VAT update

May 2015

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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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News

Digital Single Market Strategy published by European Commission

On 6 May 2015, the European Commission published a paper entitled Communication on a Digital Single Market Strategy for Europe. The strategy document includes various proposals with the intention of: providing better online access for consumers and businesses across the EU; creating the right conditions for advanced digital networks and innovative services; and, maximising the growth potential of the European digital economy. The proposals include plans aimed at minimising the burden attached to cross-border e-commerce arising from different VAT regimes around the EU.

In particular, the Commission proposes to extend the "mini one stop shop" (MOSS), currently in operation for digitally supplied services, to tangible goods. This would mean the introduction of a single electronic return for companies to file and pay VAT to their home tax authority irrespective of where their customers are located. That authority would then be responsible for distributing the relevant VAT across the EU as appropriate. The matter will be discussed in the European Council in June.

The Commission's strategy document "A Digital Single Market Strategy for Europe" can be read here.

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EU Parliament joins UK in call for change to the VAT treatment of apps and streamed music/video

As reported in our VAT update in August 2014 (and referred to above), the MOSS was introduced in January 2015 for suppliers of e-services. The simplified MOSS reporting portal has led to some widespread confusion for many UK businesses which are now required to register for VAT for the first time.

During a recent EU Parliamentary debate, MEPs from Ireland, Germany and the Netherlands confirmed that the poor uptake of the changes is not only a UK problem.

The changes were designed to bring EU VAT on consumer electronic services sales in line with other services. The Commission's original estimate was that one million businesses would register with the new scheme, however, less than 10,000 businesses having registered.

The Commission Vice President has called for the Commission to consider a €100,000 VAT registration threshold to lift micro-businesses out of the new limits. The current UK VAT threshold is £82,000 but in other EU states the rate is much lower and many small business are finding themselves forced to register for VAT in order to process EU VAT sales through MOSS. This support from the Parliament will come as welcome news to the UK Government who requested a review by the Commission in March. However, other states may resist any changes because of the potential effect on their tax revenues.

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European Commission considers VAT on crowdfunding

The Commission has launched an investigation into whether crowdfunding should be liable to EU VAT. If the Commission concludes that it should, a large number of UK projects will face a 20% VAT liability on investor returns.

The Commission is particularly concerned with the very popular "rewards crowdfunding", whereby investors contribute funds in return for products or services to be developed, usually as a result of the fundraising. These rewards projects can include, for example, films, albums, or software development, which are offered free, or at a reduced rate.

The Commission is also considering whether crowdfunding ought to qualify as a financial service under the EU VAT Directive. If it concludes that it should not, then intermediary services offered by many crowdfunding platforms will become liable to VAT.

Echoing the approach taken in recent reviews of the VAT treatment of bitcoins and other forms of digital currency, the Commission has now referred the question of crowdfunding to the EU VAT Committee.

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Cases

"Adequate Indemnity" victory for taxpayer upheld in *Littlewoods*

The Court of Appeal has upheld the taxpayer's victory in *Littlewoods Limited v HMRC*[1].

Background

The underlying facts of the case are not especially relevant save that the taxpayer had been required, and had paid, VAT which was later found not to be due. That VAT was recovered, together with statutory simple interest. The issue was the extent to which the taxpayer's right to recover interest on claims for the repayment of wrongly levied VAT was limited to simple interest, as specified under sections 78-80 VATA 1994, or whether EU law required something else.

The question was referred to the Court of Justice of the European Union[2] (CJEU). However, the judgment which emerged was not without nuance and the central issue before MrJustice Henderson when the matter returned to the UK was what the CJEU had meant when it said that national rules for the calculation of interest "should not lead to depriving the taxpayer of an **adequate indemnity** for the loss occasioned through the undue payment of VAT" [29]. Henderson J (in another case[3]) described this as "somewhat Delphic guidance", it is therefore unsurprising that when he came to hear the case, both parties claimed victory.

In the High Court[4], Henderson J recognised that the key to the problem lay in a proper understanding of the nature and content of the right to interest under EU law. Having reviewed the CJEU's decision and its subsequent application in *British Sugar*[5] and *Irimie*[6], he concluded that the right under EU law to the payment of interest on recovery of unlawfully levied tax was now firmly entrenched in the jurisprudence of the CJEU. That right could not be considered ancillary to a claim for the repayment of tax. Rather, the case law cited demonstrated that interest, as a component of a claim, ranked equally in EU law, with the right to the repayment of the tax itself.

The judge concluded that an "adequate indemnity" must require payment of an amount of interest which is "broadly commensurate with the loss of the use value of the overpaid money in the hands of the taxpayer", running from the date of payment until the date of repayment. He went on to find that the only way to provide Littlewoods with adequate compensation for the lost use value of its money would be by an award of compound interest.

Court of Appeal decision

HMRC sought to challenge Henderson J's judgment on appeal but the Court of Appeal dismissed HMRC's arguments and upheld the judge's reasoning in its entirety concluding "we are not persuaded that Henderson J fell into any error on any of the issues which we have been asked to decide".

Comment

This represents a significant victory for the taxpayer, not only in this case, but in the many cases which are stood behind it. That said, it is important to recognise that this decision does not go so far as to find that all taxpayers with EU law claims will be entitled to compound interest as a matter of course. The Court of Appeal, like Henderson J before it, emphasised that the question

1. [2015] EWCA Civ 515.
2. Case C-591/10.
3. *Investment Trust Companies (in liquidation) v Commissioners for Her Majesty's Revenue and Customs* [2013] EWHC 665 (Ch).
4. [2014] EWHC 868 (Ch).
5. Case C-147/10 and joined cases.
6. Case C-565/11.

of what will amount to an adequate indemnity must be answered by reference to the particular facts of a case. As Lady Justice Arden put it ""adequate indemnity" is not a rigid straitjacket, and certainly does not go as far as to require compound interest in every case".

What this means in practice is that there may be cases where simple interest alone will equate to the loss suffered by a claimant and satisfy the "adequate indemnity" test. This may be the case where, for example, a claim for the recovery of overpaid tax is made within a few years of the date of payment and where the difference between simple and compound interest over that period is relatively minor. Ultimately, it will come down to a question of analysis based on the particular facts of the case.

It is likely that HMRC will seek to appeal the Court of Appeal's judgment, however, it is by no means certain that its request for permission will be granted as HMRC has now lost on two occasions. The Court of Appeal will hear submissions on permission to appeal on 4 June 2015.

The CJEU decision can be read here.

The High Court decision can be read here.

The Court of Appeal decision can be read here.

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Tribunal tackles contingent discounts and finds HMRC wanting

The FTT has concluded, in *Kumon Educational UK Company Ltd v HMRC*[7], that a reward payment made by a company to its franchisee/instructor should be treated as a contingent discount and, as such, be deductible for VAT purposes.

Background

Kumon Educational UK Company Ltd (Kumon) provides educational services to 5 to 17 year olds. It franchises its teaching methods to individual instructors who each pay a licence fee (the Franchise Fee), which is calculated by reference to each pupil. The instructors are assessed on an annual basis, each receiving a "reward" based on three principal criteria: (i) the number of students taken on and retained (ii) the number of students obtaining higher levels of achievement, and (iii) the instructor's own technical level of training.

Kumon argued that these rewards were linked to the Franchise Fee and therefore fell within the definition of a "contingent discount" set out in VAT Notice 700 at 7.3.2(c), specifically: "if you offer a discount on condition that something happens later (for example on condition that the customer buys more from you) then the tax value is based on the full amount paid. If the customer later earns the discount, the tax value is then reduced and you can adjust the amount of tax by issuing a credit note". It argued that given that the number of students taught by each instructor was a fundamental element of the Franchise Fee, the reward should be treated as a contingent discount only payable on the net amount of the Franchise Fee actually paid.

HMRC argued that there was no direct link between the rewards paid and the Franchise Fee, as the rewards paid were linked to supplies which were not part of the Franchise Fee and included other services such as the quality of the teaching provided. It argued that the reward

7. [2015] UKFTT 84 (TC).

did not reduce the Franchise Fee by a set amount and there was therefore no reduction in the value of the supplies to which the Franchise Fee related as a result of the reward payments.

HMRC refused to make a repayment of output VAT and Kumon appealed to the FTT.

FTT decision
The FTT disagreed with HMRC's position that the reward payments were entirely separate from the supplies made by Kumon in return for the Franchise Fee. In its view, the obligations placed on instructors (for example, to promote the Kumon method and teach it to a particularly high standard) could not be separated from the commercial bargain on which the Franchise Fee was based.

The reward paid to instructors for procuring and retaining more students was considered a "core" part of the activities for which the Franchise Fee was paid.

In the view of the FTT, although the basis for calculating the rewards was complicated, it was based on clear criteria and was ascertainable in any given case. It criticised HMRC for not being able to provide a description of what the separate supply, to which it alleged the rewards related, actually was.

The FTT concluded that the rewards paid by Kumon to its instructors should be treated as a contingent discount, deductible for VAT purposes from the value of the Franchise Fee charged to the instructors and that Kumon was entitled to reclaim the relevant VAT paid. Kumon's appeal was therefore allowed.

Comment
The FTT focused on substance, rather than form, when considering the VAT deductions made from payments for services. It highlighted the fact that if a reward payment is not completely separate from the supply (the activity the payment relates to) then the payment received is likely to be treated as a discount and therefore deductible for VAT purposes.

The decision can be read here.

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No double-dip for Bulgarian VATman

The CJEU has prevented the Bulgarian tax authorities from taxing the same transaction twice, in *GST-Sarviz AG Germania v Direktor na Direktsia*[8].

Background
In 2010, GST-Sarviz AG Germania (GST-Sarviz), a German entity, provided technical consultancy services to GST Skafolding Bulgaria EOOD (GST Skafolding), a Bulgarian entity. GST-Sarviz also paid rent to GST Skafolding, in respect of scaffolding and materials which that company provided to it. As GST-Sarviz did not have a fixed establishment in Bulgaria for VAT purposes at the time it supplied its services, GST Skafolding paid the VAT due under the reverse charge procedure. GST Skafolding accordingly self-charged the VAT due, and simultaneously deducted it as an input VAT credit.

In 2012, the Bulgarian tax authorities determined that GST-Sarviz did have a fixed establishment in Bulgaria and was therefore liable for VAT for the period during which it supplied services to GST Skafolding.

8. Case C-111/14.

GST-Sarviz paid the VAT demanded and submitted an application to the Bulgarian tax authorities for the VAT to be offset or refunded. Its application was refused.

GST Skafolding also submitted an application for a refund which was rejected.

CJEU decision

VAT had been paid twice, once by GST-Sarviz, the supplier of the services, and also by GST Skafolding, the recipient of the services, notwithstanding that it is a fundamental principle of the VAT Directive that only the supplier of services is liable for the payment of VAT. As GST-Sarviz was found to have a fixed establishment in Bulgaria, it was the only entity liable for the VAT due. The erroneous payment by GST Skafolding, on the incorrect assumption that GST-Sarviz did not have a fixed establishment in Bulgaria, did not permit the Bulgarian tax authorities to derogate from this fundamental principle.

Any suggestion that the application of the reverse-charge mechanism by a recipient could relieve a supplier from its obligations as a VAT liable person was firmly dismissed by the CJEU.

In the view of the CJEU, the Bulgarian tax authorities' refusal to refund the VAT to GST-Sarviz was commensurate to them transferring the fiscal burden to the supplier. This was contrary to the principle of fiscal neutrality. National tax authorities are not permitted to refuse to refund VAT to the supplier of services in circumstances where the recipient of those services has also paid VAT. GST-Sarviz was accordingly entitled to a refund of the VAT it had paid.

Comment

This case illustrates one of the fundamental principles of VAT law, that the application of VAT must achieve fiscal neutrality. The operation, or disapplication, of the reverse-charge mechanism may not lead to a circumstance where this principle is disturbed and any national provision which results in a distortion must yield to this overriding principle.

The decision can be read here.

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About RPC

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