Two advocate general (AG) opinions are perhaps the highlight of the VAT month. In both cases, the AG has taken the unusual (and sometimes controversial) step of suggesting that the court should resolve the cases before it on a different basis to that indicated by questions referred to it. Whilst this certainly wouldn’t be the first time that the CJEU has taken such an approach (for example, the decision in AXA (Case C-175/09) applying the ‘debt collection’ exclusion – coincidentally relevant to another of the cases discussed below), it remains uncommon. Yet, despite some 45 years of experience with the VAT system in the UK, it is indicative of the fact that determining the correct question to ask is, in some cases, problematic, let alone finding the right answer to the correct question!

UK approach to HP contrary to EU law?
The AG has opined that the splitting a supply of a vehicle on hire purchase (HP) terms into an exempt supply of finance and a taxable supply of a vehicle is flawed: HMRC v Volkswagen Financial Services (UK) Ltd (Case C-153/17). The correct approach is to recognise it as a single, composite taxable supply. As such, a supplier of goods on HP would be entitled to input VAT credit in full, but would be obliged to charge output VAT on the whole of the consideration for its supply, including the financing element.

When providing a car under an HP arrangement, Volkswagen Financial Services (VWFS) purchases a car from a dealership and then provides that car to a customer charging a separate price for the vehicle (the same paid by VWFS to the dealership) and for finance. The UK treats those two aspects of the HP as separate supplies: a taxable supply of goods and an exempt supply of credit. VWFS sought to recover a proportion of the input VAT incurred on its general overheads, arguing for an equal split between its taxable and exempt supplies. HMRC rejected the claim, considering that the residual input VAT was solely a cost component of the exempt financing transactions. Since VWFS sold cars at the same price as they acquired them from dealers, the overhead costs were not incorporated into the price of the taxable supplies.

The AG recognised that the question referred to the court raised something of a dilemma. On the one hand, there was no doubt that VWFS used some of the goods and services constituting its overhead costs for the purposes of its taxable transactions, so it should be able to benefit from the right to deduct the input VAT. On the other hand, a right to deduct would be contrary to the fundamental principles of the VAT system where that cost is not a cost component of a taxable supply.

The way out of this dilemma was to recognise that the UK treatment of HP transactions is flawed. In particular, the AG suggests that neither the obtaining of credit nor the purchase of a vehicle constitutes an end in itself for a lessee under a HP agreement. Instead, correctly analysed, a HP agreement amounts to a single, fully taxable supply of services.

Why it matters
If confirmed by the CJEU, the single taxable supply approach may significantly increase the cost of HP transactions compared to a separate financing arrangement. Businesses currently selling goods on HP arrangements will need to carefully consider whether they can absorb these costs or need to increase the overall price of HP arrangements, affecting the position of the end consumer. In the longer term, separate financing arrangements may be more cost effective.

More generally, by side-stepping the question asked as to the priority between the cost component approach to input VAT recovery and the more general approach to overheads, the AG’s opinion represents a missed opportunity to clarify the general principles on input VAT recovery and the scope of the ‘cost component’ approach. It remains to be seen whether the CJEU, by contrast, will grasp the nettle.

VAT and ‘free’ items
The First-tier Tribunal (FTT) has held that the provision of a ‘free’ bottle of wine as part of an offer by Marks & Spencer (M&S) was subject to VAT: Marks and Spencer plc v HMRC [2018] UKFTT 238. The bottle of wine was neither ‘free’ as a matter of the true construction of the offer nor as a question of economic reality.

Before 2015, M&S ran a ‘dine in for £10’ promotion under which three food items plus a bottle of wine could be acquired for £10. From 2015, this changed to a dine in for £10 promotion based on a customer buying three food items for £10 and receiving a bottle of wine for free. M&S contended that, under the new promotion, it was no longer required to apportion part of the £10 consideration to the wine, which reduced the overall VAT due on the £10 consideration.
M&S essentially contended that it was a fundamental principle that the terms of a bargain made at arm’s length were respected by the VAT system. The promotion clearly stated that the wine was free and that the £10 consideration was entirely paid for the food items.

The FTT, however, noted that a customer could obtain the wine only by satisfying the condition that they had paid £10 for the food items. As such, the promotion was a single offer, with all four items supplied simultaneously and in the same transaction on the payment of £10. On a proper analysis of the promotion’s terms, the customer paid £10 to receive the three food items and the wine and the price must be allocated across the four items for VAT purposes. Applying ‘commercial common sense’ the term ‘free’ was clearly being used in a marketing sense only.

Even if the wine had been provided for no consideration, M&S would have been obliged to account for output VAT under the deemed supply rules in VATA 1994 Schedule 4. M&S argued that the wine would fall within the exception for a ‘business gift’ but ‘as such could not be a ‘small business gift’.

Why it matters

Whilst generally true that the VAT system will respect the terms of a bargain made at arm’s length, that bargain must be properly analysed. The decision is a reminder that the label applied by the parties to the provision of goods or services under a contract will not be determinative of the true supply for VAT purposes.

Loan servicing not exempt from VAT

The FTT has held that composite supplies by a loan servicer to a bank amounted to standard rated debt collection for VAT purposes in Target Group Ltd v HMRC [2018] UKFTT 226.

Target provided loan servicing for a bank, covering the loan’s lifecycle other than the making of the initial advance. Target had established loan accounts under its own systems, communicated with borrowers as an undisclosed agent of the bank and dealt with payments by borrowers and all administrative issues that arose during the life of the loan.

The FTT accepted that the supply by Target came, in principle, within the scope of the exemption for transactions concerning payments or transfers. The loan accounts were controlled and maintained by Target, which provided the sole record of the position between the bank and its customers. In particular, Target had authority to effect changes to the parties’ legal and financial situations by crediting and debiting entries to those accounts. Therefore, despite the recent decisions in Bookit and NEC, the activities of Target fulfilled the specific, essential functions of payments or transfers, going beyond a mere physical or technical supply. The case law of the CJEU demonstrated that the concept of transfer does not require that Ryanair should succeed on the question of economic activity exists. In this case, the Irish courts had accepted that such an intention existed. As such, the AG was clear that Ryanair v The Revenue Commissioners (Case C-249-17). According to the AG, a narrow focus on whether the acquirer would provide management services to the target is inappropriate in such a case.

In 2006, the Irish airline Ryanair made a bid to take over Aer Lingus. Although the takeover failed, Ryanair had already incurred considerable costs in connection with the planned takeover. Ryanair therefore claimed deduction of the input tax, which was refused by the Irish tax authorities.

The CJEU has recognised that, whilst a pure holding company does not carry on an economic activity, where the holding company has the intention to provide ‘remunerated management services’ to the target then an economic activity exists. In this case, the Irish courts had accepted that such an intention existed. As such, the AG was clear that Ryanair itself utilised the BACS and CHAPS payment systems, rather than effectively instructing or requesting a financial institution to do so, when making transfers to and from the bank’s accounts.

In order for that supply to be exempt, the description of the composite supply must fall within the exemption for ‘payments or transfers’ without being excluded by being ‘debt collection’. In the view of the FTT, the essence of what was being acquired by the bank, its main objective, was the collection of debts as they fell due. As such, the supplies by Target to the bank were excluded from exemption since they were, properly described, ‘debt collection’. The FTT distinguished the earlier Court of Appeal decision in EDS relied on by Target on the basis that that case involved both ‘loan arrangement and execution services’.

The FTT also dismissed Target’s separate argument that the supplies fell within the exemption for the operation of a current account. The term ‘current account’ does not have a specific legal meaning but takes its meaning from the commercial world. A banker would clearly take the view that these accounts were not current accounts, but loan accounts. In particular, an ‘important element of the functionality is that there is free ability on the part of the customer to vary the amount owed to it up and down’. That feature was missing here.

Why it matters

The decision itself is not in any way a surprising outcome – it is widely accepted that loan servicing no longer constitutes exempt payment services. In practice, however, much loan servicing can still qualify for exemption from VAT where it falls within the scope of ‘management of credit by the person granting it’.

Nevertheless, the decision may, in fact, be somewhat helpful to those outsourcing payment handling services more generally, in highlighting that exemption may still be available to non-financial institutions in some circumstances, especially where they are responsible for recording and handling ‘transfers’ via book entries that are determinative of legal and financial relationships.

Attributing input VAT on a share purchase

Where an operating company seeks to acquire a target with a view to strategically expanding its business, input VAT on that share acquisition should be attributed to the broader business of the acquiring company: Ryanair v The Revenue Commissioners (Case C-249-17). According to the AG, a narrow focus on whether the acquirer would provide management services to the target is inappropriate in such a case.

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However, the AG went on to suggest that the narrow focus on management services was inappropriate. It was clear that Ryanair itself did carry on an economic activity of operating a commercial airline business. Moreover, it was clear that the reason for the intended share acquisition was to expand that commercial airline business. The intended share acquisition was, in function, little different to an intended acquisition of business assets. In such a
case as this, therefore, a ‘functional analysis’ showed that there was a clear link between the acquisition of shares and the intended expanded turnover of the business. The expenditure had a ‘direct and immediate link’ with the wider airline business as it would form a cost component of that wider business following the takeover of Aer Lingus.

Why it matters
The AG has made a convincing case for looking at the wider business of the acquiring company in the context of a company takeover. In doing so, the opinion again draws attention to the fact that the case law of the CJEU has increasingly moved away from the narrow principle in BLP that the ultimate objective pursued by the taxpayer cannot provide a basis for deduction. It would be helpful if the CJEU could finally lay that latter decision to rest.

However, even if the CJEU follows the opinion of the AG questions will remain about the extent to which input VAT is deductible in a share acquisition context. What about the position of a newly formed acquisition vehicle? What about a holding company of an operating group? What about a situation where the acquisition relates to development of a new business, rather than an expansion of an existing business? A decision that broadens the economic activity analysis, and the ability to attribute the input VAT to that activity, will be welcome, but is unlikely to be the end of disputes in such scenarios.

VAT and customer loyalty schemes
The Upper Tribunal (UT) decision in Marriott Rewards and Whitbread Group v HMRC [2018] UKUT 129 indicates that, where a customer loyalty scheme is run by a ‘separate operator’, then VAT incurred on redemption payments by the operator will be a cost component of running the loyalty scheme, rather than third party consideration.

The Marriott Hotel chain ran a points-based customer rewards programme (the Program) operated by a US company, Marriott Rewards LLC (MR). Marriott hotels were typically franchised to local hotel operators. In the UK, one such participating hotel was run by Whitbread Group.

Under the Program, when a customer stayed at a participating hotel, that hotel would pay monies to MR and MR would issue points to that customer. Participating hotels would also accept points in payment for a hotel stay by a customer for which it received payments from MR. When a UK hotel (such as Whitbread) accepted payment in points, it charged VAT when it invoiced MR.

MR sought to recover the VAT it had been charged by UK hotels under the Thirteenth VAT Directive. It is a requirement for recovery that the amounts would be input VAT if the person was a UK taxable person. HMRC denied MR a repayment on the basis that the VAT charged to them by redeeming hotels amounted to third party consideration for supplies of hotel accommodation to customers not to MR. Alternatively, HMRC argued that the place of supply was in the US such that VAT was not properly chargeable on supplies to MR.

The UT identified a difference between promotion schemes using a ‘sub-contractor’ model and a ‘separate operator’ model (when operated by a business separate from the traders involved). The Program was an example of the latter model, similar to that considered by the Supreme Court in the LMUK case, concerning the Nectar scheme. As in that case, the redemption payments here were not third party consideration but consideration for supplies to the operator of the scheme. The payment by MR to a redeeming hotel was not for the provision of hotel accommodation by that hotel to a customer but rather for the acceptance of points by the redeeming hotel under the contractual framework of the Program.

However, the UT held that the supply by the redeeming hotel was essentially one of accepting the redemption of points which took place outside the UK, rather than one sufficiently connected with specific immovable property in the UK. Redeeming hotels merely undertook to MR to provide a hotel room, not any specific hotel room. It made no difference that the payment was actually made after the provision of a specific hotel room had been provided. Accordingly, the place of supply was the US where MR was based and did not give rise to recoverable input VAT under the Thirteenth VAT Directive.

In a joined appeal, Whitbread sought to recover overpaid output VAT for the period prior to 2010, arguing that its supplies to MR were supplies of advertising services supplied outside the UK where the recipient, MR, belonged (based on the pre-2010 place of supply rules). Whilst the purpose of the Program as a whole was advertising, the UT considered that a trader that provides goods or services to a customer is not ‘advertising’ in any relevant sense. In accepting the redemption of points, redeeming hotels were merely fulfilling their contractual obligations to MR. There was no element of advertising in that acceptance.

Why it matters
The decision contains a useful explanation of the various types of loyalty or reward scheme and their likely VAT consequences. The correct characterisation of supplies made within such a scheme will depend on the contractual arrangements and whether there is the necessary degree of reciprocity to give rise to a supply of redemption services and prevent the redemption payments simply amounting to third party consideration.

The decision also contains useful commentary on the question whether a supply is connected with immovable property and whether a supply may be of advertising services (which may still move the place of supply to where the customer belongs in the case of a supply to a non-EU non-business recipient post 2010).

What to look out for
- The closing date for comments on the government’s call for evidence on the design of the VAT registration threshold is 5 June 2018.
- The AG’s opinion is expected in MEO (Case C-295/17) on 7 June 2018, concerning the VAT treatment of a payment made in connection with the early termination of a contract.
- The closing date for comments on the government’s consultation on the VAT split payment collection model concerning the collection of VAT on online sales is 29 June 2018.

For related reading visit www.taxjournal.com
- Cases: HMRC v Volkswagen Financial Services (UK) (15.5.18)
- Hire purchases: a new opportunity to defer VAT? (Angela Lang-Horgan, 24.5.18)
- Cases: Marks and Spencer v HMRC (15.5.18)
- Cases: Target Group v HMRC (2.5.18)
- Cases: Ryanair v HMRC (15.5.18)
- Cases: Marriott Rewards and another v HMRC (2.5.18)
- VAT registration threshold conundrum (Chris Sanger & Steven Effingham, 10.5.18)