VAT update

June 2017

In this month's update we report on proposals for the reduced VAT rate for e-publications, HMRC's first publication of VAT Notes 2017, in which it explains changes to VAT for businesses, and the latest stage in the long-running compound interest litigation involving *Littlewoods*. We also comment on three recent cases involving irrecoverable output tax, the VAT treatment of leases (whether they are a supply of goods or services), and the recovery of input tax.

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Reduced VAT rate for e-publications approved by European Parliament

An EU Commission proposal to enable member states to charge a reduced rate of VAT on e-books, which would bring them into line with VAT levied on printed matter, has been endorsed by the European Parliament. more›

VAT Notes 2017 Issue 1 – changes to VAT for businesses

On 10 May 2017, HMRC published guidance VAT Notes 2017 Issue 1. This explains changes to VAT for business. more›

Littlewoods – compound interest case before the Supreme Court

The Supreme Court is due to hear HMRC's appeal against the Court of Appeal's judgment in favour of Littlewoods Ltd on 3-6 July 2017. more›

Cases

J & B Hopkins Ltd – irrecoverable output tax

In *J&B Hopkins Ltd v HMRC* [2017] UKFTT 0410 (TC), the First-tier Tribunal (FTT) upheld a VAT assessment, even though the taxpayer had not charged VAT and was unable to recover it as the recipient of the supply had gone into liquidation. more›

Mercedes Benz C-164/16 – VAT treatment of leases, goods or services?

Advocate General Szpunar has provided his opinion in *HMRC v Mercedes Benz Financial Services UK* (Case C-164/16). more›

Oval Estates (Bath) Limited – recovery of input tax

In *Oval Estates (Bath) Limited v HMRC* [2017] UKFTT 403 (TC), the FTT held that input tax was attributable to an identifiable supply and was recoverable despite allegations of deliberate and concealed behaviour. 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 Tax update on the first Thursday of every month, and a weekly blog, RPC's Tax Take.

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News

Reduced VAT rate for e-publications approved by European Parliament

An EU Commission proposal to enable member states to charge a reduced rate of VAT on e-books, which would bring them into line with VAT levied on printed matter, has been endorsed by the European Parliament.

Currently, e-books have to be taxed at an EU minimum standard rate of 15%, whereas member states are free to charge a reduced rate of 5%, or in some cases zero rate, on printed publications.

Whilst music and videos, as well as publications predominantly consisting of music and video content, will continue to be taxed at the standard VAT rate, the proposal for e-books will be welcomed by many. This proposal is in line with the Commission's 2016 Action Plan on VAT and demonstrates its commitment to keep pace with the challenges of today's digital economy. The date for the proposals to take effect has not yet been confirmed.

A copy of the European Parliament's press release is available to view here.

VAT Notes 2017 Issue 1 – changes to VAT for businesses

On 10 May 2017, HMRC published guidance VAT Notes 2017 Issue 1. This explains changes to VAT for business and includes the following:

- Alcohol Wholesaler Registration Scheme – preventing fraud
- Overseas businesses using online marketplace to sell goods in the UK
- Switching to online Machine Gaming Duty returns
- Machine Gaming Duty for Agents
- Raw Tobacco Approval Scheme
- Details of new and revised VAT notices

A copy of the Notes are available to view here.

Littlewoods – compound interest case before the Supreme Court

The Supreme Court is due to hear HMRC's appeal against the Court of Appeal's judgment in favour of Littlewoods Ltd on 3-6 July 2017.

The *Littlewoods* case relates to a dispute with HMRC over the issue of whether compound, rather than simple, interest should have been received on overpayments of VAT. Littlewoods was successful before the High Court and Court of Appeal. HMRC have now appealed to the Supreme Court.

A large number of other taxpayers have similar compound interest claims and the outcome of those claims is likely to be dependent on the outcome of the *Littlewoods* case.

If readers are interested in watching the proceedings live there is an online livestream available via the Supreme Court's website.

A copy of the Court of Appeal's judgment in *Littlewoods* is available to view here.

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Cases

J & B Hopkins Ltd – irrecoverable output tax

In *J&B Hopkins Ltd v HMRC* [2017] UKFTT 0410 (TC), the First-tier Tribunal (FTT) upheld a VAT assessment, even though the taxpayer had not charged VAT and was unable to recover it as the recipient of the supply had gone into liquidation.

Background

J&B Hopkins Ltd (J&B) entered into a construction contract with Rok Ltd (Rok), under which it agreed to construct a new place of worship for a charity. The charity had issued a zero-rating certificate to Rok who duly zero-rated its supplies of construction services. J&B was provided with a copy of the certificate and on this basis proceeded to not charge VAT on its invoices.

HMRC formed the view that, as sub-contractor, J&B was not entitled to zero-rate its supplies. Note (12) of Schedule 8, Group 5 of the Value Added Tax Act 1994 (VATA) provides that only a supply by a main contractor may be zero rated. Accordingly, HMRC raised assessments on the basis that the supplies were standard rated and that payments received from Rok were deemed to be inclusive of VAT.

After paying J&B's invoices, Rok went into administration and then into liquidation. As a consequence, J&B was unable to collect the unpaid VAT from Rok.

J&B accepted that it was not entitled to zero rate its supplies to Rok. It was also accepted that it was unlikely that Rok in turn was able to recover any input VAT from HMRC. Nevertheless, it appealed the assessments on the basis that HMRC would be unjustly enriched by the windfall (because Rok had not recovered the input VAT on the amounts it had paid to J&B). J&B relied on the European principles of effectiveness and fiscal neutrality. It argued that *Reemtsma* (Case C-35/05) applied to grant it a claim against HMRC which would effectively cancel out the assessment.

FTT's decision

The appeal was dismissed.

The FTT held that the effect of section 19(2), VATA, was that the amounts paid by the customer included output VAT. It was immaterial that the parties were unaware of that fact at the time. As such, Rok had only paid a proportion of the price due and, therefore, in reality, J&B was an unsecured creditor for the outstanding amount. It followed that as Rok had paid the amount of VAT to J&B, although it had not exercised it, Rok had a right to recover that sum from HMRC.

There was no doubt in the FTT's mind that *Reemtsma* created directly effective rights justiciable in the UK. The FTT accepted that the principle could apply in cases of underpaid VAT (such as the instant case), as well as overpaid VAT. However, the FTT concluded that the principle established in *Reemtsma* could not apply in the present case as J&B had actually been paid for the supply on which it had been assessed to tax.

In the FTT's view, *Reemtsma* required the windfall for HMRC to be at the supplier's expense, whereas in this case, it was the customer's expense. J&B was seeking relief from tax because of a windfall that HMRC might have had at the expense of Rok (or its creditors), as the price under the contract had been inclusive of VAT.

The FTT held that the principles of effectiveness and fiscal neutrality did not assist J&B. *Reemtsma* confirmed that where a customer's restitutionary rights against its supplier for overpaid VAT are ineffective due to insolvency, the obligation on the tax authority to repay the VAT is transferred from the supplier to the customer. In this case, the supplier's rights were effective as the payment received from Rok included VAT.

Finally, the FTT dealt with a point J&B raised concerning whether the assessment had been made to HMRC's best judgment (section 73(1), VATA). The FTT held that it had no jurisdiction in relation to the decision of HMRC to make the assessment. That is an exercise of discretion which can only be challenged by way of judicial review. Even if it had jurisdiction, the FTT commented that it would not have found in favour of J&B because there would not be a windfall on HMRC if J&B had correctly issued Rok VAT notices as it should have done. Moreover, the FTT considered it would not be a proper exercise of HMRC's discretion to forgo enforcement of the law to protect taxpayers against their customers' insolvency.

Comment

J&B's difficulty in this case was that it had accepted a VAT inclusive price under the misunderstanding that no VAT was payable. It serves as an important reminder that sub-contractors must take care to determine the correct VAT liability of the works they undertake and not rely on assurances given by the main-contractor.

This case is also a helpful reminder that it is essential to choose the correct forum for any public law challenge to HMRC. When considering a judicial review challenge, expert legal advice should be sought at the earliest possible opportunity.

A copy of the decision is available to view here.

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Mercedes Benz C-164/16 – VAT treatment of leases, goods or services?

Advocate General Szpunar has provided his opinion in *HMRC v Mercedes Benz Financial Services UK* (Case C-164/16). In his view, only transactions which offer certainty that ownership passes to the lessee at the end of the agreement term (such as hire purchase contracts), are supplies of goods for the purposes of VAT.

Background

Mercedes Benz Financial Services (MBFS) offers various financial products in relation to the use and acquisition of vehicles. It offers three standard types of vehicle-use agreements: leasing, hire purchase and a mixed agreement called "Agility". The case concerned the classification of the "Agility" arrangements for VAT purposes.

Under the Agility arrangements, following the expiry of the lease, the lessee had the option to purchase the vehicle, subject to payment of the final amount which corresponded to the mean anticipated value of the vehicle at the time of purchase (in the examples provided, this amount varied from 42% to 48% of the initial price). The issue was whether, for VAT purposes, this arrangement was a supply of goods or a supply of services.

MBFS marketed the Agility arrangements as involving a hire purchase contract and considered that there was a supply of services with output VAT due on receipt of each payment under the lease. HMRC disagreed. It argued that the arrangements involved a supply of goods and that output VAT was due on the full value of the supply at the outset of the lease. HMRC

relied on the wording of the VAT Directive which provides that there is a supply of goods where "in the normal course of events, ownership is to pass at the latest upon payment of the final instalment".

The matter was appealed to the FTT and then to the Upper Tribunal and the Court of Appeal. The Court of Appeal decided to refer certain questions to the Court of Justice of the European Union (CJEU).

Advocate General's opinion
On 31 May 2017, Advocate General Spuznar delivered his opinion on whether, and in what circumstances, a leasing agreement with an option for the lessee to purchase the subject matter of the lease following the expiry of the term, should be regarded as a supply of goods under Article 14(2)(b) of Directive 2006/112.

The Advocate General observed that Article 14(2)(b) covers an agreement containing a clause "which provides that in the normal course of events ownership is to pass at the latest upon payment of the final instalment". In his view, such an agreement must contain an ownership transfer clause. This can be either a decision automatically to transfer ownership by the end of the agreement term or an option to purchase the leased asset. Agreements which do not contain any decision on the transfer of ownership are not covered by Article 14(2)(b). There must be transfer of ownership following the 'normal course of events'. This should be regarded as a series of events envisaged as a result of normal performance of the agreement. It may be extended to include activities such as exercising a right to purchase, however, there must be a high degree of certainty that the option will be exercised and title will pass to the lessee. Situations where a lessee has a genuine choice are not covered by Article 14(2)(b). Finally, transfer of ownership must take place at the latest upon payment of the final instalment. Where the quantum of the lease payments are such that, over time, the lessee has paid the full price for the asset, and if the exercise of the option does not require further significant payments, then that is equivalent of transfer of ownership within the scope of Article 14(2)(b).

Applying the above analysis to the circumstances in the present case, the Advocate General agreed with MFBS. The contracts offered required substantial payment at term to secure ownership and were not therefore supplies of goods within the scope of Article 14(2)(b) but rather were supplies of services. VAT was therefore due on a cash received basis.

Comment
Due to the mixed nature of leasing agreements it is not always evident whether they should be classed as a supply of goods or a supply of services. The distinction is, however, important and can have a real impact on the economics of a lease. Although the CJEU has considered numerous cases concerning leasing arrangements, none has had a conclusive bearing on the method of classifying such transactions for VAT purposes. This case presents the CJEU with an opportunity to provide some clear guidance to taxpayers in this complex area.

Although an Advocate General's opinion is not binding on the CJEU, they are followed in the majority of cases and it will be interesting to see if the CJEU reaches the same conclusion in this case. If it does, its judgment will have major implications for the asset leasing sector.

The CJEU's judgment is expected later this year.

A copy of Advocate General Spuznar's opinion is available to view here.

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Oval Estates (Bath) Limited – recovery of input tax

In *Oval Estates (Bath) Limited v HMRC* [2017] UKFTT 403 (TC), the FTT held that input tax was attributable to an identifiable supply and was recoverable despite allegations of deliberate and concealed behaviour.

Background

Oval Estates (Bath) Limited (OEB) is one of a number of property companies under common control, many of which are single purpose vehicle companies set up for the purposes of carrying out specific developments and most, if not all, contain the name Oval.

OEB carried out a commercial development of a warehouse premises and engaged Oval Building Contracts Limited (OBC), a related company, to provide design and build construction services. As the project progressed, OBC invoiced OEB from time to time for the services it provided.

During August 2012, a supplier issued a winding up petition against OBC, and the group applied for a Creditors Voluntary Arrangement (CVA). On 30 September 2012, OBC raised invoice number 265 for services provided to OEB, so that it could be in place for the meeting of creditors. This was a standard invoice with a general description, but did not refer to the payment certificate, however, due to an oversight this invoice was raised later than it should have been and was also issued to the wrong Oval business. On 29 November 2012, OBC's application for a CVA was rejected at the creditors' meeting and OBC went into liquidation.

OEB made a claim to deduct input tax of £33,349.58 in relation to invoice number 265. However, due to an administrative error this claim was made in the 03/13 VAT return.

HMRC disallowed OEB's input tax claim on the basis that it was (1) not directly attributable to an identifiable supply, (2) the description on the supply was inaccurate, (3) the invoice was not a valid VAT invoice and (4) there was no evidence the invoice had been paid. HMRC also issued a penalty on the basis that OEB had displayed 'deliberate and concealed behaviour' because the claim had been made in the VAT period subsequent to the date when the invoice was created.

OEB appealed to the FTT.

FTT's decision

OEB's appeal was allowed, the input tax was recoverable and no penalty was due.

It was clear to the FTT that invoice number 265 did not satisfy the formal requirements for a valid invoice laid down by Article 226(6) and (7) of the VAT Directive 2006/112/EC, or the VAT Regulations. However, European case law confirms that the right to VAT recovery cannot be denied if the substantive conditions for recovery are satisfied.

The FTT found that HMRC had specific information in the form of schedules of work, valuations and contracts which provided sufficient evidence to demonstrate that there was a supply. It concluded that OEB had established its right to deduct the VAT on invoice number 265. There was evidence that OEB had effectively made payment against the invoice received.

With regard to the allegations of deliberate conduct and fraud, the FTT considered that these allegations could only succeed if the evidence established, on the balance of probabilities, that there was such conduct. In this case, the evidence indicated that there was confusion among the accounting staff but not dishonesty. Accordingly, the FTT held that the delay was innocent and not the result of any dishonest arrangement or intent.

Comment

HMRC often assess taxpayers and seek to disallow input tax claims on the basis of invalid invoices. The FTT's decision in this case provides a timely reminder of the key conditions that need to be met in respect of every invoice.

If the necessary substantive conditions for recovery of VAT are met and sufficient evidence is provided, taxpayers will be in a position to robustly challenge any assessment.

A copy of the decision is available to view here.

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