The transferee

must use the assets for carrying on the same kind of business as the transferor, and must be, or immediately become, a taxable person. In the case of a transfer of part of a business, that part must be capable of separate operation.

The main proceedings and the questions referred for a preliminary ruling

10 Scottish Mutual Assurance plc ('Scottish Mutual'), a life assurance company, is a 100% subsidiary of Abbey National, which represents it for VAT purposes.

11 In addition to its insurance business, Scottish Mutual carries on a business leasing premises for professional or commercial use. As part of that activity, it held a 125-year lease of Atholl House, Aberdeen, a building for professional and commercial use which it sublet to commercial tenants. Scottish Mutual had opted to charge VAT on the rent it received for Atholl House, in accordance with the United Kingdom legislation transposing Article 13C(a) of the Sixth Directive, and was thus able to recover all the input VAT paid on the costs connected with ownership of the building.

12 By a contract of 16 December 1992, Scottish Mutual sold its rights under the 125-year lease and its rights in the sub-lease for GBP 5 400 000 to a company not belonging to the same group. The Commissioners considered that the sale constituted a transfer as a going concern within the meaning of Regulation 5(1) of the VAT Order, that the other conditions in that regulation were satisfied, and that no VAT was therefore due on the sale price.

13 However, in order to effect the transfer, Scottish Mutual used various services and thus incurred professional fees, on which it had to pay GBP 4 365 as VAT.

14 The Commissioners considered that only part of the input VAT paid on those costs could be recovered. Abbey National, which contended that it was entitled to recover all the VAT, applied to the VAT and Duties Tribunal in London. That application was dismissed by decision of 9 June 1997. Abbey National then appealed to the High Court of Justice.

15 In those circumstances, the High Court stayed the proceedings and referred the following questions to the Court for a preliminary ruling:

'1. Having regard to the terms of Article 17(2) of the Sixth VAT Directive, do the words in Article 5(8) thereof "the recipient shall be treated as the successor to the transferor" require that the recipient's supplies should be treated as if they had been made by the transferor, for the purpose of determining the transferor's input tax deduction?

2. In the event of "a transfer ... of a totality of assets or part thereof" within Article 5(8) of the Sixth VAT Directive, where the Member State, by virtue of national measures adopted pursuant to that article, considers that no supply of goods or services has taken place, may the taxpayer, upon the proper interpretation of Articles 5(8) and 17(2), deduct the whole of the input tax in respect of costs attributable to the transfer, if the taxpayer would, apart from the application of Article 5(8), be obliged to account for output tax on the transfer?

3. Where the economic activity of the transferor prior to the transaction falling within Article 5(8) has been fully taxable, is input tax deductible in respect of a payment made in connection with the termination of that activity?'

The questions referred for a preliminary ruling

16 By those three questions, which it is appropriate to consider together, the national court is essentially asking whether, in circumstances where a Member State has exercised the option in Article 5(8) of the Sixth Directive, so that the transfer of a totality of assets or part thereof is regarded as not being a supply of goods, the transferor may deduct the VAT on the costs of the services acquired in order to effect the transfer.

Arguments of the parties

17 Abbey National contends that, where a totality of assets or part thereof is transferred, the transferor is entitled to deduct the input VAT on the expenditure he has incurred for the services acquired in order to carry out the transfer.

18 It submits in particular that for VAT purposes, where the transferor and the transferee both, one before and one after the transfer, use the assets of the transferred business to make fully taxable supplies, the transferor may under Article 5(8) of the Sixth Directive take account of the transferee's taxable supplies so as to recover the input VAT in full. In other words, although there is no taxable transaction as such, for the purposes of input VAT there is still a direct and

immediate link with the transferee's taxable economic activities relating to the assets transferred.

19 The Netherlands Government observes that, where a Member State has opted to apply Article 5(8) of the Sixth Directive, the goods and services — which are taxable by nature — supplied in connection with the transfer of the totality of assets or part thereof are 'ignored'. Such a 'silent' substitution of one taxable person for another, for the purposes of the application of VAT, can relate only to the ordinary economic activities of the transferor. Those economic activities must also determine the right to deduct the VAT on the costs incurred by him in order to effect the transfer. If the taxable person makes only exempt supplies, there is no right to deduct. If he makes both taxable supplies and exempt supplies, the pro rata rule in Articles 17(5) and 19 of the Sixth Directive applies. If the transferor's ordinary economic activities, prior to a transfer falling within Article 5(8) of the Sixth Directive, were taxed in full, the input VAT paid on the costs incurred for the purposes of the cessation of those activities is deductible.

20 The United Kingdom Government submits that, since the costs incurred in order to effect the transfer were used for the purposes of a transaction which was not taxable, there is no right to deduct the input VAT paid on those costs. A contrary interpretation would jeopardise the neutrality of VAT, as the taxable person would then, in respect of the same transaction, have the financial benefit of a deduction of the input VAT without the corresponding obligation to account for the output VAT.

21 In the alternative, the United Kingdom Government argues that the costs incurred as a result of terminating a taxable activity in the context of a principal economic activity comprising both taxable and exempt supplies may be characterised as overheads. As non-attributable input tax, the deductible proportion of that tax must therefore be determined by a method authorised by Article 17(5) of the Sixth Directive.

22 The Commission submits that it is necessary to examine whether the services acquired by the transferor in order to effect the transfer have a sufficiently direct and immediate link with a taxable economic activity. It appears from Article 5(8) of the Sixth Directive that on a transfer of a totality of assets or part thereof there is no supply of goods and the same economic activity continues. The costs incurred to acquire those services are therefore costs incurred for the purposes of that economic activity, that is to say, overheads of the business transferred.

23 However, as regards the application of Article 17(5) of the Sixth Directive, the Commission merely observes that the costs incurred for those services may be regarded either as overheads of the economic activity transferred, in which case the transferor can deduct all the VAT charged on them, or as overheads of the economic activity of the transferor taken as a whole.

Findings of the Court

24 It should be noted, to begin with, that the deduction system is meant to relieve the trader entirely of the burden of the VAT payable or paid in the course of all his economic activities. The common system of VAT consequently ensures complete neutrality of taxation of all economic activities, whatever their purpose or results, provided that they are themselves subject in principle to VAT (see, to that effect, Case 268/83 *Rompelman* v *Minister van Financiën* [1985] ECR 655, paragraph 19; Case C-37/95 *Belgian State* v *Ghent Coal Terminal* [1998] ECR I-1, paragraph 15; Joined Cases C-110/98 to C-147/98 *Gabalfrisa and Others* v *Agencia Estatal de Administración Tributaria* [2000] ECR I-1577, paragraph 44; and Case C-98/98 *Customs and Excise* v *Midland Bank* [2000] ECR I-4177, paragraph 19).

25 Article 17(5) of the Sixth Directive, in the light of which paragraph 2 of that article must be interpreted, lays down the rules applicable to the right to deduct VAT where the VAT relates to input transactions used by the taxable person 'both

for transactions covered by paragraphs 2 and 3, in respect of which value added tax is deductible, and for transactions in respect of which value added tax is not deductible'. The use in that provision of the words 'for transactions' shows that to give rise to the right to deduct under paragraph 2 the goods or services acquired must have a direct and immediate link with the output transactions which give rise to the right to deduct, and that the ultimate aim pursued by the taxable person is irrelevant in this respect (see Case C-4/94 *BLP Group* v *Customs and Excise* [1995] ECR I-983, paragraphs 18 and 19, and *Midland Bank*, paragraph 20).

26 As the Court held in paragraph 24 of *Midland Bank*, Article 2 of the First Directive and Article 17(2), (3) and (5) of the Sixth Directive must be interpreted as meaning that, in principle, the existence of a direct and immediate link between a particular input transaction and a particular output transaction or transactions giving rise to the right to deduct is necessary before the taxable person is entitled to deduct input VAT and in order to determine the extent of such entitlement.

27 It should also be borne in mind that, according to the fundamental principle which underlies the VAT system, and which follows from Article 2 of the First Directive and Article 2 of the Sixth Directive, VAT applies to each transaction by way of production or distribution after deduction of the VAT directly borne by the various cost components (*Midland Bank*, paragraph 29).

28 It follows from that principle, as well as from the rule that, in order to give rise to the right to deduct, the goods or services acquired must have a direct and immediate link with the taxable transactions, that the right to deduct the VAT borne by those goods or services presupposes that the expenditure incurred in acquiring them was part of the cost components of the taxable transactions. That expenditure must therefore form part of the costs of the output transactions which use the goods and services acquired. Consequently, those cost components

must generally have arisen before the taxable person carried out the taxable transactions to which they relate (see *Midland Bank*, paragraph 30).

29 The Court must therefore examine whether there is a direct and immediate link between the various services acquired by the transferor in order to effect the transfer of a totality of assets or part thereof and one or more taxable output transactions.

30 Article 5(8) of the Sixth Directive provides that Member States may, on a transfer of a totality of assets or part thereof, consider that no supply of goods has taken place and that the recipient is the successor to the transferor. It follows that if a Member State has made use of that option the transfer of a totality of assets or part thereof is not regarded as a supply of goods for the purposes of the Sixth Directive. Under Article 2 of the directive, such a transfer is thus not subject to VAT, and consequently cannot constitute a taxable transaction within the meaning of Article 17(2).

31 Abbey National, however, submits that since under Article 5(8) of the Sixth Directive the transferee is the successor of the transferor, the transferor may take into account the taxable supplies of the transferee so as to be able to deduct all the VAT on the expenditure incurred for the services acquired in order to effect the transfer.

32 That argument cannot be accepted. First, it is clear from Article 17(2) of the Sixth Directive that a taxable person may deduct only the VAT on the goods and services used for the purposes of his own taxable transactions. Second, in any event, the amount of VAT paid by the transferor on the costs incurred for the services acquired in order to carry out a transfer of a totality of assets or part thereof does not directly burden the various cost components of the transferee's

taxable transactions, as required by Article 2 of the First Directive. Those costs do not form part of the costs of the output transactions which use the goods and services acquired.

33 Abbey National's argument that, if the transaction had been an ordinary transfer of business assets and hence a taxable transaction, Scottish Mutual would have been able to deduct the VAT on the costs of the various services acquired in order to carry out that transaction under Article 17(2) of the Sixth Directive must also be rejected. The fact that the transfer of a totality of assets or part thereof does not constitute a taxable transaction for the purposes of that article is simply the inevitable consequence of the fact that the Member State concerned has opted to apply Article 5(8) and that the transfer is not therefore regarded as a supply of services. Consequently, it is immaterial whether the transfer of business assets would have constituted a taxable transaction giving rise to the right to deduct that expenditure if the Member State had not exercised the option provided for in that article.

34 It follows that the various services acquired by the transferor in order to effect the transfer of a totality of assets or part thereof do not have a direct and immediate link with one or more output transactions giving rise to the right to deduct.

35 However, the costs of those services form part of the taxable person's overheads, and as such are cost components of the products of a business. Even in the case of a transfer of a totality of assets, where the taxable person no longer effects transactions after using those services, their costs must be regarded as part of the economic activity of the business as a whole before the transfer. Any other interpretation of Article 17 of the Sixth Directive would be contrary to the principle that the VAT system must be completely neutral as regards the tax burden on all the economic activities of a business provided that they are

themselves subject to VAT, and would make the economic operator liable to pay VAT in the context of his economic activity without giving him the possibility of deducting it (see, to that effect, *Gabalfrisa*, paragraph 45). An arbitrary distinction would thus be drawn between expenditure incurred for the purposes of a business before it is actually operated and that incurred during its operation, on the one hand, and, on the other hand, the expenditure incurred in order to terminate its operation.

36 Thus in principle the various services used by the transferor for the purposes of the transfer of a totality of assets or part thereof have a direct and immediate link with the whole economic activity of that taxable person.

37 It follows from Article 17(5) of the Sixth Directive that a taxable person who effects both transactions in respect of which VAT is deductible and transactions in respect of which it is not may deduct only that proportion of the VAT which is attributable to the former transactions.

38 However, as the Court held in paragraph 26 of the *Midland Bank* judgment, a taxable person who effects transactions in respect of which VAT is deductible and transactions in respect of which it is not may nevertheless deduct the VAT charged on the goods or services acquired by him, where those goods or services have a direct and immediate link with the output transactions in respect of which VAT is deductible, without it being necessary to differentiate according to whether Article 17(2), (3) or (5) of the Sixth Directive applies.

39 That rule must apply also to the costs of the goods and services which form part of the overheads relating to a part of a taxable person's economic activities which

is clearly defined and in which all the transactions are subject to VAT, since those goods and services thus have a direct and immediate link with that part of his economic activities.

40 So if the various services acquired by the transferor in order to effect the transfer of a totality of assets or part thereof have a direct and immediate link with a clearly defined part of his economic activities, so that the costs of those services form part of the overheads of that part of the business, and all the transactions relating to that part are subject to VAT, he may deduct all the VAT charged on his costs of acquiring those services.

41 It is for the national court to determine whether those criteria are satisfied in the case in point in the main proceedings.

42 The answer to the questions referred must therefore be that, where a Member State has made use of the option in Article 5(8) of the Sixth Directive, so that the transfer of a totality of assets or part thereof is regarded as not being a supply of goods, the costs incurred by the transferor for services acquired in order to effect that transfer form part of that taxable person's overheads and thus in principle have a direct and immediate link with the whole of his economic activity. If, therefore, the transferor effects both transactions in respect of which VAT is deductible and transactions in respect of which it is not, it follows from Article 17(5) of the Sixth Directive that he may deduct only that proportion of the VAT which is attributable to the former transactions. However, if the various services acquired by the transferor in order to effect the transfer have a direct and immediate link with a clearly defined part of his economic activities, so that the costs of those services form part of the overheads of that part of the business, and all the transactions relating to that part of the business are subject to VAT, he may deduct all the VAT charged on his costs of acquiring those services.

Costs

43 The costs incurred by the United Kingdom and Netherlands Governments and by the Commission, which have submitted observations to the Court, are not recoverable. 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.

On those grounds,

THE COURT (Fifth Chamber)

in answer to the questions referred to it by the High Court of Justice of England and Wales, Queen's Bench Division (Divisional Court), by order of 2 November 1998, hereby rules:

Where a Member State has made use of the option in Article 5(8) of the 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, so that the transfer of a totality of assets or part thereof is regarded as not being a supply of goods, the costs incurred by the transferor for services acquired in order to effect that transfer form part of that taxable person's overheads and thus in principle have a direct and immediate link with the whole of his economic activity. If, therefore, the transferor effects both transactions in respect of which value added tax is deductible and transactions in respect of which it is not, it follows from Article 17(5) of the Sixth

Directive 77/388 that he may deduct only that proportion of the value added tax which is attributable to the former transactions. However, if the various services acquired by the transferor in order to effect the transfer have a direct and immediate link with a clearly defined part of his economic activities, so that the costs of those services form part of the overheads of that part of the business, and all the transactions relating to that part of the business are subject to value added tax, he may deduct all the value added tax charged on his costs of acquiring those services.

Edward Jann Sevón

Delivered in open court in Luxembourg on 22 February 2001.

R. Grass

Registrar

A. La Pergola

President of the Fifth Chamber