CASE LAW NOTE

Do Sale and Lease Back Transactions Require a VAT Adjustment? Towards a Pragmatic Look Through Approach

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1 Facts and questions

Mydibel is a Belgian company specialized in the development, production and commercialization of potato products. It owns several buildings that it uses for the production of its products.

This production gives Mydibel the status of taxable person for VAT purposes and as such, Mydibel deducted the VAT incurred upon the construction, alteration and renovation of its buildings.

In 2009, Mydibel entered into two financial transactions in the form of sale and lease back arrangements not subject to VAT. The 'sale' consisted of the granting of long leases on its buildings via emphyteutic rights for a period of ninety-nine years, and against the payment of emphyteutic rents (a one-off fee and an annual fee). Mydibel immediately leased the buildings back for fifteen years, at the end of which a purchase option would be available to Mydibel.

In 2012, the tax administration performed an audit of the years 2009 and 2010 and, based on the VAT exempt sale and lease back transactions, concluded that the deduction of VAT by Mydibel on the construction, alteration and renovation of its buildings had to be adjusted.

The referring court asks, whether the VAT deduction that was initially made correctly on a property should be corrected where that property was subject to a VAT-exempt sale and lease back transaction during the adjustment period.[1] If yes, the Court asks whether this would comply with the principles of neutrality and of equal treatment.

2 Principles governing the deduction right and the circumstances in which an adjustment is required

Before moving on to a detailed discussion of the *Mydibel* case,[2] it is best to set the principles governing the deduction right and the circumstances in which an adjustment is required.

As a rule, taxable persons making taxable supplies of goods or services charge VAT on their output and remit the VAT collected to the dedicated authorities. As VAT is meant to be paid by consumers only, a system of deduction applies under which, throughout the supply chain, VAT paid on sales at one stage is deductible at the next stage from the VAT to be remitted on the subsequent supply. This right of deduction is a fundamental characteristic of the EU VAT system, it cannot be limited by Member States and it is exercisable by traders immediately in respect of all the VAT charged on transactions relating to their business inputs.[3]

An essential condition of the right of deduction is that the VAT incurred on goods or services received, can only be deducted by a taxable person if and to the extent that such goods or services are destined to be used for a taxable supply. To the extent that an expenditure is related to an exempt output activity, the right of deduction shall in principle be refused (subject to some specific exceptions).

The deduction is made immediately which means that taxable persons can, at the time of purchase, immediately deduct the VAT on their inputs. However, as the extent of the initial deduction depends on the use to which the expenditures are put, or are intended to be put, events

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1 BE: Request for a preliminary ruling from the Cour d'appel de Mons, 19 Mar. 2018, Case C-201/18, *Mydibel S.A. v. État belge*, OJ C 182/15 (25 May 2018).

2 BE: CJEU 27 Mar. 2019, Case C-201/18, *Mydibel*, ECLI:EU:C:2019:254.

3 *See* inter alia ES: CJEU, 21 Mar. 2000, Joined Cases C-110/98 to C-147/98 *Gabalfrisa and Others*, ECLI:EU:C:2000:145, para. 43; UK: CJEU, 15 Dec. 2005, Case C-63/04, *Centralan Property*, ECLI:EU:C:2005:773, para. 50; BE: CJEU, 6 July 2006, Joined Cases C-439/04 and C-440/04, *Kittel and Recolta Recycling*, ECLI:EU:C:2006:446, para. 47.

occurring after the initial deduction may have a retroactive impact.[4] When changes to factors which were taken into consideration for the determination of the amount of the initial deduction occur, an adjustment of the VAT deduction may be required.[5]

Furthermore, a special adjustment regime is reserved for capital goods by reason of their durable use and the attendant writing-off of their acquisition costs.[6] In the case of a tax exempt supply of capital goods before the end of the adjustment period, a proportion of the initial input VAT deduction will, by way of adjustment, have to be repaid to the treasury. This proportion is determined by the number of remaining years of the adjustment period compared to the total duration of the adjustment period. In the present case, the question arose whether or not, a VAT exempt sale and lease back transaction had to be treated as a tax exempt supply that makes an adjustment mandatory.

3 Analysis

With the *Mydibel* case, the CJEU is confronted with a potential adjustment further to the subjection of capital goods (buildings), for which VAT was previously incurred, to a VAT exempt sale and lease back transaction.

The Court starts by analysing the requirement for (ordinary) adjustments due to a change in the factors used to determine the amount of the deduction[7] and then considers the application of the special adjustment regime for capital goods.[8] Finally, it concludes that the sale-and-lease back operations at hand do not trigger an adjustment.

3.1 *Ordinary Adjustment Rule*

Under the ordinary adjustment rule, the Court needs to examine whether or not the sale-and-lease back operations should be seen as a change in the factors used to determine the amount of the deduction made. Arguably, the fact that after the initial VAT deduction, the buildings are used for a VAT exempt emphyteutic right, could be seen as a new and different use of the buildings concerned. A use that is different from the original one that justified the VAT deduction. Indeed, the construction, alteration and renovation of Mydibel's buildings have been undertaken for the purpose of Mydibel's production of potato-based products. In practical terms, this means that because Mydibel charged VAT on its sales of potato-based products, it could deduct the VAT paid on its buildings expenditure. The factor taken into consideration in allowing this initial deduction is therefore the use of these buildings for the VAT taxable activity.

Quite interestingly, the Court underlines that for the application of the ordinary adjustment rule, the focus should remain on the close and direct relationship between the deduction and the use of the goods concerned, whereby the mere creation of an emphyteutic right not subject to VAT cannot be regarded to have the effect of breaking this close and direct relationship. This conclusion is justified by the fact that the emphyteutic right did not prevent Mydibel from using the buildings concerned in an uninterrupted and permanent manner for its economic activity. This indicates that there were no changes in the factors used to determine the amount of the deductions made.

This is not the first time that the Court seems to have disregarded an event that in itself should have led to an adjustment. Of note in this regard is the *TETS Haskovo* case where the Court ruled that the demolition of a building (for which VAT had been deducted) should not necessarily be seen as providing grounds for an adjustment.[9] In fact, the Court ruled that the replacement of old buildings with more modern buildings which fulfil the same purpose and, consequently, are used for taxable output transactions in no way breaks the direct link between the input acquisition of the buildings at issue, on the one hand, and the economic activities carried out thereafter by the taxable person, on the other. In the *Mydibel* case we now see a similar reasoning, which is an important confirmation of the view that it is possible to look through specific transactions and take into account the use of goods or services in light of the taxable person's economic activity.

It should be noted that if the Belgian court were nonetheless to find that an adjustment is needed in the case of Mydibel because of a change in the factors used to determine the amount of the deduction made, this assessment could be challenged based on a literal interpretation Article 168 of the VAT Directive. Article 168 of the VAT Directive provides that '*in so far as the goods and services are used for the purposes of the taxed transactions of a taxable person the deduction right is to be granted*' and the CJEU has endorsed its literal interpretation in the recent case, Volkswagen Financial Services (UK) Ltd.[10] When

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[4] VAT Directive: Council Directive 2006/112/EC of 28 Nov. 2006 on the common system of value added tax, OJ L 347/1 (11 Dec. 2006), Arts 184 and 185 and *see* to that effect *Centralan Property* (C-63/04), *supra* n. 3, para. 54 and the case-law cited.

[5] VAT Directive, *supra* n. 4, Art. 185(1).

[6] VAT Directive, *supra* n. 4, Arts 187 and 188.

[7] *Mydibel* (C-201/18), *supra* n. 2, paras 24 to 30.

[8] *Mydibel* (C-201/18), *supra* n. 2, paras 31 to 43.

[9] BU: CJEU, 18 Oct. 2012, Case C-234/11, *Tets Haskovo AD*, ECLI:EU:C:2012:644, paras 32 to 34.

[10] The CJEU ruled that even though the costs for which a deduction was at stake were part of the price of loans for which no VAT recovery could be granted, the deduction had to be granted because the costs were components of the taxable supplies. Being a cost component is not a matter of economic allocation. UK: CJEU, 18 Oct. 2018, Case C-153/17, *Volkswagen Financial Services (UK)*, ECLI:EU:C:2018:845.

applied to Mydibel's situation, it means that as long as Mydibel carries on using the buildings for its economic activities, it can continue to benefit from its deduction right.

3.2 *Special Adjustment Rule for Investment Goods*

The above reasoning is however not sufficient to rule out the application of the special adjustment rule for investment goods. Especially since Article 188 (1) of the VAT Directive[11] expressly provides that if investment goods are supplied during the adjustment period, then they will be treated as if they had been applied to an economic activity of the taxable person up until expiry of the adjustment period. Furthermore, this economic activity is presumed to be fully exempt in cases where the supply of the investment goods is exempt.

This raises the question whether the VAT exempt creation of the emphyteutic right should be seen as a 'supply of goods'.

To answer this question the Court refuses to assess the emphyteutic rights separately from the sale and lease back transactions. As a result, it comes to the conclusion that the sale and lease back arrangement does not constitute a supply of goods:

> *subject to verification by the referring court, each sale and lease back transaction at issue in the main proceedings constitutes a single transaction. In those circumstances, those transactions cannot be classified as 'supplies of goods'.*[12]

This is a very interesting conclusion. The Court applies the composite/single supply doctrine to a pair of transactions that are carried out by two different taxable persons (Mydibel and the leasing company) to treat both transactions as one single supply.

The composite/single supply doctrine of the CJEU is far from new.[13] In the Mydibel case the Court summarizes it as follows '*there is a single supply where two or more elements or acts supplied by the taxable person to the customer are so closely linked that they form, objectively, a single, indivisible economic supply, which it would be artificial to split*' (authors' underlining). It should be noted however that this doctrine is essentially applied to a combination of multiple supplies made by the same taxable person.[14] In the *Part Service* case the Court considered that a single supply had been artificially split up by making two related companies perform a part of the supply, so that the doctrine (in combination with the Court's anti-abuse doctrine) was applied to a supply made by two taxable persons.[15]

The present *Mydibel* case seems to take the use of the composite supply doctrine one step further. Not only is it applied to a transaction carried out by two separate taxable persons (Mydibel and the leasing company), but even more surprisingly it is applied to two 'opposite' supplies, i.e. the sale/creation of emphyteutic right on the one hand, and the lease back on the other hand. In the authors' view this opens the door to a 'new application of the composite supply doctrine'.

Notwithstanding the foregoing, the reasons for treating the sale and lease back transactions as single supplies seem perfectly sound. The CJEU upholds that the sale and lease back transactions at issue are characterized by the combined and simultaneous grant, first, of an emphyteutic right by the taxable person to the two financial institutions at issue and, second, of a lease of real property by those two institutions to the taxable person. To further assess this, it is considered that they are purely financial transactions designed to increase Mydibel's liquidity and that the buildings at issue in the main proceedings remained in the possession of Mydibel, which used them in an uninterrupted and permanent manner for the purposes of its taxable transactions. Under such circumstances the CJEU finds that the sale and lease back transactions constitute single supplies (which is for the national court to verify).

Once the CJEU has established the existence of a composite/single supply, it will normally look at the characteristics of the supply to determine its proper VAT treatment. In the case at hand, however, the Court does not offer further guidance on how this single supply should be characterized from a VAT perspective because the question put to the Court is limited to finding out whether or not this single transaction can be treated as a supply of goods made by Mydibel (which would trigger an adjustment).

Such an assessment appears deeply rooted in the economic reality and is a pretty fair reflection of the substance of the transactions. It is clear that for a supply to take place, a legal transfer of ownership is not strictly required, as long as there is a transfer of the right to dispose of the property as owner.[16] The *Mydibel* case now illustrates that even if from a legal (civil

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[11] VAT Directive, *supra* n. 4.

[12] *Mydibel* (C-201/18), *supra* n. 2, paras 41 to 42.

[13] *See* for the basic cases: UK: CJEU, 25 Feb. 1999, Case C-349/96, *Card Protection Plan Ltd (CPP) v. Commissioners of Customs & Excise*, ECLI:EU:C:1999:93, para. 27 and NL: CJEU, 27 Oct. 2005, Case C-41/04, *Levob Verzekeringen and OV Bank*, ECLI:EU:C:2005:649, para. 18.

[14] *Levob Verzekeringen and OV Bank,* (C-41/04), *supra* n. 13; *Card Protection Plan Ltd (CPP) v. Commissioners of Customs & Excise* (C-349/96), *supra* n. 13.

[15] IT: CJEU, 21 Feb. 2008, Case C-425/06, *Part Service*, ECLI:EU:C:2008:108.

[16] A supply may be constituted in the absence of a legal transfer (*See* inter alia NL: CJEU 8 Feb. 1990, Case C-320/88, *Staatssecretaris van Financiën v. Shipping and Forwarding Enterprise Safe*, ECLI:EU:C:1990:61, para. 9; UK: CJEU 21 Nov. 2013, Case C-494/12, *Dixons Retail,* ECLI:EU:C:2013:758, para. 20; PL: CJEU 22 Oct. 2015, Case C-277/

law) perspective a transaction is carried out that would ordinarily be treated as a supply of goods for VAT purposes (i.e. the creation of an emphyteutic right), it should not be treated as such if the economic reality is such that the transferees, like the beneficiaries of the emphyteutic rights in the case at hand, are not empowered to dispose of the buildings as if they were owners. Indeed, subject to confirmation by the national court, the CJEU finds that the creation of the emphyteutic rights over the buildings are not granting owner's empowerment because they are inseparable from the lease covering those buildings; a lease which deprives the beneficiaries of the emphyteutic rights of such power but grants them to the lessee.[17] The CJEU thus looks beyond the creation of the emphyteutic right itself and takes it for what it really was: part of a purely financial transaction designed to increase Mydibel's liquidity, while the buildings remained in the possession of Mydibel which used them uninterruptedly for its production of potato-based products.[18]

Even though the CJEU leaves the factual assessment to the national judge, it seems that it must have already taken into account some special circumstances such as the fact (1) that both emphyteutic rights were created for a period of ninety-nine years, (2) that Mydibel had to fully pay back the amount invested by the financial institutions within fifteen years and (3) that Mydibel had a purchase option to re-acquire the emphyteutic rights for respectively 10% and 3% of the investment value (paid by the financial institutions). It is regrettable however that the CJEU's reasoning is kept very short, so that it is not clear to what extent each of these circumstances individually has affected its analysis. The purchase option through which, at the end of the fifteen year lease, Mydibel can regain ownership of the buildings against 10% and 3% of the investment value, notably, deserved some attention. In itself such an option is a clear indication of the fact that the financial institutions had obtained a certain degree of ownership rights. Now we are left to wonder whether in a sale and leaseback operation any kind of option should be disregarded when determining if there is a supply of goods or not. Alternatively, one might question whether the CJEU disregarded the option because the price was not a high percentage of the investment value so that it was obvious that Mydibel would exercise it? It seems quite essential to the CJEU that the sale and leaseback transactions were of a purely financial nature, but to what extent might a variation in the aforementioned circumstances have affected this characterization as a financial transaction? For instance, if Mydibel had not had to fully pay back the amount invested and/or the so-called purchase option had been at a higher percentage of the investment value (e.g. 25%), then the chances of Mydibel regaining full ownership before the end of the emphyteutic rights (ninety-nine years) would have been (significantly) lower. The lease back transaction would then have more of an operational than a financial nature, but unfortunately the CJEU does not give further guidance on how to make that distinction.

Additionally, this assessment is questionable with regard to the general principle of equal treatment. That principle requires that economic operators in comparable situations be treated in the same way in order to avoid any distortion of competition within the internal market.[19] The conclusion reached in this case, that an emphyteutic sale lease accompanied by lease back arrangement is not a supply and that, therefore, no adjustments are needed threatens to treat similarly, taxable persons in different situations without any objective justification. A taxable person who enters into an exempt sale and lease back arrangement may not be in the same situation, legally or financially, as a taxable person who retains ownership of its buildings but further to the *Mydibel* case, they would nonetheless be treated similarly. That said, the principle of neutrality requires that economic decisions should not be influenced by VAT factors.[20] It is clear that this is the aim (and for the most part, the result) here. Therefore, it is not warranted to call this assessment into question on the basis of the general principle of equal treatment

3.3 *Compatibility of a Potential Adjustment with the Principles of Neutrality and Equal Treatment*

The case still needs to be assessed by the Belgian court. In this regard Mydibel somehow questioned in the reference what would happen if, in spite of the clear guidelines given by the CJEU, the national court were to rule in such a way that Mydibel's arrangements would lead to an adjustment, either because they are seen as affecting the factor which allowed the initial deduction (ordinary adjustment rule) or because they are considered to be supplies of goods for VAT purposes (special adjustment rule). Would such an adjustment be compatible with the principles of VAT neutrality and equal treatment?

Quite understandably Mydibel had raised this question as a contingency plan to provide clarity in the event that the CJEU did not come to the favourable conclusions

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14, *PPUH Stehcemp,* ECLI:EU:C:2015:719, para. 44). He who can do more can do less, one would thus expect that when a legal transfer happens, it triggers consequences (tax avoidance and fraud apart).

[17] *Mydibel* (C-201/18), *supra* n. 2, para. 40.

[18] *Mydibel* (C-201/18), *supra* n. 2, para. 40.

[19] *See* a.o. CJEU, 7 Sept. 1999, Case C-216/97, *Gregg*, para 20.

[20] *See* to that effect a situation where a taxpayer had the choice between an exempt transaction and a taxable one, UK: CJEU, 6 Apr. 1995, Case C-4/94, *BLP Group v. Commissioners of Customs & Excise*, ECLI:EU:C:1995:107, para. 26.

discussed above. Had this happened it would have hoped to have been provided with a ruling saying that even though an adjustment may be legally required, it would be against the aforementioned principles. Now that the CJEU has come to a more favourable conclusion on the question of the adjustment, these additional questions have somewhat lost their relevance, unless the Belgian Court finds that the factual circumstances are not such that it should follow the analysis of the CJEU, in which case it could nevertheless rule that an adjustment should be made.

The CJEU considers that an adjustment under such circumstances would not be against the principles of neutrality and equal treatment.[21]

4 Conclusion: the victory of the economic approach

Once again, the CJEU has demonstrated that its rulings on VAT are consistently based on an economic approach, which is supported by legal arguments rather than a purely legal and formal interpretation of the facts. For example, for years, the CJEU has used the 'substance over form' principle to recharacterize transactions that have been vitiated by artificiality.[22] It has notably ruled that '*it is necessary to bear in mind the case-law of the Court according to which consideration of economic and commercial realities is a fundamental criterion for the application of the common system of VAT*'.[23] Based on these considerations, national courts can look beyond contractual terms whenever the contract constitutes an artificial arrangement that has been set up with the sole aim of obtaining a tax benefit.

With the *Mydibel* case, the CJEU confirms this approach in yet another context. By looking beyond the creation of the emphyteutic right to consider an overview of final economic situation, the CJEU takes an approach that was rather unexpected for most practitioners. Indeed, the application of an adjustment in the case of a VAT exempt sale and lease back has been common practice (at least in Belgium). However this practice should be overturned in the future, taking into account the new and right approach by the CJEU. This evolution towards a more economic approach indicates a bright future for VAT.

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[21] *Mydibel* (C-201/18), *supra* n. 2, para. 46.

[22] UK: CJEU 20 June 2013, Case C-653/11, *Newey*, ECLI:EU:C:2013:409; PT: CJEU 22 Nov. 2018, Case C-295/17, *MEO*, ECLI:EU:C:2018:942.

[23] *Newey* (C-653/11), *supra* n. 22, para. 42.