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Judgment of the Court (Sixth Chamber) of 5 July 1988. - Vereniging Happy Family Rustenburgerstraat v Inspecteur der Omzetbelasting. - Reference for a preliminary ruling: Gerechtshof Amsterdam - Netherlands. - VAT on the illegal supply of narcotic drugs within the territory of a Member State. - Case 289/86.

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Keywords

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Tax provisions - Harmonization of laws - Turnover tax - Common system of value-added tax - Tax on the supply of goods within the territory of a Member State - Application to unlawful traffic in narcotic drugs - Not permissible - Criminal sanctions for offences - Powers of the Member States - Policy of selective prosecution with regard to supplies of hemp-based drugs - Circumstance not justifying the imposition of tax

(Council Directive 77/388, Art . 2)

Summary

The unlawful supply of narcotic drugs on the domestic market of a Member State, which, like the unlawful importation of such drugs into the Community, can give rise only to penalties under the criminal law, is alien to the provisions of the Sixth Directive on the harmonization of the laws of the Member States relating to turnover taxes . Consequently, Article 2 of the Sixth Directive must be interpreted as meaning that no liability to turnover tax arises upon the unlawful supply of narcotic drugs effected for consideration within the territory of a Member State in so far as the products in question are not confined within economic channels strictly controlled by the competent authorities for use for medical and scientific purposes .

That finding is without prejudice to the powers of Member States to impose appropriate penalties in respect of contraventions of their drugs laws, with all the attendant consequences, in particular of a pecuniary nature .

The unlawful supply of hemp-based drugs is also not liable to value-added tax even where, pursuant to a selective prosecution policy, the authorities of a Member State do not systematically bring criminal proceedings against small-scale retail dealing in such drugs .

Parties

In Case 289/86

REFERENCE to the Court under Article 177 of the EEC Treaty by the Gerechtshof (Regional Court of Appeal), Amsterdam, for a preliminary ruling in the proceedings pending before that court between

Vereniging Happy Family Rustenburgerstraat, Amsterdam,

and

Inspecteur der Omzetbelasting, Amsterdam,

on the interpretation of Article 2 (1) of the Sixth Council Directive (77/388/EEC) of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes - Common system of value-added tax : uniform basis of assessment (Official Journal 1977, L 145, p . 1),

THE COURT (Sixth Chamber)

composed of : O . Due, President of the Chamber, T . Koopmans, K . Bahlmann, C . Kakouris and T . F . O' Higgins, Judges,

Advocate General : G . F . Mancini

Registrar : B . Pastor, Administrator

after considering the observations submitted on behalf of

Vereniging Happy Family Rustenburgerstraat, by F . D . Kouwenhoven, tax consultant;

the Federal Republic of Germany, by Martin Seidel and Alfred Dittrich, acting as Agents;

the French Republic, by Gilbert Guillaume and Bernard Botte, acting as Agents;

the Kingdom of the Netherlands, by E . F . Jacobs and G . M . Borchardt, acting as Agents;

the Commission of the European Communities, by Johannes Fons Buhl and Marten Mees, acting as Agents;

having regard to the Report for the Hearing and further to the hearing on 29 October 1987,

after hearing the Opinion of the Advocate General delivered at the sitting on 21 April 1988,

gives the following

Grounds

1 By a judgment of 28 October 1986, which was received at the Court on 24 November 1986, the *Gerechtshof* (*Regional Court of Appeal*), Amsterdam, referred to the Court for a preliminary ruling under Article 177 of the EEC Treaty three questions on the interpretation of Article 2

(1) of the Sixth Council Directive (77/388/EEC) of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes - Common system of value-added tax : uniform basis of assessment (*Official Journal* 1977, L 145, p . 1) (" the Sixth Directive ").

2 Those questions were raised in proceedings brought by *Vereniging Happy Family Rustenburgerstraat*, a social and cultural association which runs a youth centre where visitors can, among other things, buy hashish from a "house dealer", and the Netherlands tax authorities' assessment to value-added tax of sales of hashish in that youth centre .

3 Hashish is a product derived from Indian hemp; its sale, supply and distribution are prohibited in the Netherlands under the *Opiumwet* (*Opium Law*). However, the guidelines issued by the Netherlands Public Prosecutor' s office on policy with regard to the investigation and prosecution of offences against the *Opiumwet* (*Nederlandse Staatscourant*, 18 July 1980, No 137, p . 7) provide, *inter alia*, as follows with regard to small-scale retail dealing in hemp products and house dealers :

"A house dealer is a dealer in hemp products who, with the trust and protection of those in charge of a youth centre, is given sole permission to sell hemp products in that centre . In principle, a house dealer incurs criminal liability under the second paragraph of Article 11 of the *Opiumwet*, which is directed in particular against dealers in drugs referred to in Schedule II .

The important factor in investigating such small dealings is its relative priority; ... in accordance with the regime laid down in the *Opiumwet*, absolute priority is given to investigating dealing in drugs which involve unacceptable risks . In practice the effect of the lower order of priority given to investigating small dealing in hemp products is that the police do not report small drug dealers to the Public Prosecutor' s office except where the dealer makes it known publicly that he is a drug dealer or otherwise conducts his dealings in a provocative manner . "

4 In its action brought against the taxation of the turnover from the sales of hashish in question, *Vereniging Happy Family* relies in particular on the Court' s judgment of 28 February 1984 in Case 294/82 *Einberger v Hauptzollamt Freiburg* ((1984)) ECR 1177, according to which in principle no import turnover tax arises upon the unlawful importation of drugs .

5 With a view to resolving that dispute, the *Gerechtshof* referred the following questions to the Court for a preliminary ruling :

"1 . Following the judgment of the Court of Justice of the European Communities of 28 February 1984 in Case 294/82 *Einberger v Hauptzollamt Freiburg*, must Article 2 (1) of the Sixth Directive be interpreted as meaning that there is also no liability to turnover tax on the supply of narcotic drugs within the territory of a Member State?

2 . If Question 1 is answered in the affirmative, does that answer apply to the supply of all kinds of narcotic drugs, including the supply of hemp-based products?

3 . If Question 2 is also answered in the affirmative, can the fact that a policy of restraint pursued by the competent judicial authorities as regards the prosecution of offences makes it possible in certain circumstances to provide prohibited supplies of hemp-based products without prosecution be a ground for taking a different view on the question whether turnover tax is due upon the supply of such products?"

6 Reference is made to the Report for the Hearing for a fuller account of the facts of the main proceedings and the observations submitted to the Court, which are mentioned or discussed hereinafter only in so far as is necessary for the reasoning of the Court .

Question 1

7 The first question seeks essentially to establish whether Article 2 (1) of the Sixth Directive is to be interpreted as meaning that no liability to turnover tax arises upon the unlawful supply of narcotic drugs within the territory of a Member State .

8 In its judgment in *Einberger* (cited above) the Court interpreted Article 2 (2) of the Sixth Directive as meaning that no import turnover tax arises upon the unlawful importation into the Community of drugs not confined within economic channels strictly controlled by the competent authorities for use for medical and scientific purposes .

9 *Vereniging Happy Family* and the Commission consider that the solution adopted in that judgment should also be applied as regards transactions within one country . They argue that the Court' s reasoning in that judgment was essentially that narcotic drugs are, by definition, subject to a total prohibition on their importation and marketing in the Community and therefore the supply of narcotic drugs within the territory of the country also falls outside the scope of the Sixth Directive .

10 The Governments of the Kingdom of the Netherlands, the French Republic and the Federal Republic of Germany contend that the judgment in *Einberger* is confined to the unlawful importation of narcotic drugs and therefore does not prejudice any decision on the supply of narcotic drugs within the territory of the country, especially since the Court expressly pointed out in that judgment that there are economic and legal differences between those two transactions . In the case of importation the chargeable event for purposes of value-added tax is essentially the same as the chargeable event for purposes of customs duties, whereas supply within the territory of the country is taxable only where it is effected for consideration by a taxable person acting as such .

11 In view of those diverging arguments it must be pointed out that Article 2 of the Sixth Directive defines the scope of value-added tax in the following terms :

"1 . the supply of goods or services effected for consideration within the territory of the country by a taxable person acting as such;

2 . the importation of goods ."

12 In this context the preliminary observation should be made that the national court's question relates exclusively to the unlawful supply of narcotic drugs within the territory of the Member State in question . The question whether such a transaction is liable to value-added tax has not yet been the subject of a decision by the Court, which, apart from judgments relating to the customs treatment of smuggled drugs, has had occasion to rule, in the judgment in *Einberger*, cited above, only on the interpretation of Article 2 (2) of the Sixth Directive in relation to the unlawful importation of narcotic drugs into the Community . That judgment did not settle the question of unlawful supply within the territory of the country .

13 In the absence of express provisions governing that point in the Sixth Directive, the first question to arise is whether or not the unlawful supply of narcotic drugs within the territory of the country constitutes a taxable transaction or whether the directive must be interpreted as leaving that decision to the Member States .

14 It should be observed that, as the Court has already stated with regard to the importation of drugs in its judgment in *Einberger*, the directive may not be interpreted as leaving that question outside its scope . Such an interpretation would be irreconcilable with the aim pursued by the directive, which is to achieve far-reaching harmonization in that area, particularly with regard to the scope of value-added tax .

15 It must next be considered whether, having regard to its context and objectives, the Sixth Directive precludes the levying of value-added tax on narcotic drugs when they are unlawfully supplied within the territory of the country .

16 It should be observed that the Sixth Directive is based on Articles 99 and 100 of the EEC Treaty and its objective is the harmonization or approximation of the legislation of the Member States on turnover taxes "in the interest of the common market ". According to the third and fourth recitals in the preamble to the directive, the establishment of a common system of value-added tax should assist the effective liberalization of the movement of persons, goods, services and capital, the integration of national economies and also the achievement of a common market permitting fair competition and resembling a real internal market .

17 Since the harmfulness of narcotic drugs is generally recognized, there is a prohibition in all the Member States on marketing them, with the exception of strictly controlled trade for use for medical and scientific purposes . As the Court has already held with regard to the illegal importation of narcotic drugs into the Community, in its judgment in *Einberger*, such drugs are, by definition, subject to a total prohibition on importation and marketing in the Community . The Court added that such goods, whose release into the economic and commercial channels of the Community is absolutely precluded and whose illegal importation can give rise only to penalties under the criminal law, are wholly alien to the provisions of the Sixth Directive on the definition of the basis of assessment and, in consequence, to the provisions on the origination of a turnover tax debt .

18 That reasoning also applies to the levying of value-added tax on supply within the territory of the country . The unlawful movement of narcotic drugs within the territory of the country, which likewise can give rise only to penalties under the criminal law, is as alien to the aforementioned objectives of the Sixth Directive, and, in consequence, to the origination of a turnover tax debt, as the unlawful importation of narcotic drugs .

19 The argument to the contrary put forward by the three governments intervening in this case seems to be motivated by fear that it will be impossible to distinguish in the case-law between illegal dealings in narcotic drugs and other unlawful economic operations and that as a result of the more favourable tax treatment of unlawful trade in general the principle of the fiscal neutrality of the value-added tax system will thus be undermined .

20 It must be acknowledged that the principle of fiscal neutrality does in fact preclude, as far as the levying of value-added tax is concerned, a generalized differentiation between lawful and unlawful transactions . However, that is not true in the case of the supply of products, such as narcotic drugs, which have special characteristics inasmuch as, because of their very nature, they are subject to a total prohibition on their being put into circulation in all the Member States, with the exception of strictly controlled economic channels for use for medical and scientific purposes . In a specific situation of that kind where all competition between a lawful economic sector and an unlawful sector is precluded, the fact that no liability to value-added tax arises cannot affect the principle of fiscal neutrality .

21 For the same reason it is not possible to accept the three governments' argument based on Article 4 (1) of the Sixth Directive that any economic activity "whatever the purpose or results of that activity" is subject to value-added tax . Although in defining the term "taxable person" Article 4 (1) covers economic activities in general without drawing a distinction between lawful and unlawful activities, that fact is irrelevant as regards the tax regime applicable to narcotic drugs, since they are already excluded from the scope of value-added tax as defined in Article 2 of the Sixth Directive .

22 It must be added that that finding is without prejudice to the powers of Member States to impose appropriate penalties in respect of contraventions of their drugs laws, with all the attendant consequences, in particular of a pecuniary nature .

23 The reply to the first question must therefore be that Article 2 (1) of the Sixth Directive must be interpreted as meaning that no liability to turnover tax arises upon the unlawful supply of narcotic drugs within the territory of a Member State in so far as the products in question are not confined within economic channels strictly controlled by the competent authorities for use for medical and scientific purposes .

Questions 2 and 3

24 The second and third questions essentially seek to establish whether the rule that no liability to value-added tax arises also applies in the case of the unlawful supply of narcotic drugs derived from hemp, even in the specific situation where the authorities in a Member State, in pursuance of a policy of selective prosecution of offences, do not systematically bring criminal proceedings against small-scale retail dealing in such drugs .

25 In that connection it must be observed at the outset that, according to the documents before the Court, drugs derived from hemp, although described in some Member States as "soft drugs", are the subject of a total legal prohibition on importation and marketing in the Community . In addition, that type of drug is among the substances which may, in particular, be imported and marketed only for medical and scientific purposes, pursuant to the Single Convention on Narcotic Drugs, 1961 (United Nations Treaty Series, 520, No 7515), to which all the Member States are now parties .

26 Consequently, the reply to the first question also covers hemp-based drugs as such .

27 As for the question whether a different solution must apply where, as in this case, the authorities of a Member State refrain, in particular circumstances, from taking proceedings against small-scale retail dealing in such drugs, the Commission states that in such a case what is

involved is an economic operation which is not inherently illegal . By refraining from prosecuting, the competent authorities tolerate such transactions, which is practically tantamount to legalizing them . It argues that there is no justification for not levying value-added tax on such an economic operation .

28 For its part, the Netherlands Government argues that even though, in certain circumstances, criminal proceedings are not brought systematically in respect of the sale of hemp-based drugs, the sale of such drugs continues to be prohibited by law . The transaction does not cease to be illegal because, with a view to ensuring the effectiveness of criminal proceedings, a degree of priority is given to the prosecution of other offences which the competent authorities regard as being more dangerous . That policy is a reflection of the principle of Netherlands criminal law that the Public Prosecutor' s office is not bound to bring proceedings in respect of all offences brought to its notice but may proceed according to criteria of expediency .

29 It must be observed first that the total prohibition on the marketing of narcotic drugs is not affected by the mere fact that, in view of their - obviously limited - manpower and means and in order to use the available resources for combating narcotic drugs in a concentrated manner, the national authorities responsible for implementing that prohibition give lower priority to bringing proceedings against a certain type of trade in drugs, because they consider other types to be more dangerous . Above all, such an approach cannot put illegal drugs dealing on the same footing as economic channels which are strictly controlled by the competent authorities in the medical and scientific field . The latter trade is actually legalized whereas prohibited dealings, albeit tolerated within certain limits, remain illegal and may at any time be the subject of police action when the competent authorities consider such action to be appropriate .

30 Secondly, the harmonization achieved at Community level of the value-added tax system would be jeopardized if the scope of value-added tax as far as a given illegal transaction was concerned were to depend on actual prosecution policy in a particular Member State, even though that transaction remained in principle prohibited in the Member State concerned .

31 Accordingly the reply to the second and third questions must be that the unlawful supply of hemp-based narcotic drugs is not liable to value-added tax even where, pursuant to a selective prosecution policy, the authorities of a Member State do not systematically bring criminal proceedings against small-scale retail dealing in such drugs .

Decision on costs

Costs

32 The costs incurred by the French Republic, the Federal Republic of Germany, the Kingdom of the Netherlands and the Commission of the European Communities, which have submitted observations to the Court, are not recoverable . Since these proceedings are, in so far as the parties to the main proceedings are concerned, in the nature of a step in the action pending before the national court, the decision on costs is a matter for that court .

Operative part

On those grounds,

THE COURT (Sixth Chamber)

in answer to the questions referred to it by the Gerechtshof, Amsterdam, by judgment of 28 October 1986, hereby rules :

(1) Article 2 (1) of the Sixth Council Directive of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes - Common system of value-added tax : uniform basis of assessment -- must be interpreted as meaning that no liability to turnover tax arises upon the unlawful supply of narcotic drugs within the territory of a Member State in so far as the products in question are not confined within economic channels strictly controlled by the competent authorities for use for medical and scientific purposes .

(2) That also applies to the unlawful supply of narcotic drugs derived from hemp even where, pursuant to a selective prosecution policy, the authorities of a Member State do not systematically bring criminal proceedings against small-scale retail dealing in such drugs .