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Opinion of Advocate General to the Court of Justice of the EU is to treat Agility hire purchase contracts as supply of goods for VAT purposes

HMRC v. Mercedes-Benz Financial Services UK Limited
C-164/16

Article by David Bowden

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Executive speed read summary

Mercedes-Benz Financial Services provided finance to customers by way of a hire purchase product called 'Agility' to enable them to buy new or used vehicles from its main dealers. A deposit was paid and the balance paid by instalments over 2 to 5 years. There was an option to purchase fee of £95 if a customer wanted to acquire title at the end of the term. HMRC raised assessments against the taxpayer for £10million saying that these Agility contracts were contracts for the supply of goods and VAT was due under the 2006 Principal VAT Directive. The taxpayer's 1st appeal to the First Tier Tribunal was dismissed but allowed by the Upper Tribunal. The Court of Appeal referred to the CJEU a number of questions of construction. Following a hearing Advocate General Szpunar has now given his opinion that hire purchase contracts are a supply of goods and, unlike leasing contracts, not a supply of services. He says that IAS 17 does not assist him in interpreting the Principal VAT Directive. The case will now proceed to a chamber hearing in the CJEU which will have to decide whether it agrees with its Advocate General or not. After this the case will go back to the Court of Appeal to apply the CJEU ruling. The Advocate General's proposes a 3 stage test for the CJEU to adopt. His opinion is that in the case of hire purchase agreements they offer certainty that in the normal course of events following the end of the agreement term ownership of the leased asset will generally be transferred to the lessee.

HM Revenue and Customs v. Mercedes-Benz Financial Services UK Limited
The Governments of the United Kingdom, the Kingdom of the Netherlands and the European Commission intervening
C-164/16 *31 May 2017*
Court of Justice of the European Union (Advocate-General Maciej Szpunar)

What are the facts?

This case concern's the taxpayer's '*Agility*' contracts and the interpretation of Article 14 of the Principle VAT Directive. The issue for the CJEU is whether for VAT purposes the Agility contract falls to be treated as a supply of services or a supply of goods. The CJEU and the European Commission have had difficulty with this issue in the past given that hire purchase as a product appears to be unique to the UK and Ireland with few other EU member states having such a mixed contract for financial services and supply of goods.

What are the features of the taxpayer's 'Agility' contracts?

Customers who want to acquire a new or used car from a Mercedes-Benz main dealership could finance it by an Agility hire purchase agreement that Mercedes-Benz Financial Services UK Limited offered. This usually required the payment of a deposit and the balance to be paid by monthly instalments over a number of years. There was an option to buy the vehicle at the end of the hire purchase agreement. The fee to exercise this option was £95.

What assessments did HMRC raise on the taxpayer?

HMRC raised backdated VAT assessments on the taxpayer in the total sum of over £10million.

What does the Principal VAT Directive provide?

Article 14 of EU Council Directive of 28 November 2006 **2006/112/EC** ('the Principal VAT Directive') provides:

> '***14.1****. "Supply of goods" shall mean the transfer of the right to dispose of tangible property as owner.*
> *2. In addition to the transaction referred to in paragraph 1, each of the following shall be regarded as a supply of goods:….*
> *(b) the actual handing over of goods pursuant to a contract for the hire of goods for a certain period, or for the sale of goods on deferred terms, which provides that in the normal course of events ownership is to pass at the latest upon payment of the final instalment;…*'

In addition Article 24(1) provides that '*supply of services'* means '*any transaction which does not constitute a supply of goods*'.

How has the UK implemented these VAT provisions?

These EU rules are found in section 5 and schedule 4 paragraph 2(b) to the Value Added Tax Act 1994

What happened in the First Tier Tribunal?

On 17 December 2012 Judges Michael Tildesley OBE and Ruth Watts Davies in a reserved judgement in the First Tier Tribunal **[2013] UKFTT 381 (TC)** ruled in favour of HMRC that these Agility hire purchase agreements were for VAT purposes a supply of goods rather than a supply of services.

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What ruling was made on 1st appeal by the Upper Tribunal?

On 2 May 2014 a reserved judgement written by Mr Justice Nugee was handed down by the Upper Tribunal – **[2014] UKUT 200 (TCC).** Surprisingly the UT allowed the taxpayer's appeal from the FTT decision ruling that '*the economic purpose of the contract is to be found by identifying the precise way in which performance satisfies the interests of the parties'* with Nugee J ruling that the Agility contract satisfies these interests of the parties '*by affording the customer an opportunity to purchase but without committing him to do so, and by giving MBFS a return on the finance it provides in circumstances where either the vehicle will be purchased or it will be returned at no risk to MBFS*.' Nugee J concluded by saying that he did not think that Agility could be '*characterised as in effect a contract for sale of the vehicle. It is a contract which may well lead to a sale of the vehicle but equally may well not*'. The UT therefore ruled that Agility was not '*a contract under which ownership is to pass in the normal course of events*'.

What happened in the Court of Appeal?

On 26 November 2015 the Court of Appeal handed down its reserved judgment - **[2015] EWCA Civ 1211.** Lord Justice Patten gave the judgment (with which the Chancellor and Lord Justice Christopher Clarke agreed) in which it decided the Upper Tribunal was wrong not to refer certain issues to the CJEU. Patten LJ ruled that '*in the absence of any direct guidance about the interpretation of Article 14(2)(b), we have reached the conclusion that the issue is not acte clair*' noting that '*although Article 14(2)(b) is directed in terms to what the relevant contract of hire provides, there is much less certainty as to whether the qualifying phrase "*in the normal course of events*" requires a tax authority to do no more than to identify the existence of an option which is not exercisable later than upon payment of the final instalment or to go further and determine the economic purpose of the contract*'.

What questions were referred by the Court of Appeal to the CJEU?

The Court of Appeal referred these 4 questions:

- What is the meaning of the words '*a contract...which provides that in the normal course of events ownership is to pass at the latest upon payment of the final instalment'* in Article 14.2(b)1?
- Does the phrase '*in the normal course of events'* require a tax authority to do no more than to identify the existence of an option to purchase which can be exercised no later than upon payment of the final instalment?
- Alternatively, does the phrase '*in the normal course of events'* require a national authority to go further and to determine the economic purpose of the contract?
- If the answer to this is 'yes':
  - should the interpretation of Article 14.2 be influenced by an analysis of whether the customer is likely to exercise such an option?
  - Is the size of the price payable on exercise of the option to purchase relevant for the purposes of determining the economic purpose of the contract?

What authorities are referred to in the Advocate-General's opinion?

These 2 prior CJEU authorities are relevant in this case:

Eon Aset Menidjmunt OOD v. Direktor na Direktsia Obzhalvane i upravlenie na izpalnenieto — Varna pri Tsentralno upravlenie na Natsionalnata agentsia za prihodite **C-118/11**
(CJEU, 2nd Chamber, Judges *Cunha Rodrigues, Lõhmus, Ó Caoimh, Arabadjiev and Fernlund. Advocate General Trstenjak)*
Where a leasing agreement provides either that ownership of the subject matter of the leasing agreement is to be transferred to the lessee on the expiry of that agreement or that all the essential powers attaching to ownership of are to be enjoyed by the lessee and substantially all the rewards and risks incidental to legal ownership of are transferred to the lessee and the present value of the amount of the lease payments is practically identical to the market value of the transaction resulting from that agreement must be treated as an acquisition of capital goods.

Auto Lease Holland BV v. Bundesamt für Finanzen **C-185/01**
(CJEU, 5th Chamber, Judges Wathelet, Timmermans, Jann, von Bahr and Rosas. Advocate General Léger)
Where there is a right to use tangible property means there is a possibility of it becoming consumed, this right is similar to ownership in a manner which justifies that right of use being regarded as constituting a supply of goods for VAT purposes.

What opinion did Advocate General Szpunar give?
Although the Court of Appeal referred 4 questions to the CJEU, disappointingly AG Szpunar said at the outset that it was '*appropriate to examine'* then '*jointly*'.

He starts his opinion by noting that the Principal VAT Directive has the '*purpose of transferring the right to dispose of tangible property as owner but which defer the transfer of that right until the time at which the property is released to the purchaser*'. He candidly confesses that a hire purchase agreement is '*mixed in nature*' because it '*combines that the features of a leasing agreement with those of a sale agreement'*.
He observes that whilst the '*transfer of ownership'* under a hire purchase agreement is '*deferred'* it does however take place *'in the normal course of events'*. The AG notes that such a transfer would not occur where there were 'extraordinary events' such as '*withdrawal by one of the parties from the agreement'* or '*failure of the part of one of the parties to fulfil its obligations'*.
The AG categorises hire purchase agreements as belonging to '*broad category of leasing agreements'* but he notes that the concept of leasing has '*no unambiguous definition and may be used to describe agreements of a very diverse legal nature'* but that instalments paid by a customer '*must, as a rule, cover the costs of acquisition, depreciation and financing of the subject matter*'. As to transfer of ownership, the AG helpfully observes that this '*may but does not have to be an element of the agreement'*. He observes that option to purchase amounts '*vary considerably, ranging from often symbolic amounts to a significant portion of the value*' of the leased goods.

The Advocate-General endorses the earlier CJEU decision in *Eon Aset Menidjmunt* which had been affirmed subsequently in *NLB Leasing* **C-209/14**.

Do International Accounting Standards assist in interpreting the principal VAT Directive?
The Advocate-General then looks at whether International Accounting Standard number 17 ('IAS17') is of any assistance to him in his VAT enquiry in this case. He correctly notes that '*finance leasing often has a trilateral dimension, in which the lessor (normally a credit institution or a specialised leasing company) plays only a financing role and the subject matter of the leasing agreement is supplied to the lessee directly by the supplier*'. For this reason the AG states that earlier CJEU decisions '*do not, however, in my view, mean that every leasing agreement which, pursuant to IAS 17, may be classified as a finance lease should be treated as a supply of goods on the basis of Article 14(2)(b)'*. This is because '*the purpose of international accounting standards is to harmonise accounting entries so as to enable them to reflect, to the greatest possible extent, the economic and financial reality of a business, even if this does not correspond to the formal legal situation.*'

The Advocate General notes that paragraph 9 of IAS 17 acknowledges that '*the application of these definitions to the differing circumstances of the lessor and lessee may result in the same lease being classified differently by them'.* Going on his opinion is that '*legal regulations are based on a different logic*' and that a '*legal classification must correspond to an objective assessment of the transaction as a concrete legal event, and the assessment should, so far as possible, be shared by all involved in the legal relations*'. For this reason he concluded that '*legal certainty'* required that lease agreements '*should be regarded as supplies of goods for the purpose of levying VAT only when it can be assumed with certainty that in the normal course of events*' that ownership '*will be transferred to the lessee'*.

As to the Principal VAT Directive, the Advocate General observes that Article 14 '*does not refer to the transfer of ownership but to the transfer of the right to dispose of tangible property as owner'*. His opinion is that '*acquisition by the purchaser of the right to dispose of tangible property as owner requires the transfer, at some point in time, of the right of ownership'*.

Do earlier CJEU decisions assist in this case?
The Advocate General reviews a number of earlier CJEU decisions but concludes that they do not assist him because all of them '*related to a situation in which the transfer of ownership had occurred or was to occur in future*' with the result that '*only the specific circumstances of that transfer'* had '*required clarification*'. He derived assistance only from *Eon Aset Menidjmunt* where the CJEU found that '*there could be a supply of goods in a situation where it was unclear, or in any event did not result, from the description of the facts*'. However the said this was not enough because '*this determination needs to be made more precise in the light of the wording and purpose of Article 14(2)(b)*' of the Principal VAT Directive. On this he said this '*serves the purpose of making this concept independent of the procedural-law aspects of the time and mode of transfer of ownership'* and that he could therefore '*disregard the formal transfer of ownership and focus instead on the actual transfer of the right to dispose of an asset*'.

The Advocate General notes that Article 14(2)(b) '*does not refer to the transfer of the right to dispose of tangible property but directly to the transfer of ownership'* and that this includes agreements where '*the transfer is deferred to after the time at which the tangible property is released'* to the lessee. The Advocate General then says that A14(2)(b) should in his view '*be interpreted as applying only to those leasing agreements which offer the certainty that in the normal course of events, following the end of the agreement term, ownership of the leased asset will generally be transferred to the lessee'* and that this '*is the situation which obtains primarily in the case of hire purchase agreements'*. For hire purchase the Advocate General says that '*the likelihood of the lessee not obtaining ownership of the asset' would arise 'only in the event of non-performance or notice of termination of the agreement'*.

What assumptions can be made about hire purchase as a product?
For hire purchase, the Advocate General helpfully goes on to say that '*an assumption'* can be made that on '*following payment of all instalments'* the lessee can acquire the ownership either '*without incurring additional fees'* or on payment of a '*symbolic fee only'* and that '*the likelihood of transfer of ownership of that asset borders on certainty'* because otherwise the actions of the lessee would be '*irrational in economic terms*'.

An argument was raised as to whether specialised plant and machinery should or could be treated differently to a regular dealer specification vehicle. On this the Advocate General says that these are '*exceptional situations which may be treated in an exceptional manner for purposes of VAT'*. He is keen to limit the ambit of his opinion as he states that he did '*not believe that the presumption that, following the expiry of the lease term, the ownership of the leased asset will be transferred to the lessee should be extended to other situations which, according to IAS 17, should be included in finance leasing'*. The Advocate General rejects the European Commission's view that a '*leasing agreement should be regarded as a supply of goods in the situation described in paragraph 10(b) of IAS 17*'.

What is the proposed 3 stage test?
The Advocate-General proposes that the CJEU should adopt this 3 stage test:

- Does the agreement contain a transfer of ownership clause?
- Must transfer of ownership follow from the normal course of events?
- Does transfer of ownership take place at the latest upon payment of the final instalment?

On this latter point he stresses that the option to purchase has to be a '*genuine choice for the lessee'*. He says that a '*lease is often a substitute for ownership of an asset'* and that a lease '*unlike hire purchase agreements*' is a '*means by which to acquire ownership'*. His opinion is that '*contractual freedom'* should not be restricted '*with the obvious exception of fraud and abuse by treating as a supply of goods, without any clear justification, a legal relationship which the parties have deliberately structured as a supply of services*'.

What is the conclusion reached?
In conclusion the Advocate General's opinion for the CJEU is that Article 14(2)(b) of the Principal VAT Directive '*should be interpreted as meaning that a leasing agreement which provides for transfer of the ownership of the leased asset to the lessee by the end of the lease or which provides that ownership of the leased asset may be transferred to the lessee by way of a unilateral declaration of intent by the lessee and where the sum of the instalments payable by the lessee under the agreement, irrespective of the declaration of intent, is virtually equivalent to the purchase price of the leased asset, including financing costs, constitutes a supply of goods within the meaning of that provision'*.

What will happen next with this case?
This case will now await a hearing before a chamber of the CJEU. It will then decide whether it agrees with the opinion of Advocate General Szpunar or not. When this judgement is delivered the case will be sent back the Court of Appeal for it to apply the chamber ruling.

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