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Supreme Court refers to CJEU whether hire purchase portfolio qualifies for apportionment of input tax for VAT purposes

HMRC v. Volkswagen Financial Services (UK) Ltd
[2017] UKSC 26

Article by David Bowden

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Executive speed read summary

The taxpayer supplied cars to retail customers on hire purchase. These retail HP contracts were mixed contracts for the supply of financial services and supply of goods. HMRC raised an assessment to VAT for nearly £0.5million for 2007-8. The taxpayer challenged the assessment claiming it was entitled to apportion input tax using a PESM (a 'partially exempt special method'). The taxpayer said the amount of the PESM using a broad brush should be 50%. The taxpayer succeeded in both the First Tier Tribunal and Court of Appeal (but failed in the Upper Tribunal on this point). The Supreme Court has decided that this matter is not clear and is referring the case to the Court of Justice of the European Union to give an opinion on the interpretation of the 2006 Principal VAT Directive. The referred question will be whether the taxpayer's overheads are all attributable to the exempt supplies of finance with the result that input tax is therefore wholly irrecoverable or whether the residual input tax should be split in proportion to the ratio of taxable transactions to the whole, which in this case has the effect of splitting the residual input tax 50/50 for hire purchase transactions. The Supreme Court rejected an alternative ground of appeal advance by HMRC that the 50% apportionment figure had not been conceded by it below. Lord Carnwath JSC ruled that when the FTT is dealing with substantial litigants represented by experienced counsel it is entitled to assume that the parties will have identified with some care what they regard as relevant issues for decision.

HM Revenue & Customs v. Volkswagen Financial Services (UK) Ltd
[2017] UKSC 26 *5 April 2017*
Supreme Court of the United Kingdom (Lords Neuberger PSC, Kerr, Reed & Carnwath JJSC & Lord Gill)

What are the facts?

Volkswagen Financial Services (UK) Limited ('the taxpayer') procures vehicles to supply to customers under hire purchase agreements. This supply includes the taxable supply of that vehicle and the exempt supply of finance. Because of this mixture, HMRC and the taxpayer agreed a PESM (a '*partially exempt special method*') for apportioning the VAT. However both parties reached different interpretations of the PESM.

From October 2007, the taxpayer accounted for VAT according to its preferred method. HMRC then raised assessments for under-claimed VAT. From October 2008, the taxpayer adopted HMRC's methodology and submitted voluntary disclosures for unpaid tax. However HMRC rejected these.

What assessments did HMRC raise on the taxpayer?

HMRC issued an assessment to VAT against Volkswagen Financial Services (UK) Limited ('VWFS') in the sum of £498,866 for period October 2007 to March 2008 on 16 June 2008.

What does the Principal VAT Directive provide?

Articles 167 to 177 of EU Council Directive of 28 November 2006 **2006/112/EC** ('the Principal VAT Directive') provide for the deduction of input tax in so far as it is used in the making of taxable supplies. Article 173 provides:

> *'In the case of goods and services used by a taxable person both for [taxable and exempt transactions], only such proportion of the value added tax as is attributable to [taxable] transactions shall be deductible.'*

How has the UK implemented these VAT provisions?

These EU rules on apportionment are found in the Value Added Tax Regulations 1995 (**SI 1995/2518**). Regulation 101 provides:

> *'(1) … the amount of input tax which a taxable person shall be entitled to deduct provisionally shall be that amount which is attributable to taxable supplies in accordance with this regulation.*
> *(2) … in respect of each prescribed accounting period—…*
> *(b) there shall be attributed to taxable supplies the whole of the input tax on such of those goods or services as are used or to be used by him exclusively in making taxable supplies,*
> *(c) no part of the input tax on such of those goods or services as are used or to be used by him exclusively in making exempt supplies, or in carrying on any activity other than the making of taxable supplies, shall be attributed to taxable supplies,*
> *(d) … there shall be attributed to taxable supplies 5 such proportion of the residual input tax as bears the same ratio to the total of such input tax as the value of taxable supplies made by him bears to the value of all supplies made by him in the period,*

> *(e) the attribution required by subparagraph (d) above may be made on the basis of the extent to which the goods or services are used or to be used by him in making taxable supplies,* …'

What happened in the First Tier Tribunal?
On 18 August 2011 Judge Roger Berner in a reserved judgement in the First Tier Tribunal [**2011] UKFTT 556 (TC)** allowed the taxpayer's appeal from the assessments to VAT that HMRC had served on it. HMRC did not challenge the taxpayer's figure that 50% should be used as the relevant figure for apportionment.

What ruling was made on 1st appeal by the Upper Tribunal?
On 12 November 2012 a reserved judgement written jointly by Mr Justice Vos and Upper Tribunal Judge Timothy Herrington was handed down by the Upper Tribunal – **[2012] UKUT 394 (TCC)**. The UT allowed HMRC's appeal from the FTT decision ruling that the taxpayer was not allowed to apportion input tax as it claimed it was entitled to do.

What happened in the Court of Appeal?
On 28 July 2015 the Court of Appeal handed down its reserved judgment - **[2015] EWCA Civ 832**. Lord Justice Patten gave the judgment (with which Lady Justices Sharp and King agreed) which reinstated the ruling of the FTT in favour of the taxpayer in relation to the apportionment issue.

What was the issue for the Supreme Court?
Under the *'partial exempt special method'* agreed by the parties ('*PESM*') what is a fair and reasonable apportionment of residual input tax on costs incurred by VWFS in its retail sector in relation to general overheads in respect of hire purchase transactions which include a mixture of VAT taxable and VAT exempt supply?

What ruling did the Supreme Court give on this issue?
The Supreme Court unanimously dismisses HMRC's appeal in a short judgement given by Lord Carnwath JSC. His judgment concerns only a secondary issue namely whether HMRC had a fall-back position on the amount of any apportionment. HMRC argued that the FTT had failed to consider this issue. In the Court of Appeal, Patten LJ said that:

> '13… *HMRC contend that they did challenge the apportionment formula contained in the proposed PESM on wider grounds and that a lower figure than 50% should be attributed to the taxable supplies of vehicles as part of the hire purchase contracts in terms of the use made of the allocated inputs.*'

HMRC claimed it had disputed the 50% apportionment figure and these documents bore this out:

- It's FTT skeleton argument,
- It's witness evidence, and
- Judge Berner's notes of the FTT hearing.

The Upper Tribunal had ruled that it did '*not see how this court is in the position to gainsay Judge Berner's understanding of the parties' position on the appeals which the FTT heard*'. HMRC submitted in the Supreme Court that the Court of Appeal failed to take account the nature of the proceedings in the FTT which enable it to not only consider an issue of principle but also the amount of any assessment.

Lord Carnwath JSC disagreed ruling that '*this issue does not require examination of general questions about the tribunal's role. One of the strengths of the new tribunal system is the flexibility of its procedures, which need to be and can be adapted to a wide range of types of case and of litigant.'* Lord Carnwath was scathing about the manner in which HMRC raised this point at the 11th hour noting that '*when the tribunal as here is dealing with substantial litigants, represented by experienced counsel, it is entitled to assume that the parties will have identified with some care what they regard as relevant issues for decision.'*

Lord Carnwath JSC agreed with Lord Justice Patten in the Court of Appeal who ruled that

> *'41. .. Other aspects of what amounts to a fair and reasonable attribution, such as ease of audit and operation, are not at issue. Nor, although the Tribunal itself asked for clarification, is the 50/50 weighting that VWFS proposes as between the taxable supplies of the vehicle and the exempt supplies of finance under the HP agreements. The evidence of Mr Cannan for HMRC shows that the weighting is accepted as realistic; indeed he concedes that it may be more realistic than that adopted by HMRC's method.'*

Finally Lord Carnwath ruled that the Supreme Court had '*no material which could justify going behind that clear statement of the position as the tribunal understood it' and that 'if there was any doubt about that, the time to have dealt with it was when the decision was received'*

Will there be a reference to the Court of Justice of the European Union?
Yes.

The Supreme Court does not regard the issue on apportionment on hire purchase contracts being partly a financial services contract and partly a contract for the supply of goods as *acte clare*. The Supreme Court is referring to the CJEU the question of whether the taxpayer's overheads are all attributable to the exempt supplies of finance with the result that input tax is therefore wholly irrecoverable or whether the residual input tax should be split in proportion to the ratio of taxable transactions to the whole, which in this case has the effect of splitting the residual input tax 50/50 for hire purchase transactions.

The exact question has to be formulated and agreed. It will then be referred to the CJEU, translated into all official EU languages and published in the Official Journal in due court.

What else is the CJEU dealing with at the moment on VAT and hire purchase?
On 26 November the Court of Appeal referred another VAT case relating to hire purchase to the CJEU - **[2015] EWCA Civ 1211.** This case was received by the CJEU on 21 March 2016. There was a hearing in this case on 19 January 2017. The Advocate-General is writing his preliminary opinion which is due to be delivered on 27 April 2017. In case **C-164/16** the 4 referred questions are:

> '*1. 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?*
>
> *2. 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?*
>
> *3. Alternatively, does the phrase "*in the normal course of events*" require the national authority to go further and to determine the economic purpose of the contract?*
>
> *4.If the answer to (3) is yes:*
>
> > *(a) Should the interpretation of Article 14.2 be influenced by an analysis of whether the customer is likely to exercise such an option?*
> > *(b) 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?*'

This case concern's that 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 no other EU member state having such a mixed contract for financial services and supply of goods.

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