

OPINION OF ADVOCATE GENERAL
SAGGIO

delivered on 30 September 1999 *

1. In the present reference for a preliminary ruling the High Court of Justice, England and Wales, asks the Court to identify the criteria necessary to establish the existence of an entitlement to deduct tax charged on an input service where it is supplied to a taxable person as a consequence of a deductible output transaction. The dispute before the national court concerns, essentially, the question whether a merchant bank, which carries out both exempt transactions and taxable transactions, can deduct input VAT paid in respect of legal services it has received both in relation to a deductible service and when defending a claim for damages brought against it for misrepresentations allegedly made by one of its directors in relation to the aforementioned transactions.

legislation of Member States concerning turnover taxes (hereinafter 'the First Directive')¹ provides that 'on each transaction, value added tax, calculated on the price of the goods or services at the rate applicable to such goods or services, shall be chargeable after deduction of the amount of value added tax borne directly by the various cost components'.

3. Article 17(1), (2)(a), (3)(c) and (5) of the 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 (hereinafter 'the Sixth Directive')² provides as follows:

Community provisions

2. The second paragraph of Article 2 of the First Council Directive 67/227/EEC of 11 April 1967 on the harmonisation of

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

* Original language: Italian.

1 — OJ, English Special Edition 1967, p. 14.

2 — OJ 1977 L 145, p. 1.

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 ...;³

...

3. Member States shall also grant every taxable person the right to the deduction or refund of the value added tax referred to in paragraph 2 in so far as the goods and services are used for the purposes of:

...

- (c) any of the transactions exempt pursuant to Article 13B(a) and (d), (1) to (5), when the customer is established outside the Community or when these

transactions are directly linked with goods intended to be exported to a country outside the Community.

...

5. As regards goods and services to be used by a taxable person both for transactions covered by paragraphs 2 and 3, in respect of which value added tax is deductible, and for transactions in respect of which value added tax is not deductible, only such proportion of the value added tax shall be deductible as is attributable to the former transactions⁷.

Article 17(5) goes on to prescribe a number of formulae for the determination of the proportional deduction, the choice of formula being left, however, to the Member States.

Article 13B(d) of the Sixth Directive, referred to in Article 17(3)(c), exempts a number of transactions usually carried out by banks (such as the granting and the negotiation of credit and the management of credit, credit guarantees, transactions concerning funds, shares, company shares and the like).

3 — As amended by Article 1(22) (see Article 28f) of Council Directive 91/680/EEC of 16 December 1991 (OJ 1991 L 376, p. 1).

National provisions

professional services supplied to that company by an English firm of solicitors, Clifford Chance.

4. The United Kingdom implemented Article 17(3)(c) of the Sixth Directive by treating the transactions referred to therein as zero-rated, while deeming them to be theoretically taxable, so that although the right to deduct exists no tax is actually charged.

Clifford Chance had acted for the Midland in relation to the acquisition of Mercantile House Holding ('Mercantile'), a company quoted on the stock exchange, a transaction which the Midland had undertaken to carry out on behalf of Quadrex Holdings Inc. ('Quadrex'), a corporation registered in Delaware, USA.

In the United Kingdom there are various formulae for calculating the amount of the input VAT that can be deducted in the case of taxable persons who use goods and services in order to carry out both taxable and exempt transactions.

The British and Commonwealth Holding plc (hereinafter 'B & C') was also interested in the abovementioned transaction. In August 1987, B & C and Quadrex entered into an agreement under which B & C was to buy Mercantile and then sell the wholesale broking division to Quadrex.

Facts and questions referred for a preliminary ruling

5. The present reference for a preliminary ruling arises out of a dispute between the Commissioners of Customs and Excise ('the Commissioners') and Samuel Montagu & Co. Ltd (part of the Midland Bank group, hereinafter referred to as 'the Midland'), a London merchant bank which supplies services, some of which are taxable and some of which are exempt so far as concerns deduction of VAT in respect of

The agreement, however, did not have the desired result in that, due to lack of funds, Quadrex was not able to purchase the abovementioned division from B & C. In early 1988 B & C accordingly brought proceedings against Quadrex for breach of contract. Quadrex, in turn, sued the Midland. In March 1988 B & C then brought an action for damages against the Midland for the alleged misrepresentation of a

director of that company to B & C as to Quadrex's finances. The Midland relied once again on the services of Clifford Chance to defend itself against that claim. The dispute was settled out of court at the end of 1994.

Between 1988 and 1995, Clifford Chance invoiced fees for the defence to the Midland.⁴

6. The Commissioners found that only part of the legal services at issue, supplied to the Midland between 1987 and 1995, were services in respect of which VAT is deductible, so that not all of the input tax on those services was deductible — the input tax would in fact have to be apportioned between the taxable supplies and the exempt supplies and only the proportion of the tax in respect of the taxable supply could be deducted by the Midland.

The Midland appealed against the Commissioners' decision before the VAT and Duties Tribunal, claiming that all the legal services, including those relating to the litigation, were attributable to taxable services (assistance in the abovementioned financial transaction, in particular the

acquisition of a business sector by Quadrex) supplied by the Midland to Quadrex.

By decision of 15 May 1996 the Tribunal allowed the appeal, holding that the input tax in respect of the fee paid to Clifford Chance for its legal services was deductible in its entirety.

The Commissioners brought an appeal on a point of law against that decision before the High Court of Justice, Queen's Bench Division, submitting that, although the legal services were supplied to the Midland in its capacity as a taxable person, they were in large part connected to the defence of the Midland against claims that it had incurred civil liability in damages as a result of actions attributable to it which were performed while it was making the taxable supply to Quadrex (the latter supply is one in respect of which VAT is deductible because, under the United Kingdom legislation, it is treated as a zero-rated taxable supply, and thus remains theoretically taxable; such a supply falls within the scope of Article 17(3)(c) of the Sixth Directive, since the Midland had supplied a service to Quadrex, a company whose head office is outwith the European Community).⁵

4 — The Midland has placed in the case-file the invoices received from Clifford Chance during that period.

5 — That aspect was never in dispute.

Finally, the Commissioners stated again that, in the present case, since Clifford Chance supplied at the same time taxable and non-taxable services to a taxable person which effects both exempt transactions and taxable transactions, the input tax had to be apportioned, and only that part of the tax relating to taxable services could be deducted pursuant to Article 17(5) of the Sixth Directive.

7. Accordingly, the High Court decided to refer the following questions to the Court of Justice for a preliminary ruling:

'On the proper interpretation of Council Directive 67/227/EEC of 11 April 1967, in particular Article 2, and Council Directive 77/388/EEC of 17 May 1977, in particular Article 17(2), (3) and (5), and having regard to the facts of the present case:

1. Is it necessary to establish a direct and immediate link between a particular input obtainable by a taxable person acting as such and a particular transac-

tion or transactions made by that person in order to

(a) establish the existence of an entitlement to deduct tax charged in respect of the input; and

(b) determine the extent of that entitlement?

2. If the answer to 1(a) or (b) is in the affirmative, what is the nature of the direct and immediate link and, in particular, in the case of a taxable person making both transactions in respect of which VAT is deductible and transactions in respect of which it is not:

(a) is the test for determining the amount of input tax that is deductible any different as between Article 17(2), (3) and (5) (and, if so, in which respects is it different); and

(b) is such a person entitled to deduct all the input tax charged in respect of an input on the ground that the input was utilised as a consequence of making a transaction falling

within Article 17(2) or (3), in particular Article 17(3)(c)?

Arguments of the parties which submitted observations

3. If the answer to 1(a) or (b) is in the negative:

(a) what is the link that has to be established; and

(b) in the case of a taxable person making both transactions in respect of which VAT is deductible and transactions in respect of which it is not:

(i) is the test for determining the amount of input tax that is deductible any different as between Article 17(2), (3) and (5) (and, if so, in which respects is it different); and

(ii) is such a person entitled to deduct all the input tax charged in respect of an input on the ground that the input was utilised as a consequence of making a transaction falling within Article 17(3)(c)?

8. The parties do not dispute that there is an entitlement to deduction provided that there is a direct and immediate link between the input and output transactions, as held by the Court of Justice in Case C-4/94 *BLP Group*.⁶

9. The Midland points out that the First Directive, which specifies in the second paragraph of Article 2 that only the amount of 'value added tax borne directly by the various cost components' of the transaction may be deducted, remains a guide to deductibility under the subsequent directives.

In the Midland's view, a cost component is an item of cost which arises for the trader because of the making of the supply (whether the supply is past, future or both). Thus, in accordance with the general economic meaning of the term 'turnover', where, in respect of the supply of a service, there is a dispute which gives rise to legal costs, such expenditure may be considered to be a cost component of that service.

⁶ — Case C-4/94 *BLP Group* [1995] ECR I-983, paragraph 19.

10. The United Kingdom does not dispute the Midland's entitlement to deduct VAT, it merely challenges the extent to which the tax may be deducted. It argues that in the present case the legal services supplied by Clifford Chance to the Midland are in fact associated with that company's business generally and that, since such business consists of both transactions giving rise to the right to deduct and transactions which confer no such right, under Article 17(5) of the Sixth Directive input VAT is deductible only in part, specifically in proportion to the professional services relating to the business giving rise to the right to deduct. The United Kingdom cannot accept that such legal services should be considered to be cost components, as provided for in Article 2 of the First Directive, of the financial transactions carried out by the Midland as a component of a transaction or of a general class of taxable transactions.

11. The Commission, like the Midland, maintains that the existence of an immediate and direct link between the business of the undertaking and the professional services, a link which is a condition necessary for the right to deduct VAT to arise, does not depend on whether the output transaction has already been effected or is to be effected at some point in the future. Article 17(1) of the Sixth Directive provides that the right to deduct arises at the time when the deductible tax becomes chargeable rather than when output tax becomes due. According to the Commission, that

approach was confirmed by the Court of Justice in *Belgian State v Ghent Coal Terminal*.⁷

12. So far as concerns the second question referred by the national court seeking to ascertain the nature of the aforementioned 'immediate and direct link', both the Midland and the Commission argue, first and foremost, that it is for the national court to ascertain, on a case-by-case basis, whether such a link exists. However, both those parties observe that in the present case there is a direct and immediate link between the legal services obtained from Clifford Chance and the financial transactions effected by the Midland and that, therefore, the entire amount of the tax to which the lawyers' fees are liable is deductible.

The Midland points out that, in order to define the conditions and the manner in which the test is to be applied, the starting point must be, according to the case-law of the Court, to establish what is relevant for the purposes of the direct and immediate test. In that respect, the Court held in Case 268/83 *Rompelman*⁸ and *BLP*,⁹ cited above, that neither the purpose or results of the output transaction nor the ultimate aim pursued by the taxable person is relevant. The test to be taken into account is therefore, according to the case-law

⁷ — Case C-37/95 *Ghent Coal Terminal* [1998] ECR I-1.

⁸ — Case 268/83 *Rompelman v Minister van Financiën* [1985] ECR 655, paragraph 19.

⁹ — See paragraph 24.

cited, an objective one. The nature of the goods which a taxable person acquires for the purposes of his economic activity is, on the other hand, an important factor in ascertaining whether there is an immediate and direct link, as the Court ruled in Case C-230/94 *Enkler v Finanzamt Homburg*.¹⁰ Essentially, in the Midland's view, the aforementioned link exists where there is an objective relationship between the input transaction and the output transaction such that the former can be said to be part of the cost to the trader of making the output, whether it be preparatory to or a consequence of the latter.

between Quadrex and B & C. Finally, in the Midland's view, the legal services supplied by Clifford Chance were closely linked to the financial transaction at issue.

Finally, the Midland lists a series of facts relating to the present case to show the existence of an immediate and direct link between the transactions at issue. Included among them, for example, is the fact that the statements made by the Midland director which gave rise to the claim for damages were made in the course of his duties on behalf of that company and in respect solely of the financial transaction at issue, and that the Midland director had been mandated by Quadrex to negotiate with B & C the purchase of Mercantile and that those negotiations centred, in particular, on the question of Quadrex's financial status (hence the significance of the statements made by the director in that connection). It was ultimately those statements which led to the termination of the contract

13. The Commission, however, puts forward a number of practical examples to illustrate cases in which the aforementioned direct and immediate link is apparent. It cites the example of a taxable person who makes 'mixed' supplies of goods and who is sued for breach of contract (on the ground that the goods were faulty) relating to a particular taxable supply, and incurs legal fees in his defence. In such circumstances, in the Commission's view, the direct and immediate link would lie between the legal services obtained and the particular taxable supply, rather than the whole of the business in general; that means that the taxable person would be entitled to full deduction of the tax on the legal fees by virtue of Article 17(2) of the Sixth Directive. On the other hand, if a manufacturer carries on a business of making both taxable and exempt supplies of goods and pays an accountant to prepare the annual accounts of the business, there is no direct and immediate link between the accountant's work and any particular supply of goods. In this case, the direct and immediate link is between the accountant's work and the business as a whole, with the result that, since that business consists of

¹⁰ — Case C-230/94 *Enkler v Finanzamt Homburg* [1996] ECR I-4517, paragraph 26.

both taxable and exempt supplies, an apportionment of the VAT will be required under Article 17(5) of the Sixth Directive.

which is a third party so far as concerns the supply made by the Midland to Quadrex.

Finally, the Commission argues that the construction put forward by the national court in the second question, namely that there exists a 'direct and immediate link' where input goods or services are supplied as a consequence of making a transaction falling within Article 17(2) or (3) of the Sixth Directive, is too narrow. In the Commission's view, the direct and immediate link test covers such a case.

15. All the parties agree, however, that a single criterion should apply when interpreting Article 17(2), (3) and (5) of the Sixth Directive (the United Kingdom points out none the less that the criteria could vary according to the formula used by the Member States in calculating the proportion within the meaning of Article 17(5)) and that it is not necessary to consider the third question put forward by the national court in light of the answers suggested for the first two questions.

14. The United Kingdom maintains, however, that in the present case there is no 'direct and immediate link' between the financial transaction and the legal defence services provided by Clifford Chance.

Introductory remarks

The claim for damages brought by B & C against the Midland could not in fact be considered to be part of the taxable services, since it lacks any connection whatsoever with the latter; in the United Kingdom's view, the link is purely coincidental. Moreover, that action did not concern solely the deductible financial transaction and in any event was brought by B & C,

16. As may be seen from the foregoing, at the heart of the problem raised by the national court is the analysis of the mechanism for deduction laid down in the VAT system. The principle of deduction of the input tax is a fundamental element of the common system of VAT: at each stage of the process of production and marketing, the taxable person pays to the revenue authorities the tax due on its sales prior to deduction of the tax paid in the preceding stage by its suppliers. Once the deduction mechanism is seen to operate in that way, the definition in Article 2 of the First

Directive of value added tax as 'a general tax on consumption exactly proportional to the price of the goods and services, whatever the number of transactions which take place in the production and distribution process before the stage at which tax is charged' may be understood.

The deduction system is intended 'to relieve the trader entirely of the burden of the VAT payable or paid in the course of all his economic activities'.¹¹ It 'consequently ensures that all economic activities, whatever their purpose or result, provided they are themselves subject to VAT, are taxed in a wholly neutral way'.¹²

17. The right to deduct arises, therefore, where the input transaction is linked to a taxable output transaction. This follows, in particular, from the abovementioned Article 17(2) of the Sixth Directive, which provides that VAT may be deducted 'in so far as the goods and services are used for the purposes of... taxable transactions'. If this general condition is met, the whole of the input VAT is deductible.

18. The Community legislature, however, provided for a number of cases in which the

general principle cannot be applied. They may be classified as follows:

- where a taxable person supplies services or goods to another taxable person, who uses it to carry out an exempt transaction (see Article 13 of the Sixth Directive); in such a case the latter may not deduct input VAT because a taxable person who is unable to pass VAT on to third parties acts as a final consumer¹³ (even where the ultimate purpose of the exempt transaction is to carry out a taxable transaction). There are, however, exceptions to that rule, such as that provided for in Article 17(3)(c) of the Sixth Directive, to which the general principle that the whole of the VAT is deducted applies;

- where the goods or services are used by a taxable person both for transactions in respect of which value added tax is deductible, and for transactions in respect of which value added tax is not deductible (such as exempt transactions)¹⁴ (Article 17(5) of the Sixth Directive); in such a case, only such proportion of the VAT is to be deductible as is attributable to the former transactions;

11 — *Ghent Coal Terminal*, cited above, paragraph 15.

12 — *Rompelman*, cited above, paragraph 19.

13 — Case 8/81 *Becker* [1982] ECR 53, paragraph 44; Opinion of Advocate General Lenz in *BLP*, cited above, paragraph 32.

14 — For example, such a category might include the renting of property by a company which carries out both exempt transactions and taxable transactions. In such a case, the rent paid cannot be linked to just one of the two transactions.

— where expenditure is for private purposes, even when incurred as part of the normal business of the undertaking (see Article 17(6) of the Sixth Directive); such expenditure is not deductible.

is to say, used for both deductible and non-deductible transactions). In such a case, deduction is to be made pursuant to Article 17(5) and Article 19 of the Sixth Directive (and in accordance with the system adopted by the United Kingdom),¹⁵ or in the proportion agreed between the Midland and the Commissioners. It should be observed that the Midland is a company which, in general, carries out both taxable transactions and exempt transactions.

19. Now, the dispute pending before the national court concerns essentially the following issues:

(a) whether the services supplied by Clifford Chance in defending the Midland (in respect of which the Midland paid VAT) may be directly linked to the transaction carried out by that company on behalf of Quadrex and thus gives rise to deduction of the whole of the VAT (within the meaning of Article 17(2) of the Sixth Directive). It must be borne in mind that, even if such a transaction falls within the category envisaged in Article 13B(d) of the Sixth Directive, the Member States may grant a right to deduct VAT (the United Kingdom applied a 'zero rating' to that type of transaction); and

20. The Midland and the Commission argue in favour of the case outlined in paragraph (a), while the United Kingdom supports that in paragraph (b). The United Kingdom, as stated above, does not deny that the Midland is entitled to obtain a deduction of the VAT on the legal fees, it merely contests the amount that may be deducted (that is to say whether the whole of the VAT paid on Clifford Chance's fees is deductible).

(b) where it is not possible to establish such a link, whether the supply at issue is to be included among the general (business) activities of the Midland, or rather among the 'mixed' supplies (that

21. The question of 'direct and immediate link' is of relevance, therefore, mainly in relation to the situation described in para-

15 — It should be borne in mind that the Community legislature has allowed every Member State to authorise or require taxable persons to determine the proportion according to various methods. See Article 17(5) of the Sixth Directive.

graph (a), and only indirectly to that in paragraph (b).¹⁶

of the development of the case-law. It is therefore appropriate first of all to set out the factual and legal context in which the Court has used that expression.

Substance

The first question

22. That being said, I now move on to analyse the first question. By that question the national court seeks to establish whether, in order for the whole of the VAT to be deductible in circumstances such as those of the Midland (that is to say an undertaking which carries out taxable transactions and exempt transactions), there must exist a 'direct and immediate link' between the input transaction (the legal services supplied by Clifford Chance to the Midland in respect of the litigation) and the output transaction (that is, the acquisition of Mercantile).

23. It should be noted that the expression 'direct and immediate link' is not contained in Community legislation but is the result

The context is that of the *BLP* case, cited several times above, in which the Court was called upon to rule on the right to deduction in respect of certain services (financial and legal advice) supplied to a company and used by it for an exempt transaction. In that case the national court had asked the Court whether BLP was entitled to deduct the whole of the input tax paid in view of the fact that the purpose and the result of carrying out the exempt transaction was to offset a taxed transaction in its entirety and specifically to discharge the company's debts.

The Court answered in the negative, holding that, in order to be able to apply the deduction referred to in Article 17(2) of the Sixth Directive, 'the goods or services in question must have a direct and immediate link with the taxable transactions, and... the ultimate aim pursued by the taxable person is irrelevant in this respect'.¹⁷

That interpretation, according to the Court, is confirmed both by the second paragraph of Article 2 of the First Directive, which provides that, in order for input tax to be deductible, it must have been

¹⁶ — According to the United Kingdom, in such a case the expenditure attributable to the services supplied by Clifford Chance in defending it in court could be considered general expenditure by merely demonstrating that it was incurred by Midland in its capacity as a business making taxable and exempt transactions, rather than in some personal capacity.

¹⁷ — Paragraph 19.

'borne directly by the various cost components', and by Article 17(3)(c) of the Sixth Directive.¹⁸

24. Admittedly, as the Commission points out, the matter at issue in *BLP* was different to that in the present case, in which what is disputed is not whether the Midland has a right to obtain deduction of the VAT but only the amount which may be deducted. However, even from this different point of view, it is still necessary to establish whether there is 'a direct and immediate link' between the input and output transactions, because even partial deduction of the VAT depends on that factor.

In that connection it should be stated at the outset that the closeness of such a link may vary according to the status of the taxable person and the nature of the output transaction and that such variables may have an influence on the burden on the trader seeking such deduction to prove the existence of the link in question.¹⁹ Thus, according to the case-law (see *Enkler*, cited

above), where a taxable person carries on a business with the purpose of carrying out only taxable transactions, it is not necessary, for the purposes of deducting the whole of the VAT, that he should prove the existence of a direct and immediate link between each and every input transaction and a particular taxable output transaction. The Community legislature only requires that the goods and services be used or be likely to be used 'for the purposes of... taxable transactions' (Article 17(2) and (3) of the Sixth Directive). The use of the words 'purposes' and 'transactions' in the plural denotes that in certain instances a link with a particular taxable transaction is not necessary, a link with the undertaking's business sufficing.

Such an interpretation is consistent with the principles on which the general system of deductions is based and in particular with the principle that all economic activities are taxed in a wholly neutral way, whatever their purpose or their results, even where such activities are themselves subject to VAT.²⁰ That is, moreover, in keeping with the *ratio* of the VAT deduction system, which, as the Court has held, must be applied 'in such a way that its scope corresponds as far as possible to the sphere of the taxable person's business activity'.²¹

25. On the other hand, the aforementioned direct and immediate link takes on parti-

18 — Paragraphs 20, 21 and 22. From that latter article 'it follows... that it is only by way of exception that the directive provides for the right to deduct VAT on goods or services used for exempt transactions' (paragraph 23).

19 — The Court ruled, for example, in *Enkler*, cited above (paragraph 26), that the nature of the goods may be taken into consideration as a factor in determining whether a taxable person has acquired goods for the purposes of his economic activities. For example, the 'fact that property is suitable only for economic exploitation will normally be sufficient to find that its owner is exploiting it for the purposes of his economic activities and, consequently, for the purpose of obtaining income on a continuing basis. On the other hand, if, by reason of its nature, property is capable of being used for both economic and private purposes, all the circumstances in which it is used will have to be examined in order to determine whether it is actually used for the purpose of obtaining income on a regular basis' (paragraph 27).

20 — *Rompelman*, cited above, paragraph 19.

21 — Case 165/86 *Intiem v Staatssecretaris van Financiën* [1988] ECR 1471, paragraph 14.

cular importance, as the United Kingdom observes, where the intention is to apply the general principle of deduction of the whole of the VAT to circumstances, such as those described by the national court, in which the taxable person carries out taxable and/or exempt transactions and/or receives services or goods which may be used both for exempt transactions and for taxable transactions. In such a case, where there is no immediate and direct link between the services and goods and the taxable transactions, the right to deduct is restricted proportionately or is precluded where the output transaction is an exempt transaction.

26. I therefore suggest that the answer to the first question should be in the affirmative, specifically to the effect that, in circumstances such as those obtaining in the present case, in order for the whole of the VAT to be deductible, there must exist a 'direct and immediate link' between a particular taxable input obtainable by a taxable person acting as such, and a particular taxable transaction or transactions made by that person. Where such a link is shown to exist, the taxable person is entitled to deduct the whole of the VAT paid on the input transaction.

The second question

27. By its second question the national court seeks to ascertain the nature of the aforementioned 'direct and immediate link'. In particular, it asks whether a person

(the Midland in this case) making both transactions in respect of which VAT is deductible and transactions in respect of which it is not, is entitled to deduct all the input tax charged (in the present case, tax charged on Clifford Chance's fees) in respect of an input (the service supplied by those chambers in defending the claim against the Midland) on the ground that the input was utilised as a consequence of making a transaction falling within Articles 17(2) or (3), in particular Article 17(3)(c).

28. It is not easy to provide an answer to such a question because it is not easy to define an abstract standard to be applied when determining subsequently, on a case-by-case basis, whether there is such a direct and immediate link between transactions.

I do not believe, however, that an adequate reply can be given to such a question merely by restating the principle that the link must be direct and immediate; that would be tantamount to referring back to the national court not only the task of ascertaining whether such a link exists in actual fact (which is certainly within its jurisdiction) but also, in large part, the task of identifying the criteria by which that assessment is to be governed.

If due account is taken of that, what the Court is asked to provide in the present case is not a mere definition but rather guidance as to the nature of the link at issue. Such guidance will enable the

national court to determine the specific approach to adopt in the case of a taxable person who, as in the present case, seeks to deduct all the VAT paid on legal services of which he made use not only in carrying out a deductible transaction but also in defending himself in court in litigation arising out of that transaction.

29. The parties' arguments on that point do not appear to be very different, even if in the present case they arrive, as has been said, at opposite conclusions.

Now, the meaning of the key legal expression 'direct and immediate link' is to be found in the words that go to make it up and in the principles developed by the Court concerning the way in which the VAT deduction system is to be implemented.

So far as concerns the wording, I would mention first that the expression 'direct and immediate link'²² was chosen by the Court, in the oft-cited *BLP* case, as a key to the interpretation of the terms used in

²² — In the French language version of the judgment in *BLP*, cited above: 'lien direct et immédiat'.

Article 17 of the Sixth Directive.²³ The use of the two adjectives 'direct' and 'immediate' cannot but refer to a particularly close link between the taxable transactions (in the present case, the financial transaction) carried out by a taxable person (in this case, the Midland) and the goods or services supplied by another taxable person (in the present case, Clifford Chance).

In particular, the adjective 'direct' means that there cannot be the appropriate link between two transactions where a third transaction takes place between them breaking the causal chain, or where the link between the two transactions is very distant in time. The example provided by the United Kingdom during the hearing seems apposite: A supplies a good to B; on delivery to B, an employee of A's drops the good on passer-by C's foot and injures him. C brings a claim for damages against A. The question then arises whether the legal costs incurred by A in defending itself against C could be seen as a cost component of the supply to B, or whether there is a different link with that supply. I am of the same view as the United Kingdom in that I believe that in such a case the link is too tenuous to be regarded as direct.

²³ — The Court has held, specifically (in paragraphs 18 and 19 of that judgment) that 'paragraph 2 of Article 17 of the Sixth Directive must be interpreted in the light of paragraph 5 of that article. Paragraph 5 lays down the rules applicable to the right to deduct VAT where the VAT relates to goods or services used by the taxable person "both for transactions covered by paragraphs 2 and 3, in respect of which value added tax is deductible, and for transactions in respect of which value added tax is not deductible". The use in that provision of the words "for transactions" shows that to give the right to deduct under paragraph 2, the goods or services in question must have a direct and immediate link with the taxable transactions, and that the ultimate aim pursued by the taxable person is irrelevant in this respect'.

The adjective 'immediate' denotes a particularly close temporal proximity between the two transactions. That does not mean, however, as the Midland correctly observes in its submissions, that the tax on the input transaction must become chargeable before the output transaction is carried out;²⁴ the only requirement is that the time which has elapsed between the two transactions should not be too long.

30. The Court has held that whether there is a 'direct and immediate link', a matter for the national court, must be determined on the basis of an objective criterion,²⁵ that is to say without taking account of the ultimate aim or the results of the economic activities of the taxable person seeking to deduct VAT, provided, of course, that those activities are themselves subject to VAT.²⁶

Let me give a specific example. Company A, which provides services for both deductible and non-deductible transactions, is entitled to deduct all the VAT in respect of services which it has received in its turn from company B, so long as the latter services are objectively linked to the deductible transactions. To that end, that require-

ment is met if the services received by B may be used for a deductible transaction or to prepare such a transaction,²⁷ or are capable of being so used.²⁸ It is not inconceivable that such a link should exist where the services have not in actual fact been used for a deductible transaction by reason of circumstances beyond the control of company A, so long as neither fraud nor abuse is involved, for example circumstances in which company A falsely claims to wish to carry out a particular economic activity.²⁹

That approach not only ensures 'that all economic activities... are taxed in a wholly neutral way',³⁰ it also serves to safeguard the principle of legal certainty. It 'is contrary to the principle of legal certainty for the rights and obligations of taxable persons to depend on facts, circumstances or events which occurred after the tax authority made a finding in respect of those rights and obligations'.³¹ y

24 — Any other solution might appear to run counter to the principles laid down by the Court, in particular in *Ghent Coal Terminal*, cited above. In that judgment, the Court held that the right to deduct remains where, by reason of circumstances beyond his control, the taxable person has never made use of those goods or services for the purpose of carrying out taxable transactions.

25 — See *BLP*, paragraphs 24 and 26, and *Rompelman*, paragraph 19.

26 — In line with the case-law of the Court. See, most recently, *Ghent Coal Terminal*, cited above, paragraph 15.

27 — In *Rompelman*, the Court held that the economic activities referred to in Article 4(1) of the Sixth Directive may consist in several consecutive transactions and that preparatory acts, such as the acquisition of assets and therefore the purchase of immovable property, which form part of those transactions must themselves be treated as constituting economic activity (paragraph 22).

28 — The Court has ruled, for example, in *Enkler* that one of the factors 'on the basis of which the tax authorities must consider whether a taxable person has acquired goods for the purposes of his economic activities is the nature of the goods concerned' (paragraph 26). See also Case C-110/94 *INZO* [1996] ECR I-857, paragraph 21.

29 — See, to that effect, *Ghent Coal Terminal*, paragraphs 20, 21 and 22.

30 — See *Ghent Coal Terminal*, paragraph 15.

31 — *INZO*, cited above.

The corollary to such an interpretation is that there is no link, and thus no possible deduction of all the VAT, where it is objectively impossible to carry out the taxable output transaction at the time when taxable person B provides a service or a good to taxable person A.

31. That having been said, I am of the opinion that, in circumstances such as those set out by the national court, there is always a 'direct and immediate link' between a taxable transaction and the supply of certain goods or services whenever, in the light of an objective assessment (which it is for the national court to carry out), the goods or services are used by the taxable person to carry out one or more taxable transactions. Such a link exists, in particular, in accordance with the second paragraph of Article 2 of the First Directive, if the amount of the tax paid in respect of the supply of a good or for the provision of a service was borne directly by the various cost components of the taxable transaction. The mere fact that a service (such as legal defence) was supplied as a consequence of a deductible transaction is not sufficient, however, for the purposes of deducting the whole of the VAT paid by a taxable person (such as the Midland) in respect of the supply of that service. Moreover, the link must be identifiable according to objective criteria; that generally means that the link should reflect the normal relationship between the two supplies, so that the second should follow the first not in a mechanical way, but according to the normal and regular order of causal chains.

32. I therefore suggest that the Court should reply in the negative to Question 2(b), to the effect that the mere fact that a service was supplied as a consequence of a deductible transaction is not sufficient, for the purposes of deducting all the VAT paid in respect of the service by a taxable person who carries out transactions in respect of which VAT is deductible and others in respect of which it is not.

33. Finally, so far as concerns Question 2(a), by which the national court seeks to ascertain whether the test for determining the amount of the deductible input tax is any different as between Article 17(2), (3) and (5) of the Sixth Directive, the reply depends on the formula chosen by the Member State in question to determine the proportion of the deductible tax, pursuant to Article 17(5). In the case of the United Kingdom, according to its observations, the formula chosen reflects that provided for in Article 17(2) and (3). In that case, then, the test to be adopted will be the same.

The third question

34. In view of the answers given to the two preceding questions, the third question does not call for an answer. I therefore put forward an answer to it only by way of an alternative.

Should the Court rule that, in circumstances such as those set out by the national court, a direct and immediate link is not necessary between a particular input obtainable by a taxable person acting as such and a particular transaction or transactions carried out by that person, I suggest that a test be chosen which in any event ensures that the deduction system is applied

in accordance with the aforementioned principles laid down in the case-law.

As to Question 3(b), I would refer the Court to my answer to the second question.

Conclusions

35. For the reasons I have given I suggest that the Court give the following answer to the questions referred by the High Court of Justice:

- (1) Article 17(2) of the Sixth Directive must be interpreted as meaning that, in circumstances such as those before the referring court, in order to determine whether all the VAT is deductible, it is necessary to establish whether there exists a direct and immediate link between a particular input obtainable by a taxable person acting as such and a particular output transaction or transactions made by that person. If such a link is shown to exist, the taxable person is entitled to deduct all the VAT paid in respect of the input transaction.

- (2) Article 17(2) and (3) of the Sixth Directive must be interpreted as meaning that, in order for all the VAT paid in respect of a service by a taxable person, who carries out both transactions in respect of which VAT is deductible and

transactions in respect of which it is not, to be deductible, the mere fact that that service was utilised also as a consequence of making a transaction falling within the scope of Article 17(2) or Article 17(3), in particular Article 17(3)(c), of the Sixth Directive is not sufficient.

Entitlement to deduct VAT does arise, however, whenever, in the light of an objective assessment (which it is for the national court to carry out), a service is utilised by the taxable person, according to the normal and regular order of causal chains, to carry out one or more taxable transactions falling within the scope of the abovementioned articles. Such a link exists, in particular, in accordance with the second paragraph of Article 2 of the First Directive, if the amount of the tax paid in respect of the supply of a service was borne directly by the various cost components of the taxable transaction.

In order to establish whether the test for determining the amount of input tax that is deductible is any different as between Article 17(2), (3) and (5), it must first be established what formula has been adopted by the Member State concerned for the determination of the proportional deduction of the VAT, within the meaning of Article 17(5) of the Sixth Directive.