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Disproportion between costs and income does not prevent input VAT recovery

The Luxembourg Court of Cassation had the opportunity to adjudicate at last instance on a condition for the right to deduct VAT asserted by the Luxembourg VAT authorities.

In a recent domestic case (case CAS-2021-00028 dated 17 March 2022), the Luxembourg Court of Cassation had the opportunity to adjudicate at last instance on a condition for the right to deduct VAT asserted by the Luxembourg VAT authorities: namely, that the amount of taxable turnover be at least as high as the costs in respect of which the deduction is claimed.

Background

In the case at hand, the taxable person (the “**Company**”) was an active holding company of a real estate group with (i) shareholding activity outside the scope of the VAT regime, not entitling the Company to deduct VAT; (ii) financing activity that was in scope but VAT exempt, not entitling the Company to deduct VAT and (iii) taxable management activity towards its subsidiaries, for which the Company was entitled to deduct VAT.

The Company outsourced the management services to an affiliated entity established abroad (the “**Service Company**”). The Service Company invoiced the Company based on a cost-plus method, while the Company charged its services to its affiliated entities based on the value of underlying real estate assets. The Company had to self-assess Luxembourg VAT at 17% on the outsourced services, and claimed a right to deduct that input VAT.

Due to the different computation methods applied to the fees charged by the Service Company and the Company, the Company’s costs for outsourcing these services always exceeded its related taxable turnover. The VAT authorities denied the Company’s entitlement to deduct VAT for the part of costs that exceeded this turnover on the grounds that this part could not be a cost component of the output transactions entitling the Company to deduct the VAT.

The court of first instance dismissed the Luxembourg VAT authorities’ approach (final judgement n°2019TALCH01/00161 dated 15 May 2019), accepting the Company’s entitlement to deduct VAT despite the discrepancy between the turnover from its relevant taxable activity and the related costs. This position taken by the trial judges has been confirmed by the Court of Appeal (judgement n°CAL-2019-01038 dated 13 January 2021), and now by the Court of Cassation as well (CAS-2021-00028 dated 17 March 2022).

VAT authorities’ approach: no entitlement to deduct VAT for costs not incorporated in the related turnover

It is a fundamental mechanism of the VAT system to entitle taxpayers to deduct the input VAT paid on goods or services acquired for the purposes of a taxable business activity. In several cases, the Court of Justice of the European Union (“**CJEU**”) has held that a taxpayer’s right to deduct such VAT arises where there is a direct and immediate link between the output transactions triggering the right and the goods or services representing the relevant costs. If there is no such link, the right can arise in respect of general costs that are, as such, components of the price charged by the taxpayer for its own taxable supplies of goods or services.

In light of the existing CJEU case law, it was the position of the Luxembourg VAT authorities that there could only be a right to deduct input VAT if:

- (i) there were a direct and immediate link between the relevant costs and a taxable activity, and
- (ii) it could therefore be shown that those costs were priced into the relevant taxable output transactions.

In the case at hand, the Luxembourg VAT authorities believed that the part of the cost of outsourcing to the Service Company that exceeded the turnover from the Company’s taxable management activity could have no direct and immediate link with that turnover, since it could not have been mathematically included in the relevant output transaction prices. The VAT authorities maintained this position despite an independent expert’s review of the service and invoicing flows attesting that such costs were directly and immediately linked with the Company’s taxable activities by nature.

Now, in line with the courts of first and second instance, the Court of Cassation has rejected the idea that incorporating the amount of input transactions into the amount of output transactions is a condition for the entitlement to deduct VAT in this case.

The Court of Cassation has held that, by taking into account the independent expert’s conclusions confirming a link between the taxable input and output transactions, irrespective of the discrepancy between the costs and the related turnover, the appeal judge gave adequate reasoning for his decision to accept the Company’s right to deduct the VAT paid on these costs.

Outcome of these Luxembourg rulings

With this case, the Court of Cassation has clarified that, under certain circumstances, a direct and immediate link for the purposes of entitlement to deduct VAT does not necessarily require that the amounts spent be mathematically priced into the relevant turnover.

Taxable persons should nonetheless evaluate their specific situations closely, including in terms of proving such a direct and immediate link when exercising the right to deduct input VAT.

Arendt’s VAT team is at your disposal should you require any further information in this regard.

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