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Treatment of the transfer of goods for business purposes without consideration

An article by the CMS VAT Group

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As opposed to free supply of services being made for valid business reasons, free supply of goods taking place for the purposes of a taxpayer's business are considered as taxable events.

As a condition to authorising various construction projects, the municipalities and other public bodies of several Member States are increasingly demanding from particularly real estate developers that various services and goods be supplied to them free of charge. In actual practice, developers cannot pass the VAT burden to the recipient entities. Member States have dealt differently with the VAT aspect of these situations. In the Member States which follow the VAT Directive word by word in this respect and the interpretations given by the Advocate General and the Court of Justice, this has serious consequences for real estate developers.

1. Current situation

It has become customary in several Member States that municipalities and other public bodies (hereinafter "public body") demand that real estate developers wishing to realise a construction project in their territory are to carry out certain additional investments for the benefit of the public body and hand them over free of charge to the public body. A typical example includes a developer wishing to build a shopping centre. Such developer will need to face the reality that the necessary licenses/authorisations will not be issued to him unless he undertakes to build e.g. a junction and/or an access road which it then will have to hand over to the public body free of charge. The same exemplary developer may equally be requested to build a school or renovate an existing one, the types of requests always depending on local needs as well as negotiating positions. If the developer wishes to proceed with its development project, he has no option but to comply with the request of the public body. Quite often such requests are fixed in writing and stated in the building permit or in a contract between the public body and the developer concerned.

It is important to point out that albeit the above mentioned developments that are imposed by the public bodies seemingly serve only public interests, unless the developer complies with the requirement to fulfil the desires of the public bodies, they will not get a building and/or operational permit. As such, as long as they do not comply with these requirements, they are unable to carry on with their business. This creates a direct and immediate link between these seemingly "public" developments and the core business of the developers.

As regards the community legislation in this respect, Article 16 of Directive No. 112/2006 (the "VAT Directive") provides that *"The application by a taxable person of goods forming part of his business assets for his private use or for that of his staff, or their disposal free of charge or, more generally, their application for purposes other than those of his business, shall be treated as a supply of goods for consideration, where the VAT on those goods or the component parts thereof was wholly or partly deductible. However, the application of goods for business use as samples or as gifts of small value shall not be treated as a supply of goods for consideration."*

On the other hand Article 26 of the VAT Directive provides that "the supply of services carried out free of charge by a taxable person for his private use or for that of his staff or, more generally, for purposes other than those of his business shall be treated as a supply of services for consideration."

In Case No. 48/97 Kuwait Petroleum Ltd. v Commissioners of Customs and Excise, the European Court of Justice held (paragraph 22) on the basis of Directive No. 388/77 (the

“Sixth Directive”) that “it is clear from the very wording of Article 5(6), first sentence, of the Sixth Directive that this provision treats as a supply made for consideration, and therefore as subject to VAT, a taxable person's disposal free of charge of goods forming part of his business assets, where input VAT was deductible on those goods, it being in principle immaterial whether their disposal was for business purposes. The second sentence of that provision, which precludes taxation of applications for the giving of samples or the making of gifts of small value for the purposes of the taxable person's business would make no sense if the first sentence did not make VAT payable on the disposal free of charge of such goods by the taxable person, even where this is done for business purposes.” In the same case, having analysed relevant parts of the Sixth Directive, the Advocate General concluded that the different wording with respect to services provided free of charge is deliberate, and thus whereas the free of charge supply of services is only considered as taxable if effected for purposes other than those of the business of the taxpayer, the free supply of goods shall be a taxable event even if made for business purposes.

Despite the above Community legislation, the practice of Member States to deal with the situation described above in respect of developers being forced into free supply of goods with a view to their immediate business objective is far from being harmonised. According to the information available to us, under the above circumstances some countries do not treat the free supply of goods as taxable events (but allow a deduction of input VAT on supplies received for purposes of the development which is later handed over free of charge). This is because these Member States consider that the free transfer occurs in the interest of the future VATable output of the developer, and VAT will be paid at that stage by the developer. Other Member States eliminate the unwanted VAT effect by accepting a nominal amount as being the tax base instead of the cost incurred by realisation of the public purpose development, yet others create a subsequent deemed self-supply allowing for deduction of the VAT paid by the developer. However, there are countries such as Germany and Hungary where either the deduction of input VAT related to the public purpose development is denied or VAT is charged on the full value of the subsequent free supply to the public body, resulting in a situation where VAT neutrality is not achieved.

Since public bodies are in general not entitled to VAT deduction and are otherwise short of funds, they do not reimburse the VAT component arising on the free transfer to the developers. As a result, in Member States requiring a VAT payment on the free hand over of goods from the developer to the public body or where the input VAT deduction is denied, developers are faced with a situation whereby in addition to bearing the net costs of the public purpose developments they also bear the full VAT burden thereof. Thus, together with the costs of the originally intended development (such as the shopping centre), the costs of the public purpose development and the VAT component of the latter become a cost component in pricing the developer’s output products/services, which are usually themselves subject to VAT. As a result, input VAT is not just a pass-through item for the developer; further, as regards the output product/service of the developer, VAT will effectively be paid on VAT.

2. Violation of VAT neutrality and distortion of competition

The above practice clearly violates the principle of VAT neutrality, as it not only denies the developer the relief from the burden of VAT on developments which are wholly connected to its (core) business, but it even subjects to VAT cost components which already include a considerable amount of VAT.

We may also pose the question whether the fact that certain Member States interpret the harmonised Community VAT legislation more favourably for the developers on the basis of the overall logic of the VAT system than others sticking to actual wording in

grammatical sense, has a distortive effect on the operation of the internal market and fair competition.

3. Proposal

We suggest to change the scope of taxable supplies, in a way that the treatment of supply of goods free of charge becomes similar to that of supply of services, i.e. such supplies are only subject to VAT if they are effected by the taxable person for a purpose other than those of his business. This is justified by the fact that as long as the free supply is clearly connected to its taxable activity, VAT will be paid by the investor when selling goods/services in the normal course of its business.

We do not really see a reason to treat the free supply of services differently from the free supply of goods and thus suggest a uniform treatment. Nevertheless, should the Commission consider that removing the free supply of goods from the scope of application of VAT on the condition that they take place for the purposes of the taxable business would be too far fetched, alternatively we suggest to constitute a more specific exception from the current general rule, in addition to the existing exception relating to transfer of goods as samples or business gifts. Such exception shall stipulate that whenever an obligation is imposed on a taxpayer by a public body or publicly owned utility company to supply free services or goods as a condition to realising its investment, the input VAT in respect of services and goods utilised for the purposes of such public purpose investment shall be deductible and no VAT shall arise on the subsequent free supply.

For further information on this tax analysis and thought, please contact:

Eszter Kálmán
Senior Associate – CMS Cameron McKenna LLP, Budapest
T +36 1 483 4800
E eszter.kalman@cms-cmck.com

Tamás Fehér
Associate – CMS Cameron McKenna LLP, Budapest
T +36 1 483 4818
E tamas.feher@cms-cmck.com

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