**VAT focus**

**Supreme Court in Airtours: Redrow redacted**

*Speed read*

The Supreme Court’s decision in *Airtours* is the latest judgment on the operation of VAT in relation to tripartite arrangements. The decision confirms that the contractual analysis of the arrangements is both the necessary starting point and, in many cases, the only basis on which the arrangements can be analysed for the purposes of determining the supplies involved. As was made clear by the CJEU in *Newey*, only where the contractual arrangements do not reflect the commercial and economic realities of the transaction should the courts depart from a purely contractual analysis. However, the three to two majority decision is indicative of how different judges can reach differing views on the true contractual arrangements and the nature of the commercial and economic realities. Going beyond the decision itself, the case raises (but does not ultimately answer) additional intriguing questions. On what basis would Airtours have been entitled to reclaim input VAT had it been successful? And is the actual recipient of a supply entitled to input VAT credit in cases involving third party consideration?

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Things can get complicated when there are three people in a relationship. Or at least they do when it comes to working out who gets to recover input VAT. Way back in 1999, when the House of Lords delivered its judgment in *Customs and Excise Comrs v Redrow Group* [1999] UKHL 4, it all seemed so simple. All you had to do was show that you had paid and received ‘anything at all’ used or to be used for the purposes of your business and input VAT recovery was yours. Seventeen years later and a multitude of big name cases have added their own nuances to the principle, to the point where it has made its way to the Supreme Court for clarification. One would have hoped the Supreme Court would resolve the matter once and for all in *Airtours Holiday Transport Ltd v HMRC* [2016] UKSC 21 (reported at page 4).

However, whilst the principles to be applied may now be reasonably clear, with their lordships split 3:2, and Lord Neuberger delivering a judgment that the dissenting minority criticised for resting on a ‘narrow legalistic approach’, the application of those principles remains problematic and, as such, that opportunity appears not to have been seized.

**Background**

In 2002, Airtours faced financial difficulties and its banks refused to let it draw down funds on its facilities. A rescue package involving the banks and other creditors became necessary. The banks formed a steering committee to oversee the rescue. As part of the process, PwC was engaged to carry out a strategic review of Airtours’ business and restructuring proposals and to liaise with the banks and the Civil Aviation Authority. Airtours was responsible for paying the professional charges of PwC and it claimed as input tax the VAT it paid on PwC’s fees. HMRC refused to allow credit, on the basis that PwC’s supplies were to Airtours’ creditors and not to Airtours itself.

All parties also agreed that the terms of the engagement letter were vital to the determination of whether Airtours received any supply from PwC.

**It is not sufficient for a taxpayer to benefit from a payment for it to amount to consideration for a supply made to that person**

The engagement letter was signed both by Airtours and on behalf of the creditors; and it obliged Airtours to pay PwC’s fees. The engagement letter stated that PwC had been retained by the creditor institutions; that its reports and letters were for the sole use of those institutions; and that the work was required by the institutions for the purpose of considering the level of facilities to be granted to Airtours. However, the terms referred to in the letter stated that ‘you’ had requested PwC’s services to enable the institutions to develop views on the group’s financial position and needs; and that ‘you’ had requested the review of the group, as the work was required by the institutions. The First-tier Tribunal regarded ‘you’ in this context as referring to all the signatories, including Airtours, and accordingly held that Airtours did receive supplies from PwC and was entitled to input VAT recovery.

On appeal, the Upper Tribunal ([2010] UKUT 404 (TCC)) considered the overall nature of the arrangements. It concluded that the substance of the transaction was that there was a supply of services by PwC to the banks and that the engagement letter should be construed as one in which the banks contracted with PwC to supply services which the banks needed for the purposes of their own businesses. It concluded that Airtours merely contracted with PwC to pay its fees rather than receiving something of value from PwC to be used for the purpose of its business in return for that payment. Accordingly, the Upper Tribunal reversed the decision of the First-tier Tribunal. The Court of Appeal ([2014] EWCA Civ 1033) confirmed that decision by a majority of two to one.
The Supreme Court’s decision

The Supreme Court has upheld the Court of Appeal decision that a company paying for a corporate restructuring review carried out by PwC and addressed to its major creditors was not entitled to input VAT recovery. In order to be entitled to reclaim input VAT on a supply, a person must be the recipient of that supply. To determine this, the court addressed two principal questions. Firstly, on a proper construction of the contracts did Airtours have a contractual right to the performance on the services? If it did, then it would be entitled to input VAT deduction. If not, the second question to ask was whether there was a supply in any event, having regard to the economic reality of the situation?

The contractual question

The majority decided that the terms of the engagement with PwC did not give Airtours a contractual right to require the report to be produced, merely an obligation to pay for its production; and, as such, no supply was made to Airtours. The argument being made was that a person paying for services, which principally benefit a third party, also receives a supply of the right to have that service provided to the third party; however, this argument can only succeed where it was borne out by a clear contractual obligation, unless the documentation does not reflect the economic reality. Lord Neuberger recognised that the lack of contractual obligation was ‘a very small point’ for the decision to turn on, but nevertheless VAT decisions are highly dependent on the factual situation at hand. Other cases might be held differently.

On a true construction of the contract, Lord Neuberger rejected the analysis that PwC had accepted any obligation towards Airtours. Whilst there was some ambiguity in the language used, Lord Neuberger considered that it was clear that PwC had agreed to provide its report to the creditors only. The engagement letter was only addressed to the creditors; only they were entitled to rely on the report; and a contractual duty of care was only owed to them. The only reason that Airtours was party to the agreement was for the purposes of enforcement of the obligation to pay PwC’s fees for the report.

Lord Neuberger also rejected the argument that there might be a term implied in the contract, giving Airtours a contractual right to PwC’s performance of its obligations to the creditors. Whilst it was plainly in Airtours’ interest for the report to be provided, it was far from clear how this factor could meet the necessary requirements to imply a term into the contract, ‘namely, that it is necessary for business efficacy or that it is so obvious that it went without saying’.

Accordingly, the majority accepted HMRC’s submission that this was a case of third party consideration and Airtours was not entitled to input VAT recovery. Airtours had no right to require PwC to produce the report and there was no contractual obligation on PwC to provide any services to Airtours. It was not sufficient that Airtours might consequentially have benefited from the services.

The second question

On this point, Lord Neuberger concluded that the relevant domestic and Court of Justice case law clearly shows that ‘where the person who pays the supplier is not entitled under the contractual documentation to receive any services from the supplier, then, unless the documentation does not reflect the economic reality, the payer has no right to reclaim by way of input tax the VAT in respect of the payment to the supplier’.

In particular, Lord Neuberger stressed that the well-known observation by Lord Millett in Redrow cannot be taken at face value. (Lord Millett’s observation was that the question to be addressed is whether the taxpayer obtained anything – anything at all – used or to be used for the purposes of his business in return for the payment.) It is not sufficient for a taxpayer to benefit from a payment for it to amount to consideration for a supply made to that person. Considering Tolsma (Case C-16/93) and the need for a legal relationship of reciprocal performance, Airtours could not succeed on the second question unless it could show that the contracts did not reflect economic reality. Lord Neuberger concluded that the contracts did reflect the economic reality and were not in any way artificial.

The payments made by Airtours amounted to third party consideration.

The Supreme Court decision in Airtours is one that turns on the contractual analysis of the engagement letter

Dissenting decisions

The dissenting decisions criticise a narrow legalistic approach by Lord Neuberger and a failure to give proper regard to the economic realities of the relationship between PwC and Airtours. In particular, Lord Clarke was strongly supportive of the approach of Lady Justice Gloster, who gave the dissenting judgment in the Court of Appeal. However, in essence, the nature of the disagreements between the judges related to the question of whether, contractually, Airtours was entitled to enforce any part of PwC’s services, rather than on the fundamental VAT analysis. On that point, the dissenting judges would have held that Airtours did have a contractual right to have performed the services (or part of the services) agreed by PwC.

Perhaps, at the most, the dissenting judges may be seen as being rather more open to a greater role for the ‘economic realities’, both in the contractual analysis and in ultimately determining the true nature of the supply. However, the difference appears to be one of degree rather than substance. The authors have great sympathy with Lord Carnwath’s challenge of what would have happened in the circumstances had PwC received its initial retainer payment of £200,000 from Airtours and then refused to perform the contract?

On Lord Neuberger’s analysis, Airtours would have had no enforceable rights. It is hard to imagine that a Commercial Court judge, faced with such a case, would hold that Airtours had nothing more than the right to sit on the sideline with a glum expression.

Where does this leave us?

The Supreme Court decision in Airtours turns on the contractual analysis of the engagement letter. Neither the ambiguous references to ‘you’, nor the
general commercial realities of the relationship could be regarded as importing any obligation in favour of Airtours. Clearly, litigation might have been avoided in this case by a contract taking into account the VAT consequences from the outset. Taxpayers and advisers will surely heed this message in future transactions.

That, however, leads to a further question: what would have been the result had the services been supplied both to the creditors and to Airtours? There seems no doubt that the court appeared willing to accept this possibility.

What would have been the result had the services been supplied both to the creditors and to Airtours?

The acceptance by the courts that more than one person might receive a supply in respect of the same service begs the question of how input VAT should be reclaimed in such cases. What would have happened in this case if Airtours had been the recipient of a supply? Would an apportionment of the input VAT have been necessary? The Court of Appeal considered that if it had decided that Airtours had been the recipient of a supply under the contract, it would not have been necessary to apportion the consideration paid by Airtours between a supply to it and a supply to the banks. In essence, the Court of Appeal considered that once it is established that taxable services have been supplied and paid for, it is not open to the court to enquire into the adequacy of the consideration. On this issue, the Supreme Court simply noted that a question of apportionment would have arisen if Airtours had been successful, but did not consider the matter further.

Where one party is VAT exempt, the approach of the Court of Appeal to this situation may operate smoothly; however, it may well run into difficulties where more than one fully taxable person is involved in tripartite arrangements. Apportionment may be the obvious answer.

However, there are indications in the decision of the Supreme Court that it may not be the correct answer (or not the only answer) in every case. The judgment of Lord Neuberger suggests that a person must both pay for a supply (or at least be liable to pay for a supply) and receive the supply in order to be entitled to input VAT credit. In particular, in paragraph 53, Lord Neuberger states that ‘where the services in respect of which he paid VAT were not supplied to the person who paid the VAT, no right to reclaim that output tax can arise.’ The implication of this statement appears to be that no one is entitled to reclaim input VAT in such circumstances, not simply that the person paying is not entitled to reclaim input VAT. What makes this surprising is the fact that HMRC apparently accepted during the hearing before the Supreme Court that there is no express requirement that the VAT must be paid by the person seeking to deduct input tax.

Accordingly, it appears that whilst the Supreme Court may have answered the direct question in this case, it may, in doing so, have cast new doubt on the question of whether a taxpayer who is the recipient of a supply can deduct, as input tax, VAT paid by another person as ‘third-party consideration.’

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- The CA judgment in Airtours: VAT in tripartite situations (Gary Barnett, 5.8.14)
- Recovering input tax on professional services in BAA and Airtours (David Anderson & Judith Lesar, 29.8.14)
- Reviewing the Upper Tribunal decision in Airtours (David Scorey, 13.111)
- Tripartite arrangements after LMUK and Boxi (Adam Craggs & Jane Bailey, 18.111)

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