OPINION OF ADVOCATE GENERAL

STIX-HACKL

delivered on 15 September 2005 1(1)

Case C-184/04

Uudenkaupungin kaupunki

(Reference for a preliminary ruling from the Korkein Hallinto-oikeus [Finland])

(Sixth VAT Directive – Deduction of input tax– Adjustment – Capital goods – Immovable property)

I – **Introductory remarks**

1. In these proceedings, the Korkein hallinto-oikeus (Supreme Administrative Court, Finland) is asking the Court for an interpretation of Sixth Council Directive 77/388/EEC on value added tax (2) (hereinafter 'the Sixth Directive'), with particular reference to the adjustment of deductions in the case of capital goods in the form of immovable property.

2. The question at issue is essentially whether, in the light of the Sixth Directive, an adjustment of the deduction of input tax in respect of capital goods may be allowed in a case where immovable property was first used in non-taxable activity but subsequently in taxable activity.

II – **The legal framework**

A – *The Sixth Directive*

3. Article 5(6) provides that:

'The application by a taxable person of goods forming part of his business assets for his private use or that of his staff, or the disposal thereof free of charge or more generally their application for purposes other than those of his business, where the value added tax on the goods in question or the component parts thereof was wholly or partly deductible, shall be treated as supplies made for consideration. However, applications for the giving of samples or the making of gifts of small value for the purposes of the taxable person's business shall not be so treated.'

4. Article 6, entitled 'Supply of services', contains the following provisions:

'2. The following shall be treated as supplies of services for consideration:

(a) the use of goods forming part of the assets of a business for the private use of the taxable person or of his staff or more generally for purposes other than those of his business where the value added tax on such goods is wholly or partly deductible;

(b) supplies of services carried out free of charge by the taxable person for his own private use or that of his staff or more generally for purposes other than those of his business.'

5. Article 13, entitled 'Exemptions within the territory of the country', contains the following provisions:

'B. *Other exemptions*

Without prejudice to other Community provisions, Member States shall exempt the following under conditions which they shall lay down for the purpose of ensuring the correct and straightforward application of the exemptions and of preventing any possible evasion, avoidance or abuse:

…

(b) the leasing or letting of immovable property …

…

C. *Options*

Member States may allow taxpayers a right of option for taxation in cases of:

(a) letting and leasing of immovable property;

…

Member States may restrict the scope of this right of option and shall fix the details of its use.'

6. Article 17, entitled 'Origin and scope of the right to deduct', contains the following provisions:

'1. The right to deduct shall arise at the time when the deductible tax becomes chargeable.

2. 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;

…

6. Before a period of four years at the latest has elapsed from the date of entry into force of this Directive, the Council, acting unanimously on a proposal from the Commission, shall decide what expenditure shall not be eligible for a deduction of value added tax. Value added tax shall in no circumstances be deductible on expenditure which is not strictly business expenditure, such as that on luxuries, amusements or entertainment.

Until the above rules come into force, Member States may retain all the exclusions provided for under their national laws when this Directive comes into force.'

7. Article 20, entitled ‘Adjustments of deductions’, contains the following provisions:

‘1. The initial deduction shall be adjusted according to the procedures laid down by the Member States, in particular:

(a) where that deduction was higher or lower than that to which the taxable person was entitled;

(b) where after the return is made some change occurs in the factors used to determine the amount to be deducted, in particular where purchases are cancelled or price reductions are obtained; however, adjustment shall not be made in cases of transactions remaining totally or partially unpaid and of destruction, loss or theft of property duly proved or confirmed, nor in the case of applications for the purpose of making gifts of small value and giving samples specified in Article 5(6). However, Member States may require adjustment in cases of transactions remaining totally or partially unpaid and of theft.

2. In the case of capital goods, adjustment shall be spread over five years including that in which the goods were acquired or manufactured. The annual adjustment shall be made only in respect of one-fifth of the tax imposed on the goods. The adjustment shall be made on the basis of the variations in the deduction entitlement in subsequent years in relation to that for the year in which the goods were acquired or manufactured.

By way of derogation from the preceding subparagraph, Member States may base the adjustment on a period of five full years starting from the time at which the goods are first used.

In the case of immovable property acquired as capital goods the adjustment period may be extended up to 20 years.

…

5. If in any Member State the practical effect of applying paragraphs 2 and 3 would be insignificant, that Member State may, subject to the consultation provided for in Article 29, forego application of these paragraphs, having regard to the need to avoid distortion of competition, the overall tax effect in the Member State concerned and the need for due economy of administration.’ (3)

B – *The relevant national provisions*

8. The Directive was transposed in Finland by the Arvonlisäverolaki (Finnish Value Added Tax Law) (‘the AVL’). The provisions concerning the taxation of supplies of immovable property are contained in Paragraphs 27 to 30 of the AVL. Under Paragraph 27, first subparagraph, of the AVL, tax is not charged on the sale of immovable property or the grant of a tenancy of land or a dwelling or an easement or a comparable right concerning immovable property. (4) Paragraph 30 provides, as an exception to that provision, that a taxable person may apply to be taxed in respect of a supply of the right to use immovable property.

9. Under Paragraph 106 of the AVL, concerning the right to deduct in respect of building services, if an owner of immovable property applies to be taxed pursuant to Paragraph 30, he may make the deduction in respect of services or goods he acquired for the purpose of a taxable supply of property before making the application. It is a condition that the owner of the property has applied to be taxed within a period of six months from bringing the property into use. The right to deduct relates only to new building and restoration of immovable property.

10. Under the AVL, the adjustment or other revision to the benefit of the taxpayer of deductions

relating to the acquisition of immovable property or new building and restoration work is not possible, and that also applies in a situation such as the present one, in which the application to be made liable to tax was made after the abovementioned date and the property was first used in non-taxable activity and subsequently in taxable activity.

III – **Facts, procedure and questions for preliminary ruling**

11. The town of Uusikaupunki (hereinafter ‘Uusikaupunki’) restored a house which it owned and leased it to the Finnish State, part from 1 June 1995 and part from 1 September 1995. The town also leased an industrial building which it had built to an undertaking which was subject to value added tax.

12. Uusikaupunki applied to the South-West Finland regional tax office in accordance with Paragraph 30 of the AVL to be made liable to value added tax on those transactions. The tax office recorded the tax liability as having commenced on the date of the application, 4 April 1996, because the application was made more than six months after the date on which the property had been supplied after completion of the building work.

13. By two applications, submitted on 8 September 1998 and 30 March 2000, Uusikaupunki applied to the tax office for reimbursement on the basis of Article 20 of the Sixth Directive of the value added tax contained in the restoration and construction costs for the accounting periods 1996, 1997, 1998 and 1999. The total sum claimed is FIM 1 651 653, including statutory interest.

14. The regional tax office rejected Uusikaupunki’s applications by decision of 3 May 2000 on the ground that revision of the deductions under Article 20 of the Sixth Directive was not possible. An owner of immovable property who had applied to be made liable to tax under Paragraph 30 of the AVL might, under Paragraph 106 of the AVL, make a deduction in respect of services or goods bought by him for a taxable supply of immovable property before making the application, or deduct the tax paid on the construction service he had himself supplied for that purpose, only if he had applied to be made liable to tax within six months of bringing the property into use.

15. Uusikaupunki appealed against the decision of the regional tax office to the Hallinto-oikeus (Administrative Court) in Helsinki, which dismissed the appeal. Uusikaupunki appealed against that decision to the Korkein hallinto-oikeus (Supreme Administrative Court).

16. The point at issue in this case, according to the Korkein hallinto-oikeus, is whether the provisions of the AVL concerning applications to be made liable to tax in respect of a supply of the right to use immovable property conflict with the provisions of the Sixth Directive concerning the right to deduct. To decide the case, the referring court therefore requires an interpretation of the Sixth Directive, in particular Article 20 concerning adjustments of deductions. It considers that the town of Uusikaupunki unquestionably acted in the capacity of a taxable person when it made purchases in connection with the restoration and new construction of the property and that the acquisitions took place for the purposes of the town’s economic activity.

17. The Korkein hallinto-oikeus accordingly asked the Court of Justice of the European Communities, by order of 16 April 2004 received at the Court Registry on 19 April 2004, to deliver a preliminary ruling in the case pending before it on the following questions:

‘1. Is Article 20 of Directive 77/388/EEC to be interpreted as meaning that the adjustment of deductions in accordance with that article is mandatory for Member States in the case of capital goods unless it follows otherwise from Article 20(5)?

2. Is Article 20 of the Directive to be interpreted as meaning that the adjustment of deductions

in accordance with that article is applicable even where the capital goods, in this case immovable property, were first used in non-taxable activity, in which case an initial deduction could not have been made at all, and only later in taxable activity during the adjustment period?

3. May the second subparagraph of Article 13(C) of the Directive be interpreted as meaning that a Member State may restrict the right to deduct for acquisitions relating to immovable property investments in the manner laid down in the Finnish Arvonlisäverolaki, where the right to deduct is excluded altogether in situations such as the present one?

4. May the second subparagraph of Article 17(6) of the Directive be interpreted as meaning that a Member State may restrict the right to deduct for acquisitions relating to immovable property investments in the manner laid down in the Finnish Arvonlisäverolaki, where the right to deduct is excluded altogether in situations such as the present one?'

IV – **The first question**

18. By its first question, the referring court seeks to ascertain whether – unless it follows otherwise from Article 20(5) – the adjustment of deductions in accordance with Article 20(2) of the Sixth Directive is mandatory for Member States in the case of capital goods or whether it is only optional.

19. It should be noted in this connection that, according to the referring court's statements in the order for reference, the AVL makes no provision for an adjustment procedure in the case of capital goods.

A – *Main arguments of the parties*

20. The Finnish Government takes the view that the possibility of adjusting deductions in accordance with Article 20 of the Sixth Directive is not to be regarded as mandatory, on a number of grounds. First, adjustment in accordance with Article 20 must, it claims, be regarded as an alternative to the provisions contained in Article 5(6) and Article 6(2) of the Sixth Directive concerning the taxation of supplies of goods and services by a taxable person for his own use. Those two tax mechanisms pursue essentially similar objectives and cannot, moreover, apply to the same situation at the same time. Second, in accordance with Article 20(4) of the Sixth Directive, Member States may define the concept of 'capital goods' and there is nothing in the Directive to suggest that construction services must necessarily be included in the concept of 'capital goods'. Third, Article 20(5) of the Sixth Directive provides Member States with the possibility, in certain circumstances which, it is claimed, obtain in the case of Finland, of not applying the provisions on the adjustment of deductions.

21. *Uusikaupunki*, the *Commission* and the *Italian Government* take the view that the provision of an adjustment procedure for capital goods is mandatory under the terms of Article 20 of the Sixth Directive.

B – *Assessment*

22. It should be noted, first, that, in accordance with the third paragraph of Article 249 EC, a directive is binding, as to the result to be achieved, upon each Member State to which it is addressed and, according to settled case-law, the Member States are obliged to adopt all the measures necessary to ensure that the directive is fully effective. (5)

23. Article 20(2) of the Sixth Directive provides that '[i]n the case of capital goods, adjustment shall be spread over five years including that in which the goods were acquired or manufactured'.

24. As Uusikaupunki, the Italian Government and the Commission have rightly pointed out, that wording does not permit the conclusion that Member States may dispense with adjustment in the case of capital goods. This is confirmed by the fact that Article 20(5) of the Sixth Directive lays down precise conditions under which a Member State may exceptionally forego application of paragraphs 2 and 3 of that article concerning adjustment in the case of capital goods.

25. Moreover, it is impossible to agree with the Finnish Government's argument concerning Articles 5(6) and 6(2) of the Sixth Directive. The fact that, as the Finnish Government pointed out, those provisions of the Sixth Directive on the application of goods or the supply of services for the trader's private use partly pursue the same objectives as adjustment and may in some circumstances relate to the same situation does not mean that a Member State may dispense with adjustment in the case of capital goods. The two provisions do not overlap so completely that they can be regarded as 'alternative' mechanisms and overlapping is only conceivable in certain cases of the application of goods or services for 'own use'.

26. In so far as practical problems of application may arise as a result of possible overlapping, as the Finish Government contends, they must be solved with all due regard to the principles underlying the Sixth Directive, such as the principle that value added tax must be levied in a wholly neutral way. In my view, however, such difficulties are not such as to simply release a Member State from the obligation to provide for adjustment in the case of capital goods in accordance with Article 20(2) of the Sixth Directive.

27. Moreover, the adjustment of deductions in accordance with Article 20 of the Sixth Directive – in so far as it differs from the rules relating to the taxation of the application or supply of goods or services for private use – is to be regarded as a necessary extension of the right to deduct in accordance with Article 17 of the Sixth Directive, which serves to relieve the trader entirely of the burden of the value added tax payable or paid in the course of all his economic activities and thus ensure that all economic activities are taxed in a wholly neutral way. (6)

28. In allowing account to be taken, in particular, of changes in the factors originally used to determine the amount to be deducted (7) – particularly important in the case of capital goods that form part of the business assets for a considerable time – the adjustment procedure helps to ensure greater precision in the matter of deduction.

29. Lastly, as regards Article 20(5) of the Sixth Directive, the first question is clearly not concerned as such with the issue of whether the conditions for the application of this exceptional provision are fulfilled in the present case.

30. In the light of the foregoing considerations, I propose that the answer to the first question should be that Article 20 of the Sixth Directive is to be interpreted as meaning that Member States must provide for the adjustment of deductions in accordance with that article in the case of capital goods unless it follows otherwise from Article 20(5).

V – **The second question**

31. By its second question, the referring court seeks essentially to ascertain whether Article 20 of the Sixth Directive is to be interpreted as meaning that the adjustment is applicable even where the capital goods, in this case immovable property, were first used in non-taxable activity, on which no deduction could have been made, and only later in taxable activity, with the result that the value

added tax contained in the capital goods is deductible.

A – *Essential arguments of the parties*

32. *Uusikaupunki* and the *Commission* take the view that the adjustment of deductions is applicable in the present case. According to the case-law of the Court, in particular the judgment in *Lennartz*, (8) the decisive factor is whether the goods or services for the capital investment were acquired by a taxable person acting as such. The immediate use of the goods for a taxable activity does not constitute a condition for the application of Article 20(2) of the Sixth Directive. In the present case, the restoration and construction works were undertaken for a taxable person, even if the activities in this connection were originally non-taxable.

33. The *Finnish Government* submits that the judgment in *Lennartz* (9) relates only to a situation in which a Member State applies the adjustment of deductions in accordance with Article 20(2) of the Sixth Directive. The Court did not, however, rule on the question of the applicability of deduction in a situation where in a Member State – as in Finland – only Article 17 concerning the origin and scope of the right to deduct is applied, not Article 20 concerning adjustments of deductions. In these circumstances, it is claimed, the right to deduct must be considered exclusively in the light of the situation obtaining at the time when the services were acquired. If they were acquired for the purposes of a non-taxable activity, there is consequently no right to deduct.

34. The *Italian Government* takes the view that the adjustment of deductions in accordance with Article 20 of the Sixth Directive is not applicable in a situation such as the present one. Member States could exclude such adjustment if the change in the right to deduct arose from a deliberate decision on the part of the taxable person.

B – *Assessment*

35. Attention must first be drawn to the connection between the origin of the right to deduct, on the one hand, and the application of the adjustment of deductions, on the other.

36. As the Court has held previously, it is apparent from the scheme of the Sixth Directive and from the actual wording of Article 20(2) that the latter provision does no more than establish the procedure for calculating the adjustments to the initial deduction; it cannot therefore give rise to any right to deduct or convert the tax paid by a taxable person in respect of his non-taxable transactions into tax that is deductible within the meaning of Article 17. (10)

37. The application of the adjustment mechanism therefore depends on the existence of a right to deduct pursuant to Article 17 of the Sixth Directive.

38. Under Article 17(1), the right to deduct arises at the time when the deductible tax becomes chargeable. Under Article 10(2) of the Sixth Directive, the tax becomes chargeable when the goods are delivered or the services are performed. (11)

39. According to settled case-law, the existence of a right to deduct is determined by whether a person who has acquired goods or services was acting as a taxable person at the time, that is, whether he has acquired the goods for the purposes of his economic activity within the meaning of Article 4 of the Sixth Directive, and that is a question of fact which must be determined in the light of all the circumstances of the case. (12)

40. In the present case, the referring court considers that in any event Uusikaupunki unquestionably had the construction and restoration work on the capital goods at issue carried out

for the purposes of its economic activity as a taxable person.

41. It must therefore be concluded that the capacity of taxable person, as a prerequisite for the existence of the right to deduct on which the application of the adjustment mechanism depends, is established.

42. Moreover, value added tax paid in respect of goods or services is deductible only in so far as the goods and services are used for the purposes of taxable transactions. (13)

43. In my view, however, the fact that the capital goods on which the construction and restoration work was undertaken were first used in non-taxable activity and only later in taxable activity based on the exercise of the right of option, does not preclude the right to deduct and consequently the application of an adjustment to the initial deduction.

44. As the Court held in its judgment in Lennartz, the use to which the goods or services are put, or intended to be put, is to be distinguished from their acquisition by a taxable person acting as such and merely determines the extent of the initial deduction to which the taxable person is entitled under Article 17 and the extent of any adjustments in the course of the following periods. As the Court also held in that judgment, it follows that 'the immediate use of the goods for taxable or exempt supplies does not in itself constitute a condition for the application of Article 20(2)'. (14)

45. I therefore assume that in principle adjustment in accordance with that article is applicable even in a situation such as the present one in which capital goods were first used in non-taxable activity and only later in taxable activity, in so far as the initial acquisitions in this connection – that is, the goods and services acquired for the capital goods – were made in the capacity of taxable person. (15)

46. Since no part of the capital goods in respect of which Uusikaupunki paid value added tax for construction and restoration work was initially used for taxable activities, no deduction was made at first. The subsequent change in the factors initially taken into account in determining the amount to be deducted, namely the use for taxable activities, was then taken into account in accordance with the available statements by way of adjustment, so as to achieve the best possible balance between the scope of the taxable activities and the deduction claimed. This solution is in line with the abovementioned objective of the rules on deduction, namely to relieve the trader entirely of the burden of the value added tax payable or paid in the course of his economic activities and thus ensure that all economic activities are taxed in a wholly neutral way. (16)

47. If, on the other hand, the adjustment mechanism did not apply in a situation in which capital goods were first used in non-taxable activity and later in taxable activity, the result would be that, contrary to the principle of neutrality, value added tax would effectively be payable more than once on goods and services included in the value of the capital goods.

48. In the light of all the foregoing, I propose that the answer to the second question should be that Article 20 of the Sixth Directive is to be interpreted as meaning that the adjustment is applicable even where the capital goods, in this case immovable property, were first used in non-taxable activity, on which no deduction could have been made, and later in taxable activity.

VI – **The third question**

49. The third question should be considered in the light of the fact that deduction of value added tax paid in connection with immovable property investments before an application is made is excluded under the AVL if the application in question is not made within six months.

50. The third question is therefore essentially whether the second subparagraph of Article 13(C) of the Sixth Directive is to be interpreted as meaning that a Member State which allows its taxpayers a right of option for taxation on the use of immovable property may exclude altogether the deduction of value added tax paid on immovable property investments before an application is made for the leasing of the property to be taxable, if that application is not made within six months.

A – *Essential arguments of the parties*

51. The *Finnish* and *Italian Governments* take the view that the second subparagraph of Article 13(C) of the Sixth Directive permits a restriction of the right to deduct in the manner laid down in the Finnish legislation.

52. The Finnish Government submits that, in accordance with the wording of the second subparagraph of Article 13(C) of the Sixth Directive, Member States may restrict the right to deduct. In its view, the purpose of the option for taxation is to enable deductions to be made in respect of expenditure relating to immovable property. The fact that Member States may restrict the scope of this right of option necessarily affects the right to deduct in respect of expenditure relating to immovable property.

53. The Italian Government considers that the right to opt for taxation does not imply a right to deduct for past acquisitions. In its view, that right applies only to future acquisitions. On the basis of Article 13(C), and in particular Article 18(3), of the Sixth Directive, Member States may nevertheless provide for the right to opt for taxation on the leasing of immovable property to be retroactive but they are not required to do so.

54. *Uusikaupunki* and the *Commission* take the view that Article 13(C) does not allow Member States to restrict the right to deduct in connection with immovable property investments in such a manner as to exclude it altogether in certain circumstances.

55. Uusikaupunki draws a distinction in its interpretation of Article 13(C) of the Sixth Directive between, on the one hand, the possibility for Member States to restrict the scope of the right of option and, on the other, the provision that they may fix the details of its use. In Uusikaupunki's view, the question of the scope of the right of option does not arise in the present case inasmuch as it is not disputed that Uusikaupunki had a right of option and that it exercised it. As to fixing the details of the use of the right of option, that provision does not in its view allow Finland to restrict the right to deduct in such a manner as to exclude it altogether.

56. The Commission largely agrees with that view and explains that Articles 17 to 20 of the Sixth Directive apply automatically from the moment a taxable person exercises his right to deduct under national law. In the light of the settled case-law of the Court, Member States may not impose further restrictions on the right to deduct in that case.

B – *Assessment*

57. Title X (Articles 13 to 16) of the Sixth Directive provides for various exemptions including in particular, under Article 13(B)(b), the leasing or letting of immovable property.

58. Member States have the power, however, under point (a) of the first subparagraph of Article 13(C), to 'reintroduce' liability to tax, by means of a right of option which they may allow their taxpayers to exercise.

59. Under the second subparagraph of Article 13(C), Member States may restrict the scope of this right of option and fix the details of its use.

60. As the Court has held previously, Member States may, by virtue of this power, allow persons benefiting from the exemptions provided for by the Sixth Directive to waive the exemption in all cases or within certain limits or subject to certain detailed rules. (17)

61. According to the case-law of the Court, it follows that the Member States have a wide discretion under Article 13(B) and (C) of the Sixth Directive. (18)

62. In this connection, I think it is important to bear in mind first that the power conferred on Member States under Article 13(C) and the associated discretion are concerned with granting taxpayers the right to opt for or against taxation. (19)

63. The Commission is therefore right in so far as Article 13(C) concerns taxation and consequently cannot in principle serve as a basis for Member States directly to restrict the scope of other provisions of the Sixth Directive or of rights such as the right to deduct.

64. In the present case, I already doubt whether excluding altogether the right to deduct value added tax paid – before the right of option was exercised – on investments in this immovable property, in a situation where six months had passed since the property was brought into use, falls within the power accorded to Member States under the second subparagraph of Article 13(C) to determine the scope of the right of option or to fix the details of its use.

65. It is true that Member States may rule on an application to deduct and provide for an approval process in this connection (20) and that they may also decide that the leasing or letting of the property is to be taxed only after the application has been made and that it may not be treated as a taxable activity retroactively. But excluding altogether, particularly by way of adjustment, the right to deduct value added tax paid on immovable property investments before an application was made is no longer, in my view, related to taxation in cases of letting and leasing of immovable property or with the scope of the right of option or the details of its use.

66. Even if it were accepted that this exclusion is to be regarded as a restriction of the scope of the right of option or as a detail of its use within the meaning of the second subparagraph of Article 13(C), care must be taken to ensure that the right to deduct itself is not improperly undermined on the basis of that provision. (21)

67. It should be noted in this connection that a basic element of the VAT system is that VAT is chargeable on each transaction only after deduction of the amount of the VAT borne directly by the cost of the various components of the price of the goods and services. (22)

68. In that light, it is in my view within the discretion of a Member State not to allow the right of option for taxation to be exercised retroactively in so far as it is not possible to deduct tax *ex post facto* for the period before the right of option was exercised. On the other hand, it appears to me to be an excessive restriction of the right to deduct and to be incompatible with the principle of tax neutrality for it not to be at least possible to deduct value added tax paid on immovable property investments before the right of option was exercised in the adjustment period remaining after the exercise of the right of option and within the scope of the adjustment laid down in Article 20(2).

69. I therefore propose that the answer to the third question should be that the second subparagraph of Article 13(C) is not to be interpreted as meaning that a Member State which allows its taxpayers a right to opt for taxation of the use of immovable property may exclude

altogether the deduction of value added tax paid in respect of immovable property investments before an application is made for the leasing of the property to be taxable, if that application is not made within six months from the bringing into use of the property.

VII – **The fourth question**

70. The fourth question is essentially whether Article 17(6) of the Sixth Directive is to be interpreted as meaning that a Member State which allows its taxpayers a right to opt for taxation of the use of immovable property may exclude altogether the deduction of value added tax paid in respect of immovable property investments before an application is made for the leasing of the property to be taxable, if that application is not made within six months.

A – *Essential arguments of the parties*

71. The *Finnish Government* takes the view that the provisions of Article 17(6) of the Sixth Directive allow Member States to restrict the right to deduct in connection with immovable property investments and even, as in the present case under the AVL, to exclude it altogether. It contends that, according to the case-law of the Court, only exclusions which relate generally to all goods or services are incompatible with the Sixth Directive.

72. *Uusikaupunki* and the *Commission* consider, on the contrary, that Article 17(6) is not applicable in the present case. In their view, the Finnish provisions represent a refusal to adjust deductions in accordance with Article 20 rather than an exclusion of the right to deduct in accordance with Article 17 of the Sixth Directive.

73. The *Italian Government* relies on its observations concerning the second question. According to those observations, Finland grants taxpayers under Paragraph 106 of the AVL a right to deduct which is not provided for in the Sixth Directive. Consequently, Article 17(6) of the Sixth Directive is applicable only in situations involving restriction, not extension, of the right to deduct, and is therefore irrelevant in the present case.

B – *Assessment*

74. Under the second subparagraph of Article 17(6), '[u]ntil the above rules come into force, Member States may retain all the exclusions' provided for under their national laws when the Sixth Directive comes into force. The term 'exclusions' in the second subparagraph is thus linked to the first subparagraph of Article 17(6). (23)

75. That subparagraph provides for the adoption by the Council of rules specifying what expenditure 'shall not be eligible for a deduction of value added tax'. The second sentence of the subparagraph states that '[v]alue added tax shall in no circumstances be deductible on expenditure which is not strictly business expenditure, such as that on luxuries, amusements or entertainment'.

76. Thus the first subparagraph of Article 17(6) relates to certain categories or types of expenditure, including – but not limited to – expenditure which is not strictly business expenditure. (24)

77. It is clear from the legislative history of Article 17(6), first, that as the Commission stated in the explanatory memorandum accompanying its proposal, certain expenditure, even though incurred in the ordinary course of the undertaking's business, would be difficult to apportion between business use and private use; secondly, it should be noted that, when the Sixth Directive was adopted, the Member States were unable to agree on the arrangements applicable

specifically to expenditure on passenger transport. (25)

78. The substance of the power conferred on Member States under the second subparagraph of Article 17(6) is therefore that Member States may retain for the time being exclusions of deduction relating to certain kinds of expenditure – namely expenditure covered by the rules to be adopted by the Council in accordance with the first subparagraph of Article 17(6).

79. I therefore take the view – like the Commission and Uusikaupunki – that the ‘exclusion of value added tax’ to which that provision relates is irrelevant in the present case and cannot therefore be invoked to justify excluding tax of the present kind. Under the AVL, immovable property investments or the costs of construction and acquisition in connection with immovable property are not in principle types of expenditure that cannot be deducted. Under point (1) of Paragraph 102(1) of the AVL, investments in connection with immovable property are deductible if the property was acquired for the purposes of a taxable activity and at a time when that activity was being exercised. The complete exclusion in the present case related only to value added tax charged before the application was made in so far as the application to be liable to tax was not made within six months from the bringing into use of the property. Primarily in issue therefore, as explained in my observations on the first three questions, are the rules on adjustment within the meaning of Article 20 of the Sixth Directive and not the rules on deduction of value added tax in accordance with Article 17 of that directive as such.

80. In my view, the answer to the fourth question should therefore be that Article 17(6) of the Sixth Directive is not to be interpreted as meaning that a Member State which allows its taxpayers a right to opt for taxation of the use of immovable property may exclude altogether the deduction of value added tax paid in respect of immovable property investments before an application is made for the leasing of the property to be taxable, if that application is not made within six months.

VIII – **Limitation of the temporal effect of the judgment**

A – *Essential arguments of the parties*

81. The *Finnish Government* asks the Court, should it disagree with its views, to limit the temporal effect of the judgment to the period after its delivery. It cites the unclear nature of the provisions at issue and the practical difficulties that would result from retroactive application. In particular, the Finnish Government stated at the hearing that it had acted in good faith. It pointed out in this connection that the Finnish provisions had been discussed at meetings of the VAT committee in 1995 and that neither the Commission nor other Member States had raised any objections.

82. The *Commission* sees no reason to limit the temporal effect of the judgment. It confirms, however, that the Finnish provisions were discussed at two meetings in 1995. At least some Member States expressed doubts at the meeting as to the compatibility of the Finnish rules on deduction in relation to capital goods. The Finnish Government, it claims, was aware that the Commission considered the Finnish provisions to be inconsistent with the Sixth Directive.

B – *Assessment*

83. In this connection, regard must first be had to the settled case-law of the Court to the effect that the interpretation which, in the exercise of the jurisdiction conferred on it by Article 234 EC, the Court gives to a rule of Community law clarifies and defines the meaning and scope of that rule as it must be or ought to have been understood and applied from the time of its entry into force. It follows that the rule as thus interpreted may, and must, be applied by the courts even to legal relationships which arose and were established before the judgment ruling on the request for

interpretation, provided that in all other respects the conditions for bringing a dispute relating to the application of that rule before the competent courts are satisfied. (26)

84. The Court has consistently held that it is only exceptionally that, in application of a general principle of legal certainty which is inherent in the Community legal order, the Court may decide to restrict the right to rely upon a provision it has interpreted with a view to calling in question legal relations established in good faith. (27)

85. The Court has taken that step only in quite specific circumstances, where there was a risk of serious economic repercussions owing in particular to the large number of legal relationships entered into in good faith on the basis of rules considered to be validly in force and where it appeared that both individuals and national authorities had been led into adopting practices which did not comply with Community legislation by reason of objective significant uncertainty regarding the implications of Community provisions, to which the conduct of other Member States or the Commission may even have contributed. (28)

86. For the Court to impose a time?limit, it must therefore be established that there are serious economic repercussions and that those concerned have acted in good faith. (29)

87. In the present case, it should be noted that the Finnish Government has – only – mentioned the practical difficulties that would arise if the effects of the judgment were not subject to a time?limit; it has, however, failed to demonstrate in detail that the judgment would have serious economic repercussions.

88. Moreover, since the Court may impose time?limits on the effects of a judgment only in exceptional circumstances, it would in my view be excessive to accept, on the basis of the vague assurances given in the present case, that the Finnish Government acted in good faith.

89. It is impossible, on the basis of the partly contradictory information supplied by the Commission and the submissions of the Finnish Government, which do not resolve these contradictions, to establish with certainty what conclusions were reached as a result of the VAT committee’s deliberations. Nor do the minutes of the meeting produced by the Commission on request shed any further light on the point. The only matter that can be established with some degree of certainty is that the contested Finnish provisions were discussed and that some Member States apparently expressed reservations. This may be attributable primarily to the ‘open’ nature of these meetings at which, according to the Commission, various subjects are freely addressed. However, in my view, some clearer evidence is needed than the apparent failure of the Commission or other Member States to raise any objections in such discussions in order to establish that a government believes in good faith that its national provisions comply with Community law. Otherwise, there would be a considerable degree of uncertainty as to the effect of the Court’s judgments and that effect would depend in practice on circumstances beyond the Court’s control.

90. The situation in the present case is thus different from the situation Advocate General Jacobs dealt with in his Opinion in *Banca Popolare di Cremona*, in which the Member State’s good faith was established in particular on the basis of a clearly worded letter signed by the competent Director?General of the Commission. (30)

91. In my view, there is consequently no reason to limit the temporal effect of the Court’s judgment in the present case. (31)

IX – **Costs**

92. The costs incurred by the Finnish Government, the Italian Government and the Commission are not recoverable. Since these proceedings are, for the parties to the main proceedings, a step in the action pending before the referring court, the decision on costs is a matter for that court.

X – **Conclusion**

93. In the light of the foregoing, I propose that the Court reply as follows to the questions submitted by the national court:

(1) Article 20 of Sixth Council VAT Directive 77/388/EEC is to be interpreted as meaning that Members States must provide for the adjustment of deductions in accordance with that article in the case of capital goods unless it follows otherwise from Article 20(5).

(2) Article 20 of the Sixth VAT Directive is to be interpreted as meaning that the adjustment is applicable even where the capital goods, in this case immovable property, were first used in non?taxable activity, on which no deduction could have been made, and later in taxable activity.

(3) The second subparagraph of Article 13(C) and Article 17(6) of the Sixth VAT Directive are not to be interpreted as meaning that a Member State which allows its taxpayers a right to opt for taxation of the use of immovable property may exclude altogether the deduction of value added tax paid in respect of immovable property investments before an application is made for the leasing of the property to be taxable, if that application is not made within six months from the bringing into use of the property.

1 – Original language: German.

2 – 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).

3 – Note on Article 20 of the Sixth Directive: The possibility of extending the adjustment period for immovable property to up to 20 years was introduced for the first time in Council Directive 95/7/EC of 10 April 1995 amending Directive 77/388/EEC and introducing new simplification measures with regard to value added tax – scope of certain exemptions and practical arrangements for implementing them (OJ 1995 L 102, p. 18). Before that, under the Sixth Directive, it could be extended only up to 10 years.

4 – Under Paragraph 28, first subparagraph, of the AVL, real property means land, buildings and permanent structures or parts thereof.

5 – See, in particular, Case C-478/99 *Commission* v *Sweden* [2002] ECR I-4147, paragraph 15, and Case C-233/00 *Commission* v *France* [2003] ECR I-6625, paragraph 75.

6 – See, in particular, Case 268/83 *Rompelman* [1985] ECR 655, paragraph 19, and Joined Cases C-110/98 to C-147/98 *Gabalfrisa and Others* [2000] ECR I-1577, paragraph 44.

7 – See Advocate General Lenz's Opinion in Case C-306/94 *Régie Dauphinoise* [1996] ECR I-3695, point 37.

8 – Case C-97/90 *Lennartz* [1991] ECR I-3795.

9 – Judgment cited in footnote 8.

10 – See *Lennartz*, cited in footnote 8, paragraphs 11 and 12, and Case C?378/02 *Waterschap Zeeuws Vlaanderen* [2005] ECR I-4685, paragraph 38.

11 – See, inter alia, *Waterschap Zeeuws Vlaanderen*, cited in footnote 10, paragraph 31.

12 – See *Lennartz*, cited in footnote 8, paragraphs 8, 15 and 21, and *Waterschap Zeeuws Vlaanderen*, cited in footnote 10, paragraphs 31 and 32.

13 – Case C-137/02 *Faxworld* [2004] ECR I-5547, paragraph 24.

14 – See *Lennartz*, cited in footnote 8, paragraphs 15 and 16.

15 – Advocate General Jacobs reached a similar conclusion in his Opinion in *Lennartz*, cited in footnote 8, in which he held that 'Article 20(2) may operate … even where a taxable person acquires goods initially for the purposes of economic transactions which, under Article 17(2) and (3), do not give rise to the right of deduction (e.g. exempt supplies) but, in subsequent years within the adjustment period, uses the goods for transactions in respect of which VAT is deductible'.

16 – See point 27 above.

17 – Case C-381/97 *Belgocodex* [1998] ECR I-8153, paragraph 16, and Case 8/81 *Becker* [1982] ECR 53, paragraph 38.

18 – *Belgocodex*, cited in footnote 17, paragraphs 16 and 17.

19 – Ibid., paragraph 17.

20 – See, in this connection, Case C-269/03 *Objekt Kirchberg* [2004] ECR I-8067, paragraph 23.

21 – Ibid, paragraph 24.

22 – See, inter alia, *Rompelman*, cited in footnote 6, paragraph 16.

23 – See Case C-43/96 *Commission* v *France* [1998] ECR I-3903, paragraphs 17 and 18.

24 – See also, in this connection, the Opinion of Advocate General Jacobs in *Commission* v *France* , cited in footnote 23, point 12.

25 – See *Commission* v *France*, cited in footnote 23, paragraph 19.

26 – See, in particular, my Opinion in Joined Cases C-453/02 and C-462/02 *Linneweber and Akritidis* [2005] ECR I-1131, at point 60, and the judgment in thoses cases, paragraph 41, and the judgments in Joined Cases C-367/93 to C?377/93 *Roders and Others* [1995] ECR I-2229, paragraph 42, and Case C-347/00 *Barreira Pérez* [2002] ECR I-8191, paragraph 44.

27 – See, in particular, Case C-104/98 *Buchner and Others* [2000] ECR I-3625, paragraph 39, and *Barreira Pérez*, cited in footnote 26, paragraph 45.

28 – Case C-184/99 *Grzelczyk* [2001] ECR I-6193, paragraph 53, and Case C-209/03 *Bidar* [2005] ECR I-2119, paragraph 69.

29 – See, to that effect, Case C-481/99 *Heiniger* [2001] ECR I-9945, paragraph 52.

30 – Opinion of Advocate General Jacobs in Case C-475/03 *Banca Popolare di Cremona*, not yet

published in the Court Reports, point 80.

31 – There is therefore no need in this case to consider the question of an appropriate time?limit for the temporal effect which Advocate General Jacobs discussed in his Opinion in *Banca Popolare di Cremona*, cited in footnote 30.