JUDGMENT OF THE COURT (Third Chamber)

6 October 2005 *

In Case C-243/03,

ACTION under Article 226 EC for failure to fulfil obligations, brought on 6 June 2003,

Commission of the European Communities, represented by E. Traversa, acting as Agent, and by N. Coutrelis, avocat, with an address for service in Luxembourg,

applicant,

v

French Republic, represented by G. de Bergues and C. Jurgensen-Mercier, acting as Agents,

defendant,

* Language of the case: French.

supported by:

Kingdom of Spain, represented by N. Díaz Abad, acting as Agent,

intervener,

THE COURT (Third Chamber),

composed of A. Rosas, President of the Chamber, J.-P. Puissochet, S. von Bahr (Rapporteur), J. Malenovský and U. Lõhmus, Judges,

Advocate General: M. Poiares Maduro,
Registrar: R. Grass,

having regard to the written procedure,

after hearing the Opinion of the Advocate General at the sitting on 10 March 2005,

gives the following

Judgment

1 By its application, the Commission of the European Communities seeks a declaration from the Court that, by introducing a special rule limiting the deductibility of value added tax ('VAT') on the purchase of capital goods on the

ground that they were financed by subsidies, the French Republic has failed to fulfil its obligations under Community law, in particular under Articles 17 and 19 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), as amended by Council Directive 95/7/EC of 10 April 1995 (OJ 1995 L 102, p. 18; 'the Sixth Directive').

Legal framework

Community legislation

2 The second paragraph of 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), as amended by the Sixth Directive ('the First Directive'), states 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'.

3 Article 11A(1)(a) of the Sixth Directive provides that the taxable amount shall be:

'in respect of supplies of goods and services ... everything which constitutes the consideration which has been or is to be obtained by the supplier from the purchaser, the customer or a third party for such supplies including subsidies directly linked to the price of such supplies.'

4 Article 17(2)(a) of that directive, in the version resulting from Article 28f thereof, provides that, '[i]n 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 ... value added tax 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'.

5 Article 17(5) provides that:

'As regards goods and services to be used by a 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, only such proportion of the value added tax shall be deductible as is attributable to the former transactions.

This proportion shall be determined, in accordance with Article 19, for all the transactions carried out by the taxable person.

...'

6 Article 19(1) of the Sixth Directive, entitled 'Calculation of the deductible proportion', states that:

'The proportion deductible under the first subparagraph of Article 17(5) shall be made up of a fraction having:

— as numerator, the total amount, exclusive of value added tax, of turnover per year attributable to transactions in respect of which value added tax is deductible under Article 17(2) and (3);

— as denominator, the total amount, exclusive of value added tax, of turnover per year attributable to transactions included in the numerator and to transactions in respect of which value added tax is not deductible. The Member States may also include in the denominator the amount of subsidies, other than those specified in Article 11A(1)(a).

...'

National legislation

7 Article 271 of the Code général des impôts (General Tax Code) ('the CGI') states that:

'I.1. The value added tax charged on the price elements of a taxable transaction may be deducted from the value added tax applicable to that transaction.

...

II. 1. In so far as the goods and services are used for their taxable transactions, and provided that VAT is deductible on those transactions, the tax which the persons liable may deduct is [inter alia]:

(a) that which appears on the purchase invoices sent to them by their vendors in so far as the latter were lawfully authorised to include it on those invoices;

...'

8 Article 212 of Annex II to the CGI, in the version brought into force by Article 2 of Decree No 94-452 of 3 June 1994 (JORF of 5 June 1994, p. 8143) provides that:

'1. Taxable persons who, in the course of activities within the scope of value added tax, do not carry out exclusively transactions in respect of which value added tax is deductible are authorised to deduct a fraction of the value added charged on goods constituting fixed assets used to perform those activities.

That fraction is equal to the sum of the tax deductible calculated after applying, if appropriate, the provisions of Article 207a, multiplied by the ratio between:

(a) as numerator, the total amount, excluding value added tax, of annual turnover attributable to transactions in respect of which value added tax is deductible including subsidies directly linked to the price of those transactions;

(b) as denominator, the total amount, excluding value added tax, of annual turnover attributable to transactions included in the numerator and to transactions in respect of which value added tax is not deductible, and of all subsidies, including those not directly linked to the price of those transactions.

...'

9 The Instruction of 8 September 1994 of the Tax Law Service (*Bulletin official des impôts*, special number 3 CA-94 of 22 September 1994; 'the Instruction of 8 September 1994') states in Book 2, as regards the rules governing the right to deduct:

'150. The meaning of capital [equipment] subsidy.

It concerns non-taxable subsidies which are, at the time of provision, granted for the financing of a given capital asset.

...

151. The rules applicable to capital subsidies.

Tax on investments financed by the subsidy can in fact be deducted in normal conditions where the person liable to tax includes the depreciation allowances for

the goods either completely or partially financed by this subsidy within the price of its transactions.

If it becomes apparent that the condition relating to the passing-on of the depreciation of these goods in prices has not been respected, the VAT in respect of these same goods cannot be deducted for the proportion of the amount financed by the capital subsidy.

Example:

A capital good with a purchase price of FRF 1 186 000 (including tax), VAT FRF 186 000, is financed partially (20%) by a capital subsidy of an amount of FRF 237 200.

The person liable has not passed on in the price of those taxable transactions the part of the depreciation of the good which corresponds to the part financed by the capital subsidy. Consequently, the tax charged on the good (FRF 186 000) will only be able to be deducted to a maximum of: FRF 186 000 x 80% = FRF 148 800.

Where appropriate and under normal conditions the person liable shall apply the percentage of deduction of the undertaking to the tax thus calculated.'

Pre-litigation procedure

10 Following a complaint, the Commission sent a formal letter of notice to the French Government on 23 April 2001 in which it alleged that the French Republic had infringed Articles 17(2) and (5) and 19 of the Sixth Directive, first, by applying a deductible proportion of VAT to all taxable persons, including those who do not carry out taxable transactions in respect of which VAT is deductible ('fully taxable persons') and, second, by limiting, with the scheme for capital subsidies, the right to deduct in cases not provided for by that directive.

11 Having not had response to that letter of formal notice within the prescribed period, the Commission issued a reasoned opinion on 20 December 2001 calling on that Member State to take the measures necessary to comply with it within two months of its notification.

12 In its letter of reply of 7 January 2002 to the Commission's letter of formal notice, the French Government stated, in particular, that the deductible proportion applied only to taxable persons carrying out, at the same time, taxable transactions and transactions exempt from VAT ('mixed taxable persons') and not to fully taxable persons.

13 On 26 June 2002, the Commission sent an additional reasoned opinion in which it dropped its first head of claim based on the application of a deductible proportion for taxable persons, but reiterated the second one, concerning the limitation of the right to deduct VAT charged on goods financed by subsidies.

14 Unsatisfied with the French Government's response to that additional reasoned opinion, the Commission decided to bring the present action.

The action

Arguments of the parties

15 The Commission alleges that the French Government introduced, in paragraphs 150 and 151 of the Instruction of 8 September 1994, a limitation of the right to deduct VAT not provided for by the Sixth Directive or justified on the basis of Article 2 of the First Directive.

16 In that regard, the Commission points out that, as regards mixed taxable persons, under the Sixth Directive the deduction of VAT is restricted to transactions in respect of which VAT is deductible, either by applying an overall proportion to the undertaking as indicated in Article 19(1) of that directive, or where appropriate and if the Member State is so inclined, particularly in order to avoid abuse, in accordance with one of the methods laid down in the third subparagraph of Article 17(5) of that directive (distinct proportions for different fields of activity of the undertaking or direct allocation of a good to a specific activity). Where a Member State applies a deductible proportion, no provision of the Sixth Directive which enables, prior to that application, the taxable amount for VAT purposes to which that proportion applies to be reduced on the basis of the origin of the funds used to acquire a good or of the method of calculation of the price of the taxed transactions carried out by the taxable person concerned.

17 As regards fully taxable persons, no provision of the Sixth Directive enables the deduction of VAT on capital goods to be subject to a restriction connected to the origin of the funds used to acquire those goods or the method for calculating the price of the transactions carried out.

18 As regards subsidies received by a taxable person, with the exception of Articles 11A (1)(a) and 19, the Sixth Directive does not at any point take into consideration subsidies on the levy of VAT owed by taxable persons. However, it is settled case-law that limitations on the right to deduct are permitted only in the cases expressly provided for by the Sixth Directive (see Case 50/87 *Commission* v *France* [1988] ECR 4797, paragraphs 16 and 17, and Case C-62/93 *BP Supergas* [1995] ECR I-1883).

19 As regards the second paragraph of Article 2 of the First Directive, the Commission submits that that provision is no different in content to Article 17(2) of the Sixth Directive.

20 The French Government considers that the provisions on capital subsidies, and, in particular, the condition relating to the depreciation of the good merely implement the general conditions governing the right to deduct defined in the second paragraph of Article 2 of the First Directive and adapted by the provisions of Article 17(2) of the Sixth Directive.

21 The result of the combined provisions of those two articles is that the right to deduct takes effect when a good is used to carry out activities giving rise to the right to deduct and when the price of the taxable transactions carried out subsequently includes the cost of that good, whether it be financed by a capital subsidy or by some other means of the taxable person.

22 According to the French Government, under the Court's case-law only the amount of VAT borne directly by the various cost components of a taxable transaction may be deducted, and in order to give rise to the right to deduct, expenses incurred by a taxable person must have a direct and immediate link with a transaction in respect of which VAT is applicable or a similar transaction (see, in particular, Case 15/81 *Schul* [1982] ECR 1409, paragraph 10, and Case C-16/00 *Cibo Participations* [2001] ECR I-6663, paragraphs 31 to 33).

23 The French Government also points out that using the option allowed for in Article 19(1) of the Sixth Directive of including capital subsidies in the denominator of the deductible proportion would have the effect of restricting the exercise of the right to deduct in respect of all the expenses incurred by the taxable person, whereas the allocation of those subsidies is necessarily ad hoc in nature.

24 In addition, that option is applicable only to mixed taxable persons, and so its use could give rise to significant distortion of competition as between mixed and fully taxable persons.

25 The French Government adds that the condition as regards the passing-on of expenditure costs borne by the taxable person in the price of transactions subject to VAT ensures that beneficiaries of non-taxable subsidies do not misuse, to their advantage, the system of deduction of that tax. In that regard, the French Government notes, in particular, that that system can, in so far as it concerns capital goods financed by capital subsidies, be applied so that the input VAT deductible is greater than the output VAT collected.

26 The Spanish Government submits that the direct limitation of the right to deduct VAT borne on the acquisition of capital goods financed by subsidies amounts to a

concrete application of the principles underlying its inclusion, under Article 19(1) of the Sixth Directive, in the denominator of the deductible proportion of subsidies which do not form part of the taxable amount in accordance with Article 11A(1)(a) thereof. That limitation is, therefore, compatible with Community law and is justified by the rules of the Sixth Directive.

27 The Spanish Government also submits that the Member States may apply Article 19 of the Sixth Directive independently of Article 17(5) thereof and that, consequently, they may apply that provision not only to mixed taxable persons, but to all taxable persons.

Findings of the Court

28 It should be remembered that, according to settled case-law, the right to deduct provided for in Article 17 et seq. of the Sixth Directive is an integral part of the VAT scheme and, in principle, may not be limited. That right must be exercised immediately in respect of all the taxes charged on input transactions. Any limitation of the right to deduct VAT affects the level of the tax burden and must be applied in a similar manner in all the Member States. Consequently, derogations are permitted only in the cases expressly provided for by the Sixth Directive (see, in particular, *Commission* v *France*, cited above, paragraphs 15 to 17; *BP Supergas*, cited above, paragraph 18; and Case C-409/99 *Metropol and Stadler* [2002] ECR I-81, paragraph 42).

29 In that regard, Article 17(1) of the directive provides that the right to deduct shall arise at the time when the deductible tax becomes chargeable and Article 17(2)

states that, 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 or paid in respect of goods or services supplied or to be supplied to him by another taxable person.

30 As regards mixed taxable persons, under the first and second subparagraphs of Article 17(5) of the Sixth Directive the right to deduct is calculated according to a fixed proportion in accordance with Article 19 thereof. The third subparagraph of Article 17(5) nevertheless permits Member States to authorise other methods for determining the right to deduct listed in that paragraph, in particular determination of a proportion for each sector of business or deduction on the basis of the use of all or part of the goods and services for a specific activity.

31 Article 11A(1)(a) of the Sixth Directive provides that subsidies directly linked to the price of a good or service are taxable in the same way as that good or service. As regards subsidies which are not directly linked to price, including those at issue in the present case, Article 19(1) of the Sixth Directive provides that the Member States may include them in the calculation of the denominator of the proportion applicable where a taxable person carries out, at the same time, transactions in respect of which VAT is deductible and others which are exempt.

32 As the Commission has rightly pointed out, with the exception of those two provisions, the Sixth Directive makes no provision for subsidies to be taken into account in the calculation of VAT.

33 However, it should be pointed out that the national provisions at issue make the right to deduct VAT, where the purchase of the good concerned is financed by a subsidy, subject to the condition that the depreciation of that good be passed on in

the price of the transactions carried out by the taxable person. That condition is not provided for in the Sixth Directive and thus constitutes a limitation of the right to deduct which is not permitted by that directive.

34 In that regard, first, the arguments of the French Government based on the second paragraph of Article 2 of the First Directive must be rejected. That provision merely lays down the principle of the right to deduct, and the conditions applicable thereto are laid down in the provisions of the Sixth Directive. It does not constitute a basis for a limitation of the right to deduct not provided for in those provisions (see *Commission* v *France*, cited above, paragraph 23).

35 Second, it should be pointed out, as noted by the Advocate General in paragraph 23 of his Opinion, that the Member States are required to apply the Sixth Directive even if they consider it to be less than perfect. It is stated in Case C-338/98 *Commission* v *Netherlands* [2001] ECR I-8265, paragraphs 55 and 56, that even if the interpretation put forward by certain Member States better served the aims of the Sixth Directive, such as fiscal neutrality, the Member States may not disregard the provisions expressly laid down in that directive.

36 As regards the arguments of the Kingdom of Spain based on Article 19 of the Sixth Directive, it should be noted, first, that that provision is only applicable to mixed taxable persons and, second, that it applies only in the situations which it provides for (see Case C-204/03 *Commission* v *Spain* [2005] ECR I-8389, paragraphs 24 and 25).

37 It must thus be held that, by introducing a special rule limiting the deductibility of VAT on the purchase of capital goods where they were financed by subsidies, the French Republic has failed to fulfil its obligations under Community law, in particular under Articles 17 and 19 of the Sixth Directive.

Costs

38 Under Article 69(2) of the Rules of Procedure, the unsuccessful party is to be ordered to pay the costs if they have been applied for in the successful party's pleadings. Since the Commission has applied for costs and the French Republic has been unsuccessful, the latter must be ordered to pay the costs. Pursuant to the first subparagraph of Article 69(4), the Kingdom of Spain, which intervened in the present case, is to bear its own costs.

On those grounds, the Court (Third Chamber) hereby:

1. **Declares that, by introducing a special rule limiting the deductibility of value added tax on the purchase of capital goods where they were financed by subsidies, the French Republic has failed to fulfil its obligations under Community law, in particular under Articles 17 and 19 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, as amended by Council Directive 95/7/EC of 10 April 1995;**

2. **Orders the Republic of France to pay the costs;**

3. **Orders the Kingdom of Spain to pay its own costs.**

[Signatures]