VAT update

June 2015

News

Compound interest on overpaid VAT: HMRC seeking to appeal against *Littlewoods*

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UK reduced rate VAT for energy-efficient materials infringes VAT Directive

The Court of Justice of the European Union (ECJ) has concluded that the UK's reduced VAT rate for supplies concerning energy-saving materials (Items 1 and 2, Group 2, Part 2, Schedule 7A, Value Added Tax Act 1994) infringes Council Directive 2006/112/EC of 28 November 2008. more›

Court of Session grants leave to appeal in *Taylor Clark*

The Court of Session has granted the taxpayer leave to appeal the Upper Tribunal's decision in *Taylor Clark Leisure Plc v HMRC* [2014] UKUT 396 (TCC) which considers entitlement to repayment of overpaid VAT in the context of VAT groups. more›

European Commission to work on a proposal for a Council Directive on modernising VAT for cross-border business to consumer e-commerce

On 6 May 2015, the European Commission published a communication on a Digital Single Market Strategy for Europe, which set out various actions, including legislative proposals to make cross border e-commerce easier and reduce burdens due to different VAT regimes. more›

Cases

Upper Tribunal prevents HMRC from reneging on a settlement agreement – *Southern Cross Employment Limited*

In *Southern Cross Employment Limited* [2015] UKUT 0122 (TCC), the Upper Tribunal upheld the decision of the First-tier Tribunal, confirming the power of HMRC to enter into settlement agreements in respect of overpayments of VAT. more›

Any comments or queries?

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About this Update

The VAT Update is published on the final Thursday of every month, and is written by members of RPC's Tax Disputes team.

We also publish a general Tax Update on the first Thursday of every month, and a weekly blog, RPC Tax Take.

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The *Halifax* principle and economic reality: Upper Tribunal upholds ruling that an offshore scheme designed to save irrecoverable VAT was not abusive

In *HMRC v Paul Newey t/a Ocean Finance* [2015] UKUT 0300, the Upper Tribunal has concluded that the offshore transfer of a business to avoid incurring irrecoverable VAT was not abusive in the sense set out by the ECJ in *Halifax* (Case C-255/02). more›

VAT scheme ruled abusive by the Supreme Court: *Pendragon*

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News

Compound interest on overpaid VAT: HMRC seeking to appeal against *Littlewoods*

On 23 June, HMRC published Revenue and Customs Brief 9(2015) which confirms its position following the Court of Appeal judgment in *Littlewoods Retail Ltd v Revenue and Customs Commissioners* [2015] EWCA Civ 515. HMRC has announced it will seek permission to appeal to the Supreme Court against the Court of Appeal's decision. The Court of Appeal dismissed HMRC's appeal against the High Court's decision that EU law entitled the taxpayer to an adequate indemnity for the loss arising from overpaying VAT, which, in the taxpayer's circumstances, required the payment to be calculated by reference to compound interest.

HMRC's policy paper also announced that, pending a decision on the permission, it will apply for any claims for compound interest (this includes claims already issued and new claims) to continue to be stayed pending the final determination of the *Littlewoods* litigation. Similarly any Tribunal appeals will continue to be stood over pending final determination. HMRC has confirmed it will refuse any new requests for compound interest.

Taxpayers who consider they may be affected by the *Littlewoods* decision should review their position as a matter of urgency.

Our recent client update on the Littlewoods decision can be read here.

The Revenue and Customs Brief can be read here.

Back to contents>

UK reduced rate VAT for energy-efficient materials infringes VAT Directive

The Court of Justice of the European Union (ECJ) has concluded that the UK's reduced VAT rate for supplies concerning energy-saving materials (Items 1 and 2, Group 2, Part 2, Schedule 7A, Value Added Tax Act 1994) infringes Council Directive 2006/112/EC of 28 November 2008. In *Commission v United Kingdom* (Case C-161/14) the ECJ held that the reduced rate should only apply to supplies that are not "social policy". The UK must now decide what constitutes "social policy" and standard-rate supplies that do not satisfy this requirement.

Back to contents>

Court of Session grants leave to appeal in *Taylor Clark*

The Court of Session has granted the taxpayer leave to appeal the Upper Tribunal's decision in *Taylor Clark Leisure Plc v HMRC* [2014] UKUT 396 (TCC) which considers entitlement to repayment of overpaid VAT in the context of VAT groups.

The taxpayer sought to rely on an in-time claim submitted by a former VAT group member, its own claim being out of time. The Upper Tribunal, agreeing with the First-tier Tribunal, held that section 80 of the Value Added Tax Act 1994 requires a claim for overpaid VAT to be made by the person who accounted for VAT (in the case of a VAT group, the representative member). However, the taxpayer's appeal was dismissed as the Upper Tribunal concluded that they could not rely on the timeous claim of a former VAT group member when its own claim was out of time.

Back to contents>

European Commission to work on a proposal for a Council Directive on modernising VAT for cross-border business to consumer e-commerce

On 6 May 2015, the European Commission published a communication on a Digital Single Market Strategy for Europe, which set out various actions, including legislative proposals to make cross border e-commerce easier and reduce burdens due to different VAT regimes.

The Commission recently updated the 2015 tax work programme and confirmed they will work on a proposal for a Council Directive on modernising VAT for cross-border business to consumer e-commerce with a view to adoption in 2015 and 2016.

As part of the proposal it will consider extending the one stop shop to B2C suppliers of goods and removing the VAT exemption for the importation of small consignments with accompanying simplification arrangements. The aim is to break down VAT barriers for cross-border trade, to facilitate the digital single market and provide a level playing field for business.

Back to contents>

Cases

Upper Tribunal prevents HMRC from reneging on a settlement agreement – *Southern Cross Employment Limited*

In *Southern Cross Employment Limited* [2015] UKUT 0122 (TCC), the Upper Tribunal upheld the decision of the First-tier Tribunal, confirming the power of HMRC to enter into settlement agreements in respect of overpayments of VAT.

Background

In 2009, Southern Cross submitted a Fleming claim to recover VAT overpaid in the periods from 1993 to 1997 on supplies of nursing staff. The basis of the claim was that the supplies were exempt from VAT. The claim was initially rejected, however, following various correspondence between the parties, in May 2010 an agreement was reached and HMRC repaid Southern Cross 74% of its claim.

Within three months of the repayment however, HMRC changed its position. It wrote to Southern Cross in July 2010 to advise that following the decision in *Mohair* (FTC/61/2011) it now considered that the supplies were standard rated and not exempt. HMRC issued a recovery assessment to claw back the 74% repayment.

Southern Cross appealed this assessment to the First-tier Tribunal on the basis that the repayment was made pursuant to an enforceable contract in full and final settlement. Its appeal was allowed by the First-tier Tribunal, for the following reasons:

- applying the ordinary principles of contract law, the First-tier Tribunal considered the agreement was arrived at following a process of offer, counter-offer and acceptance and was binding
- the agreement was not ultra vires. HMRC has the power to compromise where the actual tax recoverable has not been quantified
- HMRC therefore had no power to assess and claw-back the sums which it had paid to Southern Cross.

The Upper Tribunal's decision

The Upper Tribunal considered the same three key issues identified by the Fist-tier Tribunal, although in reverse order.

- **Did section 80 of Value Added Tax Act 1994 bar HMRC from entering into a binding agreement?**
  - The Upper Tribunal concluded that section 80 did not bar HMRC from entering into a binding agreement to settle a claim. The mechanism provided by section 80 was only intended to prevent taxpayers from seeking to recover overpayments by other remedies, eg common law claims for restitution. It was not parliament's intention to prevent HMRC from settling claims made under section 80.
  - The Upper Tribunal further commented that parties should not have to resort to litigation to achieve a binding agreement; section 85 makes provision to this effect in the context of an appeal. It therefore concluded that HMRC should be able to, if it so chooses, to dispose of claims under section 80 on a final basis regardless of whether there was a pending appeal.

- **Was the agreement *ultra vires*?**
  - In the Upper Tribunal's view, HMRC's decision to enter into the contract was based on good intentions, having regard to relevant considerations at the time. The key question however was whether it was fatal to the validity of the agreement that HMRC did not appreciate that Southern Cross's supplies were in fact taxable.
  - The Upper Tribunal concluded that HMRC could not escape an agreement simply because the supplies had subsequently been shown to be taxable. The fact the supplies have now been found to be standard rated does not mean HMRC misdirected itself in law. At the time the agreement was entered into there was no clarity as to the VAT position and the parties could not have known with certainty the liability of the supplies in question. HMRC could not claim the agreement was invalid as a result of its failure to predict the change in law and in particular the *Mohair* decision.
  - In the circumstances, and based on the evidence, the Upper Tribunal found it impossible to determine whether HMRC was or was not conscious that there was doubt over the correct treatment of the supplies. In any event, had HMRC been aware that the supplies might not be exempt, the Upper Tribunal was of the view that that would not constitute an error of law; a state of doubt is different from a mistake.

- **Was there a binding agreement?**
  - Finally, the Upper Tribunal considered whether a contractual agreement was entered into. It upheld the decision of the First-tier Tribunal and agreed that there was a binding agreement between the parties. Viewed objectively, the pattern of correspondence between the parties, and specific wording used, pointed to a clear process of negotiation and an intention to conclude a contractual agreement.

Comment

This decision is good news for taxpayers and provides some certainty for taxpayers who enter into VAT settlements with HMRC. The outcome confirms that HMRC cannot renege on settlements reached with taxpayers in circumstances where the law is clarified after a settlement has been reached.

In this case it was the process, not the outcome that protected Southern Cross. The compromise agreement reached with HMRC was arrived at following a process of offer, counter-offer and acceptance. Whether a binding agreement exists between the taxpayer and HMRC in other circumstances will very much depend on the facts of each individual case.

In the light of this decision, it is clear that appropriate evidence is crucial. Taxpayers who enter negotiations for settlement or agreements with HMRC are therefore strongly advised to ensure that correspondence and discussions are carefully documented.

The judgment can be read here.

Back to contents>

The *Halifax* principle and economic reality: Upper Tribunal upholds ruling that an offshore scheme designed to save irrecoverable VAT was not abusive

In *HMRC v Paul Newey t/a Ocean Finance* [2015] UKUT 0300, the Upper Tribunal has concluded that the offshore transfer of a business to avoid incurring irrecoverable VAT was not abusive in the sense set out by the ECJ in *Halifax* (Case C-255/02).

Background

Mr Newey was a loan broker established in the UK who sold in the UK market. The dispute concerned a change in Mr Newey's business structure. He transferred his business to a company resident in Jersey, Alabaster, which outsourced the processing operations back to the UK, in order to mitigate the VAT costs of advertising in the UK. HMRC challenged the business structure on two grounds. Firstly, that it was abusive under the *Halifax* principle and secondly, that the supplies were not made to the entity in Jersey at all but to Mr Newey in the UK.

The First-tier Tribunal allowed Mr Newey's appeal. HMRC appealed this decision to the Upper Tribunal.

Upper Tribunal's decision

HMRC's appeal was dismissed. The Upper Tribunal agreed with the First-tier Tribunal that abuse could not be established in this case.

In reaching this conclusion, the Upper Tribunal considered that although the essential aim of the structure was to create a tax advantage, this was only half of the *Halifax* abuse test. It was implicit from the ECJ's decision that it was only permissible to depart from and redefine the contractual terms if the arrangements were deemed to be wholly artificial and did not reflect economic and commercial reality.

To determine 'economic reality' the Upper Tribunal assessed the contractual position based on the findings of fact established by the First-tier Tribunal. It did accept the force of some of HMRC's criticisms of the contractual arrangements, for example, the lack of knowledge and experience of the directors of the offshore entity, which could suggest that the entity concerned was not genuinely engaged in commercial activities. However, this was not held to be sufficient to cast doubt on the First-tier Tribunal's findings in this case. Alabaster had contracted with a third party advertising agency, it paid its own bills and had genuine business relationship. It had also had some involvement in the final decision regarding whether the loan applications could proceed and was not just a brass plate office, rubber-stamping decisions taken in the UK. On this basis it was determined the structure was not artificial. The contracts were genuine.

Significantly, agreeing with the First-tier Tribunal, the Upper Tribunal held that the fact a change of structure was wholly tax driven did not mean that the resulting structure, had it been set up initially, would have given rise to an abusive practice. It is perfectly acceptable for taxpayers to structure their affairs (as in this case) so as to limit their tax liability. Structures must be viewed on their own merits, without comparing them to pre-existing or other structures that might have applied in the past. The question was not whether the change in structure resulted in a tax advantage as compared with the pre-existing structure. Only if the structure is considered artificial, is it necessary to consider the second limb of *Halifax*, the principle of abuse.

Furthermore, in assessing whether the essential aim of a structure gives rise to an abusive practice (the second limb of the *Halifax* test), the Upper Tribunal confirmed that the test is objective. HMRC's appeal was dismissed.

Comment

This is the first of two decisions this month which consider the doctrine of abuse established in *Halifax* (see also our commentary below on *Pendragon*). In dismissing the appeal, the Upper Tribunal provides some helpful guidance on the approach to be taken when considering the *Halifax* principle, particularly in relation to economic reality.

The Upper Tribunal confirmed that the first limb of the *Halifax* test requires an analysis of the contractual terms and economic reality of the transactions under consideration. Only if the structure is considered wholly artificial is it necessary to consider the second limb of the *Halifax* test, the principle of abuse.

In assessing 'economic reality', the Upper Tribunal concluded that a transaction should be judged objectively by reference to the context and not the reason for the change from an existing structure. The Upper Tribunal commented that a distinction should be drawn between the aims of a structure and nature of the transactions. A decision taken wholly for tax purposes will not necessarily be fatal to the characterisation of a structure provided the transactions are genuine. Unfortunately, no further guidance was provided on the factors to be taken into account in determining the 'economic reality'.

The judgment can be read here.

Back to contents>

VAT scheme ruled abusive by the Supreme Court: *Pendragon*

The Supreme Court, reversing the decision of the Court of Appeal, has found that arrangements designed to avoid VAT on the resale of demonstrator cars was abusive for VAT purposes.

Background

The case concerned a complex arrangement involving the creation of leases over cars which were then used as security for obtaining finance from a Jersey bank. The arrangements were designed to enable car dealerships in the group to recover all of the input VAT incurred on the purchase of new cars from manufacturers. The application of the profit margin scheme on the eventual sale of the cars meant that VAT was only accounted for on the profit element.

It was common ground between the parties that the arrangements achieved the intended fiscal result, and satisfied the conditions for exemption from VAT and application of the margin scheme. However, HMRC challenged the arrangements arguing that it was abusive (in the *Halifax* sense) and contrary to the purpose of the legislation.

The First-tier Tribunal and Court of Appeal found in favour of the taxpayer, agreeing that the arrangements were a tax efficient means of obtaining finance. The Upper Tribunal, however, disagreed, finding in favour of HMRC. It concluded that the sole aim of the arrangements was to obtain a tax advantage.

HMRC appealed the Court of Appeal's decision to the Supreme Court.

Supreme Court's decision

The Supreme Court allowed HMRC's appeal and held that the arrangements were abusive.

The Supreme Court considered that there was no separate test of whether the relevant transaction constituted "normal commercial operations". The normality of the transactions was relevant to the operation and purpose of the relevant legislation, which in this case was the profit margin scheme. The aim of the profit margin scheme was to avoid double taxation, whereas the effect of the arrangements in this case was to avoid taxation for Pendragon altogether. The Supreme Court therefore concluded that the arrangements were contrary to the legislation and the first limb of the *Halifax* test was met.

The Supreme Court commented that the application of the principle of abuse of law to tax avoidance is that of concurrent purposes. Tax avoidance schemes are rarely directed exclusively to tax avoidance. They are usually directed to achieving a commercial purpose, in a way which avoids a tax liability that would otherwise be associated with it. The potential for abuse consists in the method chosen to achieve the commercial purpose. Identifying the "essential aim" (the second limb of the *Halifax* test) therefore depends on an objective analysis of the method used to achieve the commercial purpose.

In assessing the "essential aim" of the transaction the Supreme Court referred to the First-tier Tribunal's findings which showed that the overall result of the arrangements was to achieve a number of rational commercial objectives. The arrangements did, however, have two special features, both of which were essential to the tax efficacy of the arrangements. Critically, neither feature had any commercial rationale other than the achievement of a tax advantage. The Supreme Court therefore concluded that the second limb of the *Halifax* test was also satisfied.

As the arrangements were an abuse of law, it fell to be redefined. Redefinition had to deprive Pendragon of the illegitimate advantage of paying VAT only on its profit margin. The Supreme Court did this by redefining the transaction as a sale and leaseback transaction, followed by a sale to customers.

Comment

The various judicial interpretations at the different stages of the UK court and tribunal system illustrate the difficulty in determining the boundaries of the principles of abuse to a given set of facts.

The decision does however shed further light on the scope of *Halifax* and provides guidance on the factors to be considered in an objective assessment of the essential aim of the arrangements under consideration. The Supreme Court commented that relevant evidence might include evidence not just of the background knowledge available to the parties, but of the financial position and objective commercial requirements of the party obtaining the tax advantage, the relationship between the parties, reasonableness of consideration and the normal course of relevant business.

Whilst the Supreme Court has (in line with the UK courts and tribunals below) confirmed that taxpayers are entitled to structure their businesses in a tax-efficient way, the decision demonstrates that there are limits on this right.

The judgment can be read here.

Back to contents>

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