Reference for a preliminary ruling by the CJEU on the restriction on the deduction of input VAT on customer and employee entertainment expenses

Tax Alert

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The Supreme Court ("SC") has referred to the Court of Justice of the European Union ("CJEU") a question regarding the restriction on the deduction of input VAT on customer and employee entertainment expenses provided for in article 96 of Value Added Tax Law 37/1992 of 28 December 1992 (the "VAT Law").

The reference for a preliminary ruling is set out in this Order of 22 July 2024, which was issued in an appeal in cassation lodged with the SC against a National Court (NC) judgment.

The NC held that while customer and employee entertainment expenses may be deductible for corporate income tax purposes, this is not the case of the related input VAT, which, per sections 4 and 5 of article 96.One. of the VAT Law, is non-deductible for VAT purposes.

Deduction of the input VAT on customer and employee entertainment expenses. The domestic and EU regulatory framework (the "standstill clause").

Articles 95 and 96 of the VAT Law set out certain restrictions on the right to deduct input VAT.

Firstly, article 95.One of the VAT Law on *"Restrictions on the right of deduction"* provides that:

> *"Entrepreneurs or professionals may not deduct the input VAT, or VAT paid, on acquisitions or imports of goods or services that are not used directly and exclusively for their business or professional activity."*

Moreover, sections 4 and 5 of article 96.One of the VAT Law on *"Exclusions and restrictions on the right of deduction"* state that:

> *"No proportion of the VAT paid as a result of the acquisition - including for self-consumption - , import, lease, transformation, repair, maintenance or use of the goods and services listed below may be deducted: [...]*
>
> *4.- Shows and recreational services*
>
> *5.- Goods and services for the entertainment of customers, employees or third parties".*

At Community level, VAT Directive 2006/112/EC provides, as a general rule, that input VAT on goods and services used for business or professional purposes is deductible.

However, under what is known as a **"standstill clause"**, the VAT Directive also allows Member States to restrict the deductibility of input VAT to the extent that such restrictions were provided for in their domestic legislation prior to their accession to the European Union.

This clause featured in article 17.6 of the Sixth Directive and, in Article 176 of the Directive now in force, it reads as follows:

> *"Member States may retain all the exclusions provided for under their national laws at 1 January 1979 or, in the case of the Member States which acceded to the Community after that date, on the date of their accession".*

The above "standstill clause" constitutes an exception to the general principle of VAT neutrality as it deems national legislation that provides for restrictions on the right to deduct VAT over and above those provided for in the Community Directive to be in conformity with Community law. Nonetheless, these restrictions are only accepted where they were in force in the relevant Member State's national legislation on 1 January 1979 or prior to the date of its accession to the EU, whichever fell later.

Peculiarities of the Spanish case and the "standstill clause"

In Spain's case, the legislation restricting the deduction of VAT entered into force on 1 January 1986[1], the date on which it joined the EU.

Since the restriction on the right to deduction was

[1] The restrictions provided for in Article 96.One were introduced by the first VAT Law, Law 30/1985of 2 August 1985, which entered into force on 1 January 1986 (final provision one), coinciding with the entry into force of the Treaty of Accession of Spain to the European Economic Community.

introduced simultaneously with Spain's accession to the EU (and given the absence, until such date, of a valid national provision in this regard) there is some doubt as to the compatibility of the restriction provided for in Spanish law with the VAT Directive and, more specifically, with the “standstill clause'.

These doubts have now reached the SC, which has granted leave for three cassation appeals[2] in which the Court will analyse whether or not the restriction on the right to deduction provided for in sections 4 and 5 of article 96. One. of the VAT Law is covered by the so-called "standstill clause" provided for in the second paragraph of Article 176 of the current VAT Directive.

The SC has already upheld the restriction on the deduction of VAT on expenses related to customer entertainment, finding it to be in accordance with European law. When it did so, it placed the emphasis on the expression “provided for” found in the European legislation, holding that the “standstill clause” referred not to the “validity”, but to the existence, of provisions in the national legislation of the relevant Member State. Since the 1985 VAT Law was approved before 1 January 1986 (the provisions existed in August 1985), it held that the Spanish legislation was not contrary to European law (SC Judgments of 17 February 2001 on appeal for judicial review 8314/1995, and of 7 March 2002 on appeal for judicial review 9156/1996).

However, the SC considers that the time has come to revisit this matter, which revolves around the interpretation of the aforementioned "standstill clause" relied upon by the tax authorities to uphold the restriction on the right to deduct input VAT.

The SC reminds us that VAT is based on the principle of neutrality, and that care should be taken to ensure, on the one hand, that the entrepreneur or professional is not ultimately the end customer in the chain for VAT purposes and, on the other hand, that the tax is correctly collected.

For its part, the CJEU has ruled on the “standstill clause”, stating that as a scheme that derogates from the principle of the right to deduct VAT, it should be interpreted in the strict sense (see, in this regard, paragraph 59 of the Metropol and Stadler judgment and paragraph 28 of the Magoora judgment C-414/07). Similarly, in Case C-124/12 AES-3C Maritza East the CJEU held that the exclusion of the right to deduct VAT would not be protected by the *standstill* clause if it was not provided for in the national legislation in force up to the date of accession of the Member State in question to the Union.
With this in mind, in the recently published order, the SC referred the following questions to the CJEU for a preliminary ruling:

1. Are provisions such as sections 4 and 5 of article 96.One of the VAT Law, which preclude the deduction of any proportion of the input VAT on the acquisition of goods and services such as sporting events and those intended for the entertainment of customers, employees or third parties, in accordance with article 168(a) and the first paragraph of article 176 of Directive 2006/112/EC, even if the taxpayer can demonstrate that the relevant expenses are directly related to their business or professional activity, that they were incurred for a strictly business or professional purpose, and that the goods and services have been used for the purposes of taxable transactions carried out by the taxable person, even if the amount in question *is* a tax-deductible expense for the purposes of personal taxes on income (personal income tax and corporate income tax)?

2. Are provisions such as sections 4 and 5 of article 96.One of the VAT Law - which introduce restrictions on the right of deduction, and which entered into force on the very day that the Kingdom of Spain joined the European Union (1 January 1986) - compatible with the *standstill clause*, even though no provision in force up to the date of such accession envisaged such a restriction?

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In its order notifying that the matter was to be referred for a preliminary ruling, the SC expresses doubts as to the conformity with the EU *standstill* clause of sections 4 and 5 of article 96.One of the VAT Law, and warns that the CJEU decision may lead to a shift in the view taken in its previous case law.

Should the CJEU find that Spanish legislation contravenes the EU Directive on VAT, the Judgment may affect both inspection proceedings and any claims and appeals currently underway. In this connection, companies would be well advised to review the criteria applied in prior assessment periods in case of a potential increase in the amount of deductible input VAT. They should also bear in mind the potential effect on corporate income tax or personal income tax - if the undeducted input VAT was treated as a deductible expense for the purposes of such taxes.

[2] Supreme Court Order of 24 April 2024 (appeal 5101/2023); Supreme Court Order of 29 September 2023 (appeal 246/2023); and Supreme Court Order of 8 February 2023 (appeal 5250/2022).

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