[2018] UKFTT 0663 (TC)

# TC06811

**Appeal number: TC/2015/07160**

***VAT – whether the margin scheme applies to sales of vehicles made by a financier following the recovery of possession of the vehicles on the termination of hire purchase transactions – if not, whether the sales are treated as neither supplies of goods nor services under article 4(1)(a) of the Value Added Tax (Cars) Order 1992/3122 – compatibility of the exclusion from this article under article 4(1AA) of that order with EU law - appeal dismissed***

**FIRST-TIER TRIBUNAL**
**TAX CHAMBER**

**VOLKSWAGEN FINANCIAL SERVICES (UK) LIMITED** **Appellant**

**- and -**

**THE COMMISSIONERS FOR HER MAJESTY'S REVENUE & CUSTOMS** **Respondents**

**TRIBUNAL: JUDGE HARRIET MORGAN**

**Sitting in public at Taylor House, 88 Rosebery Avenue, London on 22, 23 and 24 January 2018**

**Mrs Amanda Brown, of KPMG LLP, for the Appellant**

**Mr Peter Mantle, counsel, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents**

## DECISION

1. Volkswagen Financial Services (UK) Limited ("**VWFS**") provides finance to members of the public for the purchase of motor vehicles under hire purchase agreements and personal contract plan agreements (together "**finance agreements**"). VWFS accounts for VAT in respect of these arrangements on the basis that it makes supplies of goods to its customers in return for the full capital amount due under the finance agreements (under article 14 of Directive 2006/112/EC ("**PVD**") as enacted in UK law in para 2 of schedule 4 of the Value Added Tax Act 1994 ("**VATA**")). The VAT initially accounted for is subject to subsequent adjustment on early termination of the finance agreements as set out below. I refer to transactions made under such finance agreements and the corresponding supplies of goods as "**HP transactions**" and "**HP supplies**" respectively.

2. VWFS appealed against HMRC's decision to reject its claims for a refund of over £24 million of output tax which it considered it had overpaid on sales of vehicles to third parties (typically at auction) which were either voluntarily returned to it or repossessed on the early termination of the finance agreements ("**resales**"). The claims were made under s 80 of the Value Added Tax Act 1994 ("**VATA**") in relation to resales made by VWFS in the period from 1 July 2010 to 30 June 2014. The tribunal was asked to determine whether in principle VWFS is entitled to a refund and not, at this stage, the amount of any such refund.

3. I refer to the facts and circumstances of this case in the present tense for convenience; the position as described relates to the relevant period to which the appeal relates unless expressly stated otherwise.

### Overview

4. VWFS has accounted for VAT on the full sales price received on the resales. HMRC maintains that is the correct position. VWFS now contends, however, that a refund is due on the basis that:

(1) VAT is due on the resales only by reference to VWFS' profit margin under the margin scheme for dealers in second-hand goods (as provided for in articles 312 to 315 PVD as enacted in the UK in article 8 of the Value Added Tax (Cars) Order 1992/3122 (the "**Cars Order**")). Broadly, under the margin scheme VAT is charged only on the difference between the price paid by the dealer for the goods and the price received on the onward sale. On VWFS' view as to how the scheme applies, it would not usually be required to charge to VAT on the resales.

(2) If the margin scheme is held not to apply, no VAT is due on the resales under article 4(1)(a) of the Cars Order (the "**de-supply provision**") which provides that a disposal of a "used motor car by a person who repossessed it under the terms of a finance agreement, where the motor car is in the same condition as it was in when it was repossessed" is neither a supply of goods nor services.

5. The de-supply provision is subject to an exclusion introduced in 2006 (under article 4(1AA) of the Cars Order (the "**2006 exclusion**")). This provides that the de-supply provision does not apply where the financier can obtain, as VWFS can in this case, an adjustment which takes account of the VAT on the initial supply under the finance agreement as a result of repossession. Where the 2006 exclusion applies, therefore, the financier remains liable to account for VAT on the full sales proceeds received on resales unless some other form of relief applies.

6. It was common ground that VWFS correctly claims a VAT adjustment on early termination of the HP transactions by recognising, as a reduction in the consideration for the HP supply, an amount equal to (a) the capital instalments no longer due after the termination date (where the customer terminates voluntarily) or (b) the net sales proceeds received on the resale which are set off against the amount owed by the customer (in a default scenario). This adjustment is provided for under regulation 38 of the Value Added Tax Regulations 1995 (SI 1995/2518) ("**regulation 38**")). In a default scenario VWFS may also claim bad debt relief for VAT purposes on the balance owed by the customer after the set-off of the net sale proceeds.

7. It was also common ground that the 2006 exclusion was introduced specifically to counter the effect of the interaction of regulation 38 and the de-supply provision as interpreted in *Revenue and Customs Commissioners v General Motors Acceptance Corporation (UK) plc* [2004] EWHC 192, [2004] STC 577 ("*GMAC 1*"). In that case it was held that a financier could obtain the benefit of both a downward VAT adjustment under regulation 38 in respect of the initial HP supply and of the de-supply provision on the subsequent resale. VWFS considered that the effect of the provisions, as interpreted in that case, is entirely compatible with EU VAT law.

8. VWFS did not dispute that the resales fall within the scope of the 2006 exclusion according to the terms of that provision. However, in its view, the 2006 exclusion is compatible with EU law only if the margin scheme applies to the resales. If that scheme applies on the basis VWFS argues for, as noted, usually the result would be that no VAT is due on the resales thereby giving the same result as if the de-supply provision applied. If it is found that the margin scheme does not apply, VWFS considers that the 2006 exclusion is unenforceable (on the basis it is incompatible with EU law) and that it is entitled to rely on the de-supply provision disregarding the 2006 exclusion. If either of these arguments succeed, therefore, the result would be that VWFS would not be liable to account for VAT on the resales (or only minimal VAT).

9. VWFS' position is founded on the proposition that, under the principles underpinning the EU VAT regime, it must obtain relief from charging VAT on the sales proceeds received on the resales to avoid double taxation. VWFS noted that article 1(2) PVD provides as follows:

> "The principle of the common system of VAT entails the application to goods and services of a general tax on consumption exactly proportional to the price of the goods and services, however many transactions take place in the production and distribution process before the stage at which the tax is charged.

> On each transaction, VAT, calculated on the price of the goods or services at the rate applicable to such goods or services, shall be chargeable after deduction of the amount of VAT borne directly by the various cost components.
>
> The common system of VAT shall be applied up to and including the retail trade stage."

10. This principle is given effect to under the general scheme of VAT accounting whereby a taxable person obtains recovery of or credit for input tax paid on supplies received, broadly, to the extent that it is attributable to the making of onward taxable supplies. Under this regime VAT is charged on the "value added" at each stage in the supply chain until, for example, the relevant goods are subject to a final charge in the hands of the consumer who, as a non-taxable person, cannot recover the VAT charged.

11. As established in the case law of the Court of Justice of the European Union ("**CJEU**") it is a fundamental principle, which follows from this overall aim, that goods should not be taxed in full again once they have entered "final consumption" on being supplied to the final "retail" consumer. There should not be a full charge to VAT, therefore, if such goods re-enter the commercial supply chain, for example, if the consumer sells the goods to a commercial dealer who sells them on, unless the dealer can obtain relief for the VAT burden imposed on the consumer.

12. As recognised in the margin scheme, special provision is needed to provide the required relief; the irrecoverable VAT suffered by the consumer is "embedded" in the goods as a cost for which otherwise the dealer can obtain no relief under the general scheme of VAT. Hence the margin scheme provides that dealers in second-hand goods can account for VAT on the taxable supply of such goods only on the difference between the price the dealer pays for the goods and the price received on the sale of the goods. In effect the VAT charge is confined to the value added on that supply.

13. VWFS said that in this case there is an "embedded" irrecoverable VAT cost in the vehicles as a result of the HP supplies to its customers who, as non-taxable persons, cannot recover the VAT charged by VWFS on those supplies. In its view, that VAT cost must be relieved when the vehicles are "reintroduced" into the commercial supply chain when VWFS receives or takes back possession of the vehicles on early termination of the finance agreements and the vehicles are sold at auction.

14. In outline, in accordance with its aims, the margin scheme applies to sales of goods by taxable dealers where the goods have been supplied to the dealer by a person, such as a non-taxable person, who has suffered irrecoverable VAT on his own acquisition of the goods and who is not required to charge VAT on the supply to the dealer. VWFS argued that this requirement is satisfied on the novel proposition that its customers make supplies of the vehicles to it when the vehicles are handed back or repossessed on termination of the finance agreements. VWFS considers that it provides consideration to the customers for these supplies in the form of a release from the sums otherwise due under the finance agreements, namely, the amounts which are taken into account as a reduction in the consideration for the HP supplies

under regulation 38 (see [6] above). I refer to this as the customer supply issue or question.

15. VWFS argued that there is a supply as a matter of substance but also that there is a fiscal imperative for this interpretation inherent within the application of article 14 itself and, it seems, in order to give effect to the desired (and in VWFS's view necessary) fiscal outcome that the margin scheme applies. VWFS said that the fact that the customer is treated as the owner of the vehicle under the HP supply (under article 14 PVD) means that the customer must of necessity be regarded as making a supply of the vehicle to VWFS as otherwise VWFS could not be regarded as making an onward supply on the resale of the vehicle at auction.

16. In VWFS' view its profit margin, on which it is to be taxed under the scheme, is confined to the difference between the amount which the customer has paid under the HP supply (being, in its view, the subjective value of the consideration provided by VWFS for the supply by the customer) and the price received on the sale at auction. Usually that produces zero or a negative amount so that no VAT is in fact due on that basis.

17. In HMRC's view, in fact if the margin scheme or the de-supply provision were to apply as VWFS' argue, there would be under taxation. There simply is no "embedded" VAT cost as a result of the HP supply of a kind which needs to be relieved in effect by exempting from VAT all (or substantially all) of the sales proceeds received on the resales. The vehicles are not reintroduced into the commercial supply chain when they are handed back or repossessed by VWFS; there is no supply by the customer for consideration in those circumstances which engages the margin scheme.

18. HMRC noted that the supply of the vehicle made by the dealer to VWFS and the related cost is ultimately used or consumed by VWFS in making two different supplies in respect of the vehicle; the HP supplies and those made on resales. The VAT charged on the HP supplies is confined to the actual consideration received by VWFS (under regulation 38 and subject to bad debt relief where appropriate). To charge VAT on the subsequent sales proceeds gives an entirely proportionate result in line with the fundamental principle that VAT is to be charged on the full consideration received for each separate supply. If VWFS' approach is instead adopted, VWFS would obtain full tax recovery on the cost component incurred in making these supplies (the purchase price of the vehicle) but would account for VAT only on the HP supplies (as adjusted to take into account the reduction in consideration on termination and bad debt relief) and not on the resales.

19. In HMRC's view the decision is *GMAC 1* has been superseded by later cases which, in their view, make it clear that this is the correct analysis. The decisions HMRC relied on are those of the CJEU in *GMAC UK* (Judgment of the Court) [2014] EUECJ C-589/12 (made on a referral from the Upper Tribunal following their decision in *HMRC v GMAC UK Plc* [2012] UKUT 279 (TCC)) and *NLB Leasing doo v Republic of Slovenia* (Case C-209/14) [2016] STC 55 (respectively "*GMAC 3*" and "*NLB*"). HMRC submitted, therefore, that it is in accordance with EU law that the 2006 exclusion prevents the sales proceeds from being exempted from VAT and that the margin scheme does not apply.

20. For all the reasons set out below, I have concluded that the margin scheme does not apply to the resales on the basis that the customer does not make a supply of goods to VWFS when it recovers possession of the vehicle on termination of the HP transactions. The fact that the margin scheme does not apply, in my view, does not mean that the 2006 exclusion is incompatible with EU law. It is not in accordance with EU law for VWFS to obtain the benefit of the margin scheme or the de-supply provision in the circumstances under consideration in this appeal. That would, as HMRC submitted, lead to under taxation contrary to the fundamental principles underpinning EU law.

## Facts

21. I have found the following facts on the basis of the evidence given by Mr Watson of VWFS who attended the hearing and was cross-examined and the documents in the bundles provided for the hearing. Mr Watson was a credible witness and his evidence was uncontroversial.

*Overview of HP transactions*

22. Once a customer identifies a vehicle he/she wishes to purchase, provided that the customer meets VWFS' underwriting criteria", VWFS purchases the vehicle from the dealer. The dealer charges VWFS VAT on the sale which VWFS recovers as input tax in the usual way. VWFS then enters into a finance agreement with the customer in respect of that vehicle which is regulated under the terms of the Consumer Credit Act 1974 (as amended by the Consumer Credit Act 2006) (the "**CCA**").

23. Under the terms of the finance agreements, the HP transactions operate as follows:

(1) Customers obtain the right to use the vehicle for the specified term and have the option to purchase the vehicle at the end of the term once all instalments stated to be due have been paid. The instalments are calculated (a) to repay over the stated term the capital cost of the car to VWFS plus an amount representing the VAT which VWFS is required to account for on the capital amount and (b) to include its financing charge for the credit or loan VWFS in effect provides. The first monthly instalment also includes an acceptance fee charged by VWFS.

(2) Under a HP agreement the customer is liable to pay the instalments due in equal monthly amounts whereas under a PCP agreement the customer is liable to make smaller equal monthly payments during the majority of the term and a large "balloon" payment at the end of the term.

(3) The balloon payment is set by VWFS at the start of the contract by reference to the expected residual realisable value of the car at the end of the term on the assumption that the customer complies with the terms of the PCP agreement relating to the mileage expected to be undertaken and the condition of the car. VWFS determines the residual value by considering matters such as the value of cars in the market, risk analysis concerning economic cycles and how popular particular types of car are. The balloon payment typically represents around 40% of the total price.

(4) Legal title to the vehicle is transferred to the customer if the customer exercises the option to purchase the vehicle on paying a small option to

purchase fee (of around £60) and provided all instalments are paid, including the balloon payment. The option fee has to be paid when the final instalment is due. The customer is required to sign a declaration in the finance agreement that "you….understand that the Vehicle will not become your property until you have made all the payments and exercised the option to purchase."

(5) Under a PCP agreement the customer can choose to "hand back" the car shortly before the balloon payment is due, in which case, it can ask VWFS to act as its agent for the sale of the vehicle at auction as set out in further detail below. Cases where customers have elected to do so are not the subject of the VAT reclaims made by VWFS which are the subject of this appeal.

(6) A customer can terminate a finance agreement voluntarily without the customer incurring a cost (subject to any excess mileage and damage charges) once he or she has paid or, on paying, at least half the total amount payable under the agreement (a "**voluntary termination**"). This reflects a customer's statutory right to terminate in these circumstances under ss 99 and 100 CCA.

(7) If, when the customer wishes to terminate the agreement, he or she has not already paid 50% of the total amount due, the customer must proceed to do so. Mr Watson said that voluntary terminations occur most commonly where the customer chooses to hand back the car after having already paid 50% or more of the monthly instalments.

(8) VWFS is entitled to terminate the contract and repossess the car where the customer defaults on his or her obligations under the agreement (a "**forced termination**"). Where this occurs before the customer has paid one third of the total price, VWFS can simply repossess the car. Where the consumer has paid one third or more of the total price, VWFS is required either to obtain the consumer's consent to the repossession or to get a court order before repossessing the car to avoid the customer being able to reclaim all monies paid under the agreement (pursuant to s 90 and s 91 CCA).

24. Following a voluntary or forced termination, VWFS sells the car usually at auction. Depending on the type of the car, its condition and mileage the sale price of the car may exceed, be equal to or be less than the amount which is outstanding under the finance agreement at the time the car is handed back and the agreement is terminated. Mr Watson said that there are multiple factors which influence the price which a second hand car achieves on resale.

25. Mr Watson said that in the relevant period VWFS financed around 30% of the financing transactions it undertook for new cars under HP agreements and the balance under PCP agreements. He thought that the arrangements under PCP agreements are more affordable for customers given that the monthly payments are less than those due under a traditional HP agreement. He noted that the right to terminate voluntarily once 50% of the price has been paid is set out in the literature relating to the products,

as well as in the agreement itself, and that the dealer gives an explanation of the termination rights before the customer signs the agreement.

*Termination and recovery of possession*

26. The finance agreements clearly set out the parties' respective rights and obligations as regards early termination of the HP transaction as follows:

(1) Under a heading "Termination Your Rights" a customer's ability to voluntarily terminate is set out as follows:

> "You have a right to end this agreement. To do so, you should write to the person you make your payments to. They will then be entitled to return of the goods and to half the total amount payable under this agreement, that is £[]. If you have already paid at least this amount plus any overdue instalments and have taken reasonable care of the goods, you will not have to pay any more".

(2) Under a heading "Repossession Your Rights", there is a provision explaining the customer's rights on a forced termination as regards when VWFS needs a court order to repossess the vehicle and the finance agreements state that:

> (a) VWFS is entitled to terminate the agreement "on expiry of the requisite statutory written notice, if you are in breach of any of the terms of this Agreement, or you have made a material misrepresentation to us on which we have relied on entering into this Agreement".
>
> (b) The customer must in that scenario pay to VWFS (i) any arrears which have accrued and remain unpaid under the agreement at the date of termination (ii) as agreed damages, the total amount payable under the agreement, less the aggregate of the amount of repayments already made, any rebate calculated in line with the Consumer Credit (Rebate on Early Settlement) Regulations 2004, "if we repossess and sell the Vehicle, the net proceeds of sale, after deduction of the expenses of repossession and sale" and any refunded part of a valid Road Fund Licence.

(3) As regards the return of the vehicle, the finance agreements contain the following provision:

> "On termination (or expiry of this Agreement without exercise of the Option to Purchase), you must return the Vehicle to us immediately, at such address as we may reasonably require, at your own expense together with everything supplied with the Vehicle (including the servicing book and all sets of car keys) and the registration document and MOT certificates."

(4) The customer is alerted to the fact that the timing of the payments due and compliance with the other terms, is "of the essence of this agreement" and that missing payments may lead "to us serving a default notice on you,

> on the expiry of which we may terminate the agreement….We may in addition take legal action against you. If you still fail to pay us any outstanding monies following judgment against you for those monies, we may apply to the court for a charging order over your property and subsequently apply to the court for its sale".
>
> (5) The customer also has the right at any time to make early repayment and, if the customer discharges all his or her indebtedness under the agreement and pays the option fee, the customer can at the same time give notice to exercise the option to purchase the Vehicle.

27. Mr Watson confirmed that under a HP agreement the right to terminate voluntarily crystallises at the half way point in the agreed term. Under a PCP agreement, as the balloon payment typically represents around 40% of the total price, the right to terminate typically arises around two to three months before that payment is due.

28. He said that a customer may wish to terminate voluntarily for a variety of reasons. The customer may have a change in personal circumstances, such as a change in job or a move abroad, or a change in their financial position. The customer may be influenced by changes in the expected value of the car. The customer may decide to take action if it appears that the vehicle is in fact going to be worth less than the relevant payments. On a forced termination the customer is unwilling or, as is more likely, unable to make the payments due under the finance agreement

29. On a voluntary termination, VWFS arranges for its collection agent to contact the customer and arrange collection. The customer has to provide the keys and documents relating to the car and make sure it is in reasonable condition and remove all personal items including personalised number plates.

30. Prior to a forced termination, VWFS goes through a process to enable the customer to remedy the default which commences in any case where the customer has an outstanding payment obligation for more than 30 days. VWFS sends a number of letters to the customer. First VWFS asks for the failure to be remedied within a specified time frame. If it is not remedied, VWFS notifies the customer of the amounts due plus interest and that action needs to be taken quickly to avoid further costs. If the failure continues, VWFS issues a notice of default warning that the on-going default amounts to repudiation of the finance agreement. The default notice sets out the customer's rights if the customer has paid at least one third of the total amount and that on paying 50% the customer can terminate voluntarily (which would not then impact on the customer's credit record). Finally VWFS issues the customer with notice of termination (although depending on the circumstances a court order may be needed at this stage).

31. Mr Watson noted that forced terminations sometimes occur after the point at which the customer has paid more than 50% of the total amount but the credit team works with the customer to achieve the best outcome for him or her. At the hearing he said that it is rare for there to be a forced termination in such circumstances; it could be because of a breach other than as regards payment (such as if the customer uses the vehicle for commercial purposes).

32. VWFS uses a specialist agent to carry out the repossession to ensure that appropriate and consistent standards are applied.

*Conditions of hire of the vehicle*

33. Customers are subject to a number of restrictions and responsibilities on the customer as regards the use and care of the vehicle. It is stated in the finance agreements that whilst VWFS owns the vehicle the customer must:

> "- keep it in your possession and control and must not sell, hire out or otherwise dispose of it or attempt to do so.
> - not use the Vehicle as security for a loan or other obligation.
> - not allow the Vehicle to be taken outside the United Kingdom without our permission except that you may take it to any country within the European Union for up to 60 days in any calendar year.
> - not use the Vehicle, or allow it to be used, for racing, trials or rallying or reward.
> - pay the road fund licence and all other licence fees, taxes, insurance premiums, fines, penalties, costs and other payments associated with the Vehicle, including without limitation those arising out of or as a result of the seizure of the Vehicle by any statutory authorities, as they become due.
> - keep the Vehicle in good repair and condition, commensurate with its age and mileage.
> - allow us to inspect it at all reasonable times and allow us access for this purpose to any premises where the Vehicle is being kept."

34. It is provided that the customer is responsible for "any damage to or deterioration of the Vehicle which is in excess of fair wear and tear commensurate with the age and mileage of the Vehicle." The customer is required to insure the vehicle whilst the agreement is in place and the insurance proceeds are required to be applied essentially for the benefit of VWFS.

35. The customer is prohibited from transferring the agreement or any rights or responsibilities under it to any other person. VWFS is entitled to transfer all or any of its rights under the agreement but notice is required to be given to the customer "before there is any change to the arrangements for servicing of the credit under this Agreement as far as you are concerned".

36. Under PCP agreements, customers are required to pay excess mileage charges at a specified rate for each mile which the vehicle is driven over a specified maximum annual mileage limit and a maximum total mileage limit. Charges paid for exceeding the annual limit are deducted from the charges otherwise due under the total limit. If the agreement is terminated early, the maximum total mileage limit is reduced in the proportion which the actual period of hire bears to the period of hire originally agreed and any charges calculated by reference to that revised limit. There is no mileage charge where the customer has exercised the option to purchase and paid all amounts due if VWFS does not accept an appointment to sell the vehicle as the customer's agent (and any mileage charges already paid are refunded).

37. Under PCP agreements, provided the customer has paid all amounts other than the final balloon payment (including the option fee) and returned the vehicle to VWFS, the customer can ask VWFS to act as its agent for the sale of the vehicle. If VWFS agrees to act as agent, the customer becomes the owner of the vehicle and the sales proceeds realised on the sale are used to settle the payment of the final balloon payment and any other charges due from the customer under the PCP agreement (such as mileage charges), the costs of sale and VWFS' commission charge. If the sales proceeds (after deducting the costs of sale) are less than the total of the outstanding final balloon payment, provided that the customer has paid all other amounts still due under the agreement (including any mileage charge) the customer does not have to pay any additional amount. If VWFS does not agree to act as agent, the customer has to make the final balloon payment (and pay all other outstanding charges due under the PCP agreement) and VWFS returns the vehicle to the customer.

**Law and VAT accounting**

*VAT on HP transaction*

38. The parties were of the view that when VWFS enters into the HP transactions, it correctly accounts for VAT on the basis that it makes supplies of goods to the HP customers for consideration equal to the full amount of capital payments due from the customers (under article 14 PVD as enacted in UK law in para 2 of schedule 4 VATA). They differed, however, in their view as to which part of article 14 applies.

*Provisions on supplies of goods*

39. Under article 14(1) PVD ("**article 14(1)**") a supply of goods is defined as "the transfer of the right to dispose of tangible property as owner". Article 14(2)(b) PVD ("**article 14(2)(b)**") provides that the following is also a supply of goods:

> "the actual handing over of goods pursuant to a contract for the hire of goods for a certain period, or for the sale of goods on deferred terms, which provides that in the normal course of events ownership is to pass at the latest upon payment of the final instalment."

40. The UK rules provide that "any transfer of the whole property of goods is a supply of goods" but "the transfer….of the possession of goods is a supply of services" unless:

> "the possession is transferred -
>
> (a) under an agreement for the sale of the goods, or
>
> (b) under agreements which expressly contemplate that the property also will pass at some time in the future (determined by, or ascertainable from, the agreements but in any case not later than when the goods are fully paid for)…"

41. VWFS considered that the supplies fall within both parts of article 14 whereas HMRC considered that they fall within article 14(2)(b) only.

*Example of VAT position at the outset of the HP transaction*

42. VWFS claims credit for the VAT it is charged on the purchase of the vehicles from the dealer as input tax in the usual way (on the basis that it relates to its onward

taxable HP supplies to the customers) and accounts for output tax on the HP supplies on the full amount of capital payments due

43. For the purposes of illustration it is assumed that VWFS pays £120 for the vehicle it acquires from the dealer which includes £20 of VAT and charges the customer a capital sum of £120 which includes in total £20 of VAT. The capital sum of £120 is payable by the customer in 10 instalments of £12 which includes £2 of VAT in respect of each instalment. The same figures and assumptions are used in illustrations throughout this decision.

44. As VWFS emphasised, as it has to account for the £20 of output tax at the outset, it suffers a cash flow cost. It has to fund the payment of £20 of VAT charged by the dealer but only collects the output tax it accounts for in respect of the HP supply in instalments when the capital repayments are made (in the sum of £2 when each of the 10 instalments is paid).

*VAT position of termination of the HP transaction*

45. At the point when a finance agreement is terminated early, VWFS has collected from the customer only part of the output tax which it was required to account for initially on the HP supply. However, VWFS then claims a downward adjustment to its VAT account in respect of the HP supply under regulation 38 and, following a forced termination, may claim bad debt relief.

46. Regulation 38 and the bad debt reliefs rules are intended to enact in the UK article 90 PVD (together the "**adjustment provisions**"). Article 90(1) PVD provides that the taxable amount on which VAT is charged in cases of "cancellation, refusal or total or partial non-payment, or where the price is reduced after the supply takes place shall be reduced under conditions which shall be determined by the Member States". It is provided that member states can derogate from paragraph 90(1) in the case of "total or partial non-payment" only (under article 90(2) PVD).

47. Regulation 38 provides that where there is a decrease in the consideration for a supply, which includes an amount of VAT, which occurs after the end of the prescribed accounting period in which the original supply took place, the supplier is required to adjust his VAT account by making a negative entry in the VAT payable portion of his VAT account. The entry is required to be made by reference to the prescribed accounting period in which the decrease is given effect in the supplier's business accounts. There are corresponding provisions as regards an increase in consideration.

48. It did not appear to be disputed that on both a forced and voluntary termination VWFS is entitled under regulation 38 to such a downward adjustment on the basis that there is a reduction in the consideration given for the HP supply of an amount equal to:

> (1) on a voluntary termination, the unpaid element of the total capital amount due under the finance agreement; and
>
> (2) on a forced termination, the net sales proceeds realised on the resale which, under the finance agreements, are set-off against the remaining amounts owed by the customer.

49. On a forced termination, VWFS treats any outstanding balance owed by the customer more than six months after the termination as a bad debt for VAT purposes and VWFS makes a further VAT adjustment.

*Illustration of VAT position on early termination*

50. Following the above, example, if the customer terminates voluntarily half way through the term of the finance agreement, at that point the customer has paid to VWFS £50 of capital instalments plus £10 representing VAT on those instalments. VWFS makes a VAT adjustment under regulation 38 reflecting that it will not receive the further £50 due but for termination. The effect of such an adjustment is that VWFS obtains a credit for or repayment of VAT of £10 for which it is no longer liable and will no longer receive from the customer.

51. If the termination occurs on the customer's default and VWFS sells the vehicle for £30, VWFS makes a VAT adjustment under regulation 38 reflecting an amount equal to the sales proceeds of £30 as a reduction in the consideration for the HP supply. VWFS may be able to claim bad debt relief in respect of the remaining amount owed of £20.

*VAT on the sales*

52. As noted above, the disposal of a "used motor car by a person who repossessed it under the terms of a finance agreement, where the motor car is in the same condition as it was in when it was repossessed" is treated as neither a supply of goods nor a supply of services under the de-supply provisions but that provision does not apply under the 2006 exclusion where:

> "…… adjustment, whether or not made under regulation 38 of the Value Added Tax Regulations 1995, has taken account, or may later take account, of VAT on the initial supply under the finance agreement as a result of repossession and the motor car delivered under that agreement was delivered on or after 1 September 2006."

53. It is also provided that the de-supply provision does not apply "unless the tax on any previous supply…was wholly excluded from credit under section 25 [VATA]" (under article 4(1A) of the Cars Order).

54. VWFS initially accounted for output tax on the sales on the basis that the de-supply provision does not apply due to the 2006 exclusion. It subsequently, however, claimed repayment of the relevant sums for the reasons set out in this decision, the rejection of which by HMRC has resulted in the present appeal.

*No input tax recovery by customers and purchasers of the vehicles*

55. It was common ground that in the transactions directly relevant to this appeal, each customer and each purchaser of a repossessed vehicle is not entitled to deduct as input tax the VAT on the HP supply and the sale respectively as the final "retail" consumers.

*Margin scheme*

56. The dispute is, therefore, whether the sales can be taxed under the margin scheme and, if not, whether VWFS can rely on the de-supply provision on the basis that the 2006 exclusion is incompatible with EU law.

57. The margin scheme is provided for in article 312 to 315 PVD:

(1) The preamble to the PVD states at 51 that the margin scheme is to be applied "with a view to preventing double taxation and the distortion of competition as between taxable persons".

(2) In articles 313 and 314 it is set out that the "special scheme for taxing the profit margin" made by a "taxable dealer of second-hand goods" applies "where those goods have been supplied to him" within the European Community by one of a list of specified persons:

> (a) "a non-taxable person;
>
> (b) another taxable person, in so far as the supply of goods by that other taxable person is exempt pursuant to Article 136;
>
> (c) another taxable person in so far as the supply of goods by that other taxable person is covered by the exemption for small enterprises provided for in Articles 282 to 292 and involves capital goods;
>
> (d) another taxable dealer, in so far as VAT has been applied to the supply of goods by that other taxable dealer in accordance with this margin scheme."

(3) For this purpose:

> (a) "second hand goods" means "movable tangible property that is suitable for further use as it is or after repair" other than certain specified items; and
>
> (b) "taxable dealer" means "any taxable person who, in the course of his economic activity and with a view to resale, purchases, or applies for the purposes of his business, or imports, second-hand goods…., whether that taxable person is acting for himself or on behalf of another person pursuant to a contract under which commission is payable on purchase or sale;"

(4) The taxable amount in respect of supplies of goods falling within these provisions is to be calculated as "the profit margin made by the taxable dealer, less the amount of VAT relating to the profit margin". The profit margin is "equal to the difference between the selling price charged by the taxable dealer for the goods and the purchase price" (under article 315) on the basis that (as defined under article 312):

> (a) the "selling price" is:
>
> > "everything which constitutes the consideration obtained or to be obtained by the taxable dealer from the customer or from a third party, including subsidies directly linked to the transaction, taxes, duties, levies and charges and incidental expenses such as commission, packaging, transport and insurance costs charged by the taxable dealer to the customer, but excluding the amounts referred to in Article 79"; and

(b) the "purchase price" is:

> "everything which constitutes the consideration, for the purposes of point (1) [referring to the selling price definition], obtained or to be obtained from the taxable dealer by his supplier."

58. In the UK the margin scheme is provided for in article 8 of the Cars Order as follows:

> "8(1) Subject to complying with such conditions (including the keeping of such records and accounts) as the Commissioners may direct in a notice published by them for the purposes of this Order or may otherwise direct, and subject to paragraph (3) below, where a person supplies a used motor car which he took possession of in any of the circumstances set out in paragraph (2) below, he may opt to account for the VAT chargeable on the supply on the profit margin on the supply instead of by reference to its value.
>
> (2) The circumstances referred to in paragraph (1) above are that the taxable person took possession of the motor car pursuant to -
>
> (a) a supply in respect of which no VAT was chargeable under the Act…;
>
> (b) a supply on which VAT was chargeable on the profit margin in accordance with paragraph (1) above, or a corresponding provision…
>
> (5) Subject to paragraph (6) below, for the purpose of determining the profit margin-
>
> (a) the price at which the motor car was obtained shall be calculated as follows-
>
> (i) (where the taxable person took possession of the used motor car pursuant to a supply) in the same way as the consideration for the supply would be calculated for the purposes of the Act…..
>
> (b) the price at which the motor car is sold shall be calculated in the same way as the consideration for the supply would be calculated for the purposes of the Act;"

**Discussion and decision – compatibility of the UK rules with EU law**

*Overview*

59. To recap VWFS' argument hinges on the proposition that the UK regime relating to the taxation of resales does not comply with EU law unless the margin scheme applies to the resales. VWFS' stance centres on the view that, under the principles underpinning the EU VAT regime, VWFS is entitled, one way or another, to relief from charging VAT on the full price received on the resales to avoid double taxation.

60. As set out above, VWFS said that there is an "embedded" irrecoverable VAT cost in the vehicles as a result of the HP supplies to the customers who, as non-taxable persons, cannot recover the VAT charged by VWFS. In its view, under the principles referred to, that VAT cost must be relieved when the vehicles are "reintroduced" into

the commercial supply chain when VWFS receives or takes back possession of the vehicles on early termination of the finance agreements and the vehicles are re-sold at auction. On the other hand, HMRC's stance is that, in fact, if relief is given as VWFS argue for, there is under taxation contrary to the aims behind the VAT regime.

61. I have considered the underlying principles and the compatibility issue first before considering whether the conditions for the margin scheme to apply are met. The directly opposing views on whether in these circumstances, under the fundamental principles on which the EU VAT regime operate, there is double taxation which needs to be relieved or, if relief is given, there is under taxation, is at the heart of the dispute.

*Interaction of de-supply provision and adjustment provisions*

62. To understand VWFS' arguments it is necessary to consider the history of the UK de-supply rules, as interpreted in the courts, and the aims behind the margin scheme.

63. VWFS contended that the margin scheme provides the relief it considers necessary albeit that in the UK it has generally been thought that the margin scheme does not apply to resales. In the UK the de-supply provision was originally introduced to provide the necessary relief by excluding resales from the charge to VAT; that provision has been in the UK legislation since before the margin scheme was introduced. As VWFS submitted, that this is the aim behind the de-supply provision was recognised by the High Court in *GMAC 1*.

64. I note, however, that the adjustment provision, which is now in regulation 38, was not in place when the de-supply provision was introduced. Originally, therefore, it seems clear that the de-supply provision was needed because otherwise on termination of a HP transaction relating to a vehicle a financier such as VWFS (a) would not obtain any reduction in its VAT account as regards the HP supply (except possibly by way of bad debt relief) but (b) would be required to account for VAT on the full amount of the sales proceeds received on resale of the vehicle. In that situation, plainly there would be double taxation.

65. To illustrate this I use the same example as set out above where the financier pays £100 for the vehicle plus £20 of VAT and correspondingly under the HP transaction the customer is required to pay a total capital amount of £100 plus an amount representing £20 of VAT. I assume the financier terminates the transaction when the customer has paid £50 of capital instalments and £10 representing VAT and the financier sells the vehicle at auction for £60 (inclusive of VAT). The financier obtains no VAT adjustment in respect of the HP supply; in this case there is no provision giving a reduction in consideration equal to the amount of the sales proceeds which are off-set against the amounts owed by the customer under the HP transaction. The financier remains liable, therefore, to account for output tax of £20 on the HP supply. If the financer also has to account for VAT on the resale by reference to the sales proceeds, giving rise to a charge to VAT of £10, absent any relief, there is clearly double taxation. A similar position arises if, on a voluntary termination, the financier is required to account for VAT on the full instalments originally provided for under the HP supply and the sales proceeds on the sale at auction.

66. However, it appears that once the equivalent of regulation 38 was introduced HMRC became concerned that its interaction with the de-supply provision in fact

resulted in under taxation. That was the source of the dispute in *GMAC 1*. I have set out that decision in some detail as essentially VWFS relies on this decision as correctly reflecting the relevant principles.

*GMAC 1*

67. In *GMAC 1* the issue was the correct VAT position on the termination of HP transactions GMAC had entered into with customers in relation to vehicles. HMRC took a different stance as regards a forced termination and a voluntary termination, to achieve what it regarded as the right result.

(1) On a forced termination, HMRC accepted that the resales made by GMAC were not subject to VAT under the de-supply provision as it applied at the time. The dispute was as to how the sale proceeds should be treated in relation to the HP supply.

(a) It was provided in the hire purchase agreement that on termination, as compensation or liquidated damages, the hirer was liable for the rest of the payments due after the date of termination less the net resale price of the goods or their trade value (and less any statutory rebate).

(b) In GMAC's view the effect of this provision was that the net sale proceeds were not received as part of the consideration for the HP supply. Accordingly this was a case where the price for the supply was reduced within the meaning of article 11C(1) of EC Council Directive 77/388 (the "**Sixth Directive**") (which is the predecessor to article 90(1) PVD) as given effect in the UK in regulation 38. On that basis, GMAC submitted that its VAT account should be adjusted to reflect a corresponding decrease in consideration under regulation 38.

(c) HMRC argued that the hirer remained liable for the full amount due albeit the sales proceeds were used to off-set that amount. On that basis, the situation was a total or partial non-payment within the meaning of article 11C(1) and GMAC was entitled only to bad debt relief under the UK provisions giving effect to that part of the article. In HMRC's view, bad debt relief was to be calculated on the difference between the unpaid sums and the sales proceeds.

(2) On a voluntary termination, it was common ground that GMAC was entitled to adjust its VAT account under regulation 38 by reference to the sums no longer due in respect of the HP supply. HMRC disputed that GMAC could obtain the benefit of the de-supply provision on the sale of the vehicle.

68. As was clear from the examples HMRC produced to the court, in each case, HMRC's concern was that if the combined effect of the de-supply provision and regulation 38 was as GMAC argued for, there would be under taxation. In effect, on a forced termination, the sales proceeds would be relieved from VAT twice over; they would be deducted in full from the consideration for the HP supply (under regulation

38) and they would be excluded from tax on the sale (under the de-supply provision) (see [20]). On a voluntary termination, similarly the amounts which were no longer due under the HP transaction would be treated as a reduction in consideration for the HP supply and the sales proceeds would escape tax altogether under the de-supply provision (see [23]). The High Court decided, however, in favour of GMAC as the tribunal had done.

69. Mr Justice Field said, at [21], that, in a forced termination scenario the effect of the relevant provision in the hire purchase agreements (as set out at [67(1)] above) was that the consideration for the HP supply was reduced by agreement to the cash price *less* any outstanding instalments and the resale proceeds. Given that was the case, to hold that the effect of article 11C(1) (the predecessor to article 90 PVD) is that the sale proceeds are part of the consideration for the HP supply:

> "would involve breaching the fundamental principle that the taxable party is only accountable for the amount of VAT paid by the consumer, in this case the hirer. This is so because, where the agreement terminates and clause 9 applies, the hirer does not pay the full VAT element of the cash price but only the VAT element of the instalments paid or payable at the time of termination and of that part of the outstanding instalments that remains after the resale proceeds have been deducted.".

70. As regards the voluntary termination scenario, Field J referred to the tribunal's conclusion, at [18], that they were satisfied that the term "repossessed" in the de-supply provision applies whether termination is voluntary or forced and that the "evident purpose" of the provision, as set out in the Explanatory Note published when it was introduced is:

> "to avoid more than one charge to VAT on the same added value in relation to the same motor car."

71. He set out, at [23], that, at [19] of their decision, the tribunal noted that HMRC argued that if their approach was not taken a mismatch would result in the sense that the total consideration received for the HP supply and the sale of the car would not be brought into account. The tribunal concluded, at [22], that this was not persuasive. In their view (a) there was nothing which required them to link the de-supply provision with regulation 38 when construing that provision (b) the de-supply provision was a much earlier provision than regulation 38 (which appears to have been introduced to implement article 11C(1)) and (c) they were not satisfied that "the circumstances of this one particular example are so representative as to demonstrate a necessary implication that the word "repossessed" should be given the narrow meaning" HMRC argued for.

72. On the appeal to the High Court, as set out at [24] and [25], HMRC argued that the tribunal's conclusion was wrong as a matter of interpretation of the wording of the de-supply provision and, in the alternative, on the basis that the provision is "ambiguous" and that it:

> "should be interpreted in light of the fundamental principle that VAT is a broadly based proportionate consumer tax levied at every stage of commercial supply on supplies of goods and services; pursuant to this

> principle, given that GMAC will benefit from a regulation 38 adjustment if there is a consensual termination, article 4(1)(a) should be construed as applying only where the hirer is in breach, since in this latter situation GMAC will be entitled only to bad debt relief……."

73. GMAC disputed both these contentions arguing, as regards the second point, as set out at [27], that:

> "the article 4(1)(a) regime and the regulation 38 regime are quite separate and independent and GMAC is entitled to rely on both…….the Explanatory Note to the first Cars Order - which contained a provision identical to article 4(1)(a) - can be looked at to determine the article's purpose, because the article is ambiguous…The Explanatory Note reads:
>
> > "This Order removes from the scope of VAT disposals by finance houses … of certain used cars. Any such disposals would otherwise be a supply of goods…and would be chargeable to tax even though the goods had previously borne tax."

74. GMAC said, as set out at [28], that this shows "that the purpose of article 4(1)(a) is to preclude a second charge to VAT on the resale of a used car which has already borne VAT on the occasion of the first supply to a non-taxable person i.e. the hirer". GMAC said that there are two reasons why there should be no VAT on the resale:

> (1) The imposition of the tax on such a transaction would distort the used car market for traders because many of the sellers in that market are ordinary individuals who do not have to charge VAT. GMAC referred to the decisions in *EC Commission v Netherlands* (Case 16/84) [1985] ECR 2355 at 2371, at [18] and in *EC Commission v Ireland* (Case 17/84) [1985] ECR 2375 at 2380 at [14] (see [116] to [121] below).
>
> (2) Unless the resale is made a non-chargeable supply there would be "double taxation":
>
> > "because there would be residual VAT from the first supply even after the regulation 38 adjustment. Sales of repossessed cars by finance companies have never qualified for the profit margin scheme that is the principal instrument for ensuring that traders are not disadvantaged in the used car market. Article 4(1)(a) was therefore enacted both to avoid double taxation and to relieve finance companies of what would otherwise be a disadvantage in the used car market that would distort competition…."

75. Mr Justice Field concluded, at [29] and [32], that when the de-supply provision is construed in its context, without reference to the Explanatory Note, its plain and ordinary meaning is that it applies where the reseller has regained possession of the car in accordance with the terms of the finance agreement, whether or not there has been a breach by the hirer and whether or not the finance company has had actively to exercise a contractual right to take the car back.

76. He continued, at [30], that even if he was wrong and the de-supply provision is ambiguous, he still rejected HMRC's argument. He noted that when it was first

enacted in 1973, there were no regulations in place corresponding to regulation 38. At that time it was provided that regulations could be made to make provision for the adjustment of VAT where the consideration is reduced or no consideration becomes payable but such regulations were introduced only in 1989. He said that the current de-supply provision must mean the same as the provision in the 1973 legislation:

> "and no one knew when the [1973 provisions were made] just what provision would be enacted for adjustments to VAT where the consideration is reduced or none becomes payable. It would therefore have been impossible to construe the previous provision in conjunction with the adjustment provisions. In any event, construing article 4(1)(a) in the light of regulation 38 does not help [HMRC] because I have already held that regulation 38 applies where the agreement terminates on the hirer's breach and clause 9 operates."

77. At [31], he accepted that if the de-supply provision is ambiguous, the Explanatory Note to the 1973 Order may be taken into account in interpreting the article and that it is clear from the Note:

> "that the purpose of article 4(1)(a) is to preclude a second charge to VAT on the re-sale of a used car which has already borne VAT on the occasion of the first supply to a non-taxable person. In my opinion Mr Prosser is right when he says that article (4)(1)(a) was necessary because sales of repossessed cars by finance companies were not covered by the profit margin scheme, and such sales had to be made non-chargeable to avoid double taxation (there is residual VAT in the car even after the regulation 38 adjustment) and distortion of the used car market."

78. VWFS relies in particular on this comment where the High Court accepted GMAC's argument that there was residual VAT which needed to be relieved because the consumer was subject to a definitive charge to VAT on the HP supply notwithstanding that GMAC obtained an adjustment under regulation 38. VWFS considers that the High Court's comments correctly reflect the principles outlined above and that, as interpreted in that case, the UK regime in place at the time accordingly operated entirely in accordance with EU law. Hence, in its view, the subsequent introduction of the 2006 exclusion, which was made expressly to counter the effect of that decision, renders the UK rules incompatible with EU law unless UK law provides another means of relief for the "embedded" irrecoverable VAT cost such as under the margin scheme. In its view the margin scheme is aimed precisely at providing relief in this situation. VWFS referred to a number of authorities on the margin scheme which, in its view, support that it is intended to apply in these circumstances which I have considered below.

*HMRC's submissions*

79. HMRC did not dispute that the fundamental principles underpinning the VAT regime and the margin scheme are as set out above. However, in their view VWFS' approach in this case leads to a result directly contrary to those principles and the aim of the margin scheme. They take the same view essentially as that they took in *GMAC 1*. VWFS' approach would lead, they said, to the erosion of the tax base. It is inherent in the proportional nature of the tax, that VAT should be charged on the full

amount of consideration received by the supplier for each supply *(*referring to *Elida Gibbs Ltd v CCE* (Case C-317/94) [1996] STC 1387 and *Yorkshire Co-operatives Ltd v CCE* (Case C-398/99) [2003] STC 234). Taxing only the profit margin of VWFS on the resales or leaving the sales proceeds out of account altogether would result in VWFS recovering all of the input tax it incurred on purchasing the vehicle but accounting for VAT on an amount lower than it had actually received overall in respect of the HP supply and the resale.

80. HMRC said that the decision in *GMAC 1* has been superseded by the introduction of the 2006 exclusion and by later cases, in particular, the judgments of the CJEU in *NLB* and *GMAC 3*. The tribunal must decide this case on the basis of the law as it now stands. Moreover, the comments made by the High Court in *GMAC 1* on the purpose behind the de-supply provision are not part of the binding decision made by the court.

81. In HMRC's view the later cases establish that normally, where there is a hire purchase or similar supply, followed by repossession and sale of the goods, no issue of double taxation arises. The HP supply and the supply on the subsequent repossession sale are each to be taxed on the full consideration received for each supply. They submitted that there cannot be any question of double taxation which ought to be relieved under the margin scheme unless (1) the recipient of the HP supply is a final consumer *and* (2) that consumer makes a supply of the vehicle to the taxable dealer in return for consideration. Under the usual principles applied to determine who supplies what to whom, there is simply no such supply in this case and no "embedded" irrecoverable tax charge of the kind which needs to be relieved in VWFS' hands.

*Comment on GMAC 1*

82. I largely agree with HMRC's points. In my view the decision in *GMAC 1* is of limited relevance given the change in law made by the introduction of the 2006 exclusion and the decision of the CJEU in *GMAC 3*. (I do not consider the decision in *NLB* to be of material assistance in this case for the reasons set out below).

83. I note that Field J of course made his decision in *GMAC 1* on the basis of the law as it then stood with the attendant difficulties of interpreting the de-supply provision in the light of the adjustment provisions which were introduced sometime after the de-supply provision was originally enacted.

84. The difficulty which HMRC faced in reaching what they considered to be the right VAT result in a default termination scenario was that, on the basis of the UK law as it stood at the time, they argued that the effect of the adjustment provisions should be restricted. As Field J set out, however, given his interpretation that the hire purchase agreement provided for a reduced price to be paid in that scenario, to deny the taxpayer an adjustment under regulation 38 to reflect that reduction would have been in breach of the fundamental principle that VAT should be charged only on the consideration actually received for a supply. That accords with the stance taken by the CJEU on the effect of article 11C(1) of the Sixth Directive (which is now article 90 PVD) in *GMAC 3* as set out below.

85. In a voluntary termination scenario, on the other hand, HMRC argued that the de-supply provision did not apply. Field J held, however, that, on the plain meaning of

the de-supply provision, there was simply no reason to distinguish between a resale made following a forced termination, where it was accepted that the de-supply provision applied, and that made following a voluntary termination. The reference to the Explanatory Note as showing that the aim of the de-supply provision was to avoid double taxation and related comments were relevant only if, contrary to Field J's decision, the provision was ambiguous. These comments are not, therefore, part of the binding decision of the High Court; in lawyers' terms they are obiter dicta.

86. I note that the Explanatory Note on the aim of the de-supply provision was issued before it was known when and how article 11C(1) of the Sixth Directive (as now reflected in article 90 PVD) would be given full effect in the UK; there was no equivalent of regulation 38 in place when the de-supply provision was enacted. The Explanatory Note stated that the relief given by the de-supply provision was necessary as otherwise resales would be "chargeable to tax even though the goods had previously borne tax". As illustrated at [65] above, before regulation 38 (or its predecessor) was introduced, there plainly was double taxation if the resale proceeds were taxed. The further comments made by Field J that there was "residual VAT" which needed to be relieved notwithstanding that regulation 38 then applied to give a downward VAT adjustment on the HP supply were not supported by any illustration or explanation of how this "residual VAT" arose.

87. In my view, as HMRC said, in fact the combined effect of the application of regulation 38 and the de-supply provision, as these provisions were held to apply in *GMAC 1*, results in under taxation as was clarified by the Upper Tribunal in their comments in *GMAC 3* and as the CJEU plainly accepted in their decision in that case.

*GMAC 3*

88. The decision in *GMAC 3* also relates to the interaction of the adjustment provisions and the de-supply provision as it applied prior to the introduction of the 2006 exclusion. In summary, following the decision in *GMAC 1*, in a default scenario in addition to claiming an adjustment under regulation 38 GMAC claimed bad debt relief on the outstanding balance due. HMRC sought to deny this relief.

89. The Upper Tribunal considered, as set out at [101] of their decision, that the combination of regulation 38 (as interpreted in *GMAC 1*) and the de-supply provision was "an ineffective implementation" of the Directive, giving an excessive relief from VAT inconsistent with the objective of the Directive and thus not compliant with EU law". They referred to the CJEU the question of to what extent a taxable person is entitled, in these circumstances, to invoke the direct effect of article 11C(1) of the Sixth Directive (the predecessor to article 90(1) PVD) on the HP transaction and to rely on the de-supply provisions in national law in respect of the resale:

> "when to do so would produce an overall fiscal result in relation to the two transactions which neither national law nor the Sixth Directive applied separately to those two transactions produces or is intended to produce..".

90. The CJEU decided essentially that, in these circumstances a taxpayer is entitled to rely on article 11C(1), as a provision of the PVD with direct effect. The fact that the de-supply provision, as a provision of UK law, may apply to give a result which in

the UK's view is not in accordance with the PVD is not a reason to deny the taxpayer the benefit of such a directly effective provision.

91. The CJEU noted, at [20] and [21], that until the decision in *GMAC 1* HMRC did not accept that regulation 38 applied when the customer defaulted and the car was repossessed and sold and that the High Court "also considered that the [de-supply provision] applied as well, with the result that GMAC does not have to pay VAT on the auction proceeds". They said that the referring court pointed out:

> "that the application of those provisions, taken together, produces a "windfall" in that the VAT ultimately payable is less than it would have been if the Sixth Directive had been correctly implemented."

92. At [29] to [33] the CJEU concluded that article 11C(1) fulfils the conditions for it to have direct effect. At [33] they said that the request for a ruling was explained on the basis that the UK tax authorities took the view:

> "that the taxable person cannot, at the same time, benefit from the 'windfall' and from the first subparagraph of [article 11C(1)], in particular because of the fact that the cumulative application of Regulation 38…., [the de-supply provision] and that directive would produce an overall fiscal result which, in their opinion, neither national law nor the Sixth Directive, applied separately to those transactions, produces or is intended to produce."

93. At [34], the CJEU continued to note that according to the UK:

> "the VAT charged to the final consumer and accounted for to the tax authorities is not calculated on the consideration actually received by the taxable person for the supplies made. It argues that direct effect is not a principle of EU law that can be used so as to achieve the opposite of the result intended by the directive. It therefore submits that the taxable person is not entitled to rely on the provisions of national law in relation to one transaction and on the direct effect of the first subparagraph of [article 11C(1)] in relation to another transaction."

94. They said, at [35], that the UK government's line of argument could not be accepted. At [36], they noted that as article 11C(1) has direct effect, in these circumstances:

> "the question as to whether a taxable person such as GMAC may rely, after supplying goods under a hire purchase contract, on the right which that provision confers on it to obtain a reduction in the taxable amount depends on whether GMAC's customers fail to perform in whole or in part their payment obligation under that contract".

95. At [37] they said that this provision embodies one of the fundamental principles, according to which the taxable amount is the consideration actually received and the corollary of which is that the tax authorities may not charge an amount of VAT exceeding the tax paid to the taxable person.

96. However, they said, at [38], that it appeared that if the sale at auction of the repossessed car were not, under the national legislation itself, exempt from VAT the consideration received for each transaction would be subject to tax. The tax base would then be made up of amounts paid by the hire purchase customer and by the

buyer at the auction sale. In that case, the taxable amount would correspond, in accordance with the principle set out at [37], to the consideration actually received by GMAC.

97. They continued, at [39], to refer to the settled case-law, according to which a member state which has not adopted the implementing measures required by a directive within the prescribed period may not plead, as against individuals, its own failure to perform the obligations which the directive entails.

98. They concluded, at [40], that the fact that the sale of the car was de-supplied under UK law did not prevent a taxpayer being able to rely on the direct effect of article 11C(1). They said, at [41], that it follows that according to the fundamental principle which underlies the common system of VAT:

> "VAT applies to each transaction by way of production or distribution after deduction of the VAT borne directly by the various cost components (see, inter alia, judgments in *Midland Bank*, C-98/98….., paragraph 29, and *Zita Modes*, C-497/01……. paragraph 37)."

99. Therefore, at [42]:

> "in the event of total or partial non-payment, the amount of the tax base of the hire purchase contract for a car must be adjusted by reference to the consideration actually received by the taxable person under that contract. The consideration received by that taxable person which is paid by a third party in the context of a different transaction - in the present case the sale at auction of the car returned by the hire purchase customer - has no effect on the conclusion that the taxable person may rely on the direct effect of the first subparagraph of [article 11C(1)] in the context of the hire purchase contract."

100. They concluded, at [43], that it follows that the question as to whether or not the national law applicable to the auction sale is in conformity with the Sixth Directive is not relevant for the purpose of determining whether a taxable person such as GMAC is entitled to invoke the rights which it derives from article 11C(1).

101. They noted, at [44], that the UK further submitted that it would amount to abuse were a person to invoke the direct effect of article 11C(1) selectively, so as to engineer a situation in which the result intended by the legislation in question is not achieved. Having referred, at [46], to the judgment in *Halifax and Others* (C-255/02) they said essentially that it was for the national court to verify whether there was an abusive practice but they could provide guidance as follows, at [47]:

> "It should be noted that, if, as the United Kingdom Government states, the objective pursued by the Sixth Directive cannot be achieved, that is so because of a 'windfall' resulting solely from the application of national law. In fact, as is apparent from paragraph 38 of this judgment, the attainment of the tax advantage in question arises, in essence, from the fact that, under Article 4 of the Cars Order, there is no taxation of the sale at auction of the car recovered from the hire purchase customer."

*Comment on GMAC 3*

102. In my view, in *GMAC 3* the CJEU plainly recognised that there is under taxation in circumstances where the proceeds realised on resales are both (a) taken into account in adjusting the VAT position under the HP supply (under what is now article 90 PVD (which regulation 38 and the bad debt relief rules give effect to in the UK) and (b) excluded from tax under the de-supply provision. The CJEU did not consider, however, that this justified the UK authorities seeking to deny taxpayers the benefit of what is now article 90 PVD, as a provision with direct effect.

103. As VWFS pointed out the CJEU did not express a definitive view on whether the de-supply provision was in conformity with EU law; that was not the question they were asked. However, it is implicit in the decision that the CJEU considered that, if the effect of the combination of article 90 and the de-supply provision was as they set out, namely, that the tax base for the two transactions was not taxed in full, the de-supply provision was not in fact in conformity. It was for the UK to put that right as it has done by introducing the 2006 exclusion to prevent the sales proceeds from being exempted from tax in precisely these circumstances.

104. VWFS said that the CJEU decision does not preclude the application of the margin scheme in the circumstances under consideration in this appeal. In its view the CJEU can be taken to mean that the full amount of consideration received for both the HP supply and for the resale should be brought into account for VAT purposes and not necessarily that the full amount will be taxed; whether and to what extent tax is in fact due depends on the availability of any relief such as under the margin scheme. Under the margin scheme the sales proceeds are brought into account for VAT purposes albeit that the resulting VAT charge is confined to the difference between those proceeds and the purchase price paid for the relevant goods.

105. The CJEU were not specifically asked to consider the margin scheme in this case; as noted, it is not generally thought that the margin scheme applies in these circumstances. However, in my view the reasoning that there is a windfall where both the adjustment provisions and the de-supply provision apply, which the CJEU seemed to accept, applies equally if both the adjustment provisions and the margin scheme were to apply. Indeed the outcome in those circumstances (on VWFS interpretation of how the scheme applies) would generally be the same as the outcome under the de-supply provision, namely, that there is no VAT charge on the sales proceeds. I have commented further below on the precise effect of the de-supply provision and the margin scheme in these circumstances.

*NLB*

106. In *NLB*, the CJEU considered the VAT position on termination of a commercial property financing transaction between two parties in Slovenia. In outline:

> (1) NLB leased a property to a third party lessee for a period of a few months on terms that, before the leases expired, the lessee had to choose between: extending the duration of the agreements, returning the property to NLB or exercising its option to purchase that property by paying all the outstanding instalments to NLB.

(2) When the lease agreements expired, the lessee had not paid all the instalments due to NLB and, as was permitted under the agreements, NLB took back possession of the property which it then sold to a third party.

(3) Under the lease terms, NLB paid the balance of the sales proceeds to the lessee after deducting an amount equal to (i) the VAT which it had paid on the sale, (ii) the unpaid purchase option instalments, and (iii) the monthly instalments for which the lessee was still liable to NLB. NLB issued the lessee with credit notes for an amount equal to the purchase option instalments and, in doing so, cancelled those instalments.

(4) NLB had accounted for VAT upfront when the leases were entered into on an amount equal to all instalments due under the leases including those for the purchase option. Following the sale it sought an adjustment to the VAT previously paid in respect of an amount equal to the purchase option instalments.

(5) The Slovenian tax authorities refused to grant NLB's request for an adjustment. In their view the requirements were not met for the relevant Slovenian law provisions, which transpose article 90(1) PVD into that law, to apply. They did not regard the leases as having been terminated. They said that the lessor in fact took on the role of the lessee's pledgee and sold the properties on the lessee's behalf to the third party.

107. As set out at [23] the questions for the CJEU were (a) whether there was a supply of goods under article 14 under the lease agreements for which the instalments due for the purchase options were consideration, (b) whether under article 90(1) PVD, the taxable amount under the leases was to be reduced as a result of the return of the property and its sale and, (c) if the sum in question was to be regarded as consideration for the supply of goods, whether the principle of neutrality of VAT precluded the lessor having to pay output VAT both (i) in respect of the leases and (ii) on the subsequent sale of the property (even though the liability to pay VAT on the second supply was passed on to the lessee in the final account).

108. The CJEU considered the authorities on when there is a supply of goods referring in particular, at [28] to [30], to *Eon Aset Menidjmunt* (at [38] to [40] of that case) (see [180] to [183] below)). The CJEU said, at [31], that the material facts suggested that the objective of the lease agreements was the transfer to the lessee of ownership of the relevant property, which it is for the referring court to determine in the light of the criteria they set out.

109. The court noted, at [35], that article 90(1) embodies one of the fundamental principles of the PVD according to which "the taxable amount is the consideration actually received and the corollary of which is that the tax authorities may not collect an amount of VAT exceeding the tax which the taxable person received" (referring to *Almos Agrárkülkereskedelmi*, C-337/13 at [22]). They held, at [37], that the taxable amount for a supply cannot be reduced where, under the terms of the contract, the supplier has in fact received all the payments in consideration for the service which he supplied or where, without the contract having been refused or cancelled, the recipient of that service is no longer liable to the taxable person for the agreed price. The court

indicated, therefore, that no adjustment was possible in this case because in fact NLB received the full consideration for the initial supply to the lessee.

110. On the double taxation question, the CJEU noted, at [40], that it follows from the court's case-law that the principle of fiscal neutrality inherent in the common system of VAT precludes the taxation of a taxable person's business activities leading to double taxation. They continued, at [41], that the court has also held that for VAT purposes:

> "every supply must normally be regarded as distinct and independent…….However, in certain circumstances several formally distinct services, which could be supplied separately and thus give rise, in turn, to taxation or exemption, must be considered to be a single transaction when they are not independent".

111. They said, at [42], it is for the referring court to ascertain whether the relevant transactions, namely, "the services provided to [the lessee]" and the sale of immovable property to a third party, must be regarded as a "single supply". They noted that that would be the case where several elements or acts supplied by the taxable person are so closely linked that they form, objectively, a single, indivisible economic supply, which it would be artificial to split.

112. At [43] they continued that "[w]hen it is shown that such transactions cannot be regarded as forming a single supply, the principle of fiscal neutrality does not preclude those transactions from being taxed separately for VAT purposes". They considered that it followed that:

> "the principle of fiscal neutrality must be interpreted as not precluding, first, a leasing service relating to immovable property and, second, the sale of that property to a person who is a third party to the lease agreement, being taxed separately for VAT purposes, where those transactions cannot be regarded as forming a single supply, which is a matter for the referring court to determine."

113. I note that the circumstances in *NLB* are materially different from those in this case. In particular it appears that there was no termination of the leases (they simply expired without the lessee having fully complied with the terms) and that in effect NLB acted as agent or pledgee for the lessee in selling the property when it was repossessed. It was for the national court to decide the matter in light of the CJEU's guidance but the CJEU indicated that, in those circumstances, (1) NLB remained liable to account for VAT on all sums provided for on the supplies made under the leases of the property on the basis that there was no reduction in the consideration for those supplies by reference to the portion of the proceeds from the sale of the property which it applied in satisfaction of the sums owed by the lessee and (2) it was also liable to account for VAT on the sale of the property by reference to the sale proceeds unless the leases and the subsequent sale could be regarded as a single supply.

114. The decision reinforces that in a HP or leasing transaction which is treated as a supply of goods, the initial HP supply and any subsequent sale of the underlying asset are usually to be taxed as separate and distinct transactions. According to the CJEU the principle of fiscal neutrality did not prevent the particular transactions in that case being taxed separately unless they formed a single supply (which was for the national

court to decide). The decision is in line, therefore, with the view that in this case the HP supply and the subsequent resales should be taxed in full (given that there is no argument that they form a single supply). It does not seem to me, however, that this decision of itself provides a definitive answer in these circumstances given the factual differences.

115. I note that VWFS cast some doubt on the decision in this case because, in considering the double taxation argument, the CJEU referred to the supply under the leases as a supply of services whereas they were asked to consider this question only on the assumption that NLB made a supply of goods under the leases. This is an oddity but having regard to the overall decision and context the CJEU can hardly have been in doubt about what they were being asked to address.

*CJEU caselaw on the margin scheme*

116. As noted VWFS also referred to the cases on the margin scheme as providing further support for its view that there is double taxation in this case unless relief is obtained under that scheme or the de-supply provision (ignoring the 2006 exclusion). In my view, on the contrary, the explanation provided in those cases of the principles behind the margin scheme, reinforces this is not a situation where the resales should be relieved from tax and that to do so would lead to under taxation as recognised in *GMAC 3*.

117. A comprehensive explanation of the need for the margin scheme is set out by the CJEU in *Commission v Ireland* (C-17/84). At [11] the CJEU referred to the general principle which is now in article 1(2) PVD that the VAT system provides for the application of VAT to goods and services up to and including "the retail stage" of:

> "a general tax on consumption which is exactly proportional to the price of the goods and services, irrespective of the number of transactions which take place in the production and distribution process before the stage at which tax is charged.

118. They noted, however, that VAT is chargeable on each transaction in the production and distribution process "only after deduction of the amount of VAT borne directly by the various costs components". They continued that:

> "As regards goods, the chargeable event is the supply of goods for valuable consideration by a taxable person acting as such as only taxable persons are authorised to deduct from the VAT for which they are liable the tax already charged on the goods at a previous stage."

119. They said, at [12], that it follows from this principle of proportional taxation that the goods are in fact taxed at each stage of production and distribution only on the basis of the value added at that stage. However once the goods reach the initial consumer who is not a taxable person:

> "the goods remain burdened with an amount of VAT proportional to the price paid by that consumer to his supplier."

120. They explained, at [13], that if the consumer subsequently supplies the goods to another non-taxable consumer, no tax is charged or deducted in respect of that transaction. If the consumer supplies the goods to a taxable trader, such supply does not give rise to a charge to tax either, but where the goods are resold by the taxable

person an amount of VAT proportional to the resale price is charged but the taxable person is not entitled to any deduction of the VAT which the goods have already borne.

121. They continued, at [14], to explain how the reintroduction of second hand goods (in the sense of goods which have suffered an irrecoverable VAT charge) into the commercial supply chain causes two potential problems:

> (1) The goods may suffer double taxation in the sense that if they are reintroduced into commercial circulation, they are taxed again "whereas second-hand goods which pass directly from one consumer to another remain burdened solely by the tax imposed on the occasion of the first sale to a non-taxable consumer".
>
> (2) Especially where the rate of VAT is high, the difference in treatment "distorts competition between direct sales from one consumer to another and transactions passing through ordinary commercial channels, and thus places at a disadvantage branches of trade in which a large number of transactions involve second-hand goods, such as the motor-trade in particular."

122. The CJEU acknowledged, therefore, that these issues lead to the need for a margin scheme.

123. VWFS referred to a number of authorities but most of these simply reinforce the aims behind the scheme set out in *Ireland*. In *K Line Air Line Services Europe BV v Eulaerts NV and Belgian State* C131/91 [1996] STC 597 it was confirmed that the application of any such scheme depends on whether the goods have suffered a definitive charge to tax and not whether the goods have been used physically. At [32] of his opinion, the Advocate General said that:

> "the concept of consumption is undoubtedly more relevant to the definition of second-hand goods than the used condition of the goods, VAT being a tax intended to be imposed definitively on goods, after a cycle of taxation and deductions, when they reach the stage of final consumption, that is to say, the stage at which they pass to a non-taxable person….for the purposes of Article 32 second-hand goods are ones in respect of which the VAT chain of seller and purchaser has been interrupted by the intervention of a final consumer."

124. In the CJEU at [19] the court similarly held that:

> "….the purpose of [the relevant provisions regarding the adoption of a margin scheme], in the context of the common system of VAT, is to provide for the adoption of a special system for the taxation of goods on which VAT has definitively been charged and which may, therefore, on their reintroduction into commercial channels, be taxed a second time without the tax still included in their price being taken into account. It follows that capital goods, even if used, on which a taxable person has been able to exercise his right to a deduction do not come [within the scheme]."

125. In the later cases of *Jyske Finans A/S v Skatteministeriet (Nordania Finans A/S and BG Factoring A/S intervening* (C-280/04) [2006] STC 1744 and *Bawaria Motors*

*Sp z oo v Minister Finansow* (C-160/11) [2012] STC 2088 the CJEU noted that the margin scheme is a special regime which derogates from the general scheme and, therefore, should not be applied beyond the extent necessary to achieve its objectives.

126. In *Bawaria* the issue was whether the margin scheme applied on the basis that Bawaria acquired the vehicles from taxable persons, vendors, under exempt supplies under article 136(b) PVD such that article 314(b) of the margin scheme applied. Article 136(b) provides an exemption for the supply of goods on the acquisition of which the supplier was not entitled to VAT recovery (under article 176 PVD). The difficulty was that under national law the exemption applied on the basis that the vendor had a partial right to recovery of the input tax incurred on their acquisition.

127. It was recognised by the CJEU that, if the margin scheme did not apply, Bawaria was subject to partial double taxation. As it received the vehicles under an exempt supply it could not obtain relief for the portion of input tax which was not recovered by the vendors on their own acquisition and was, therefore, in effect embedded in the vehicles as an irrecoverable cost. The CJEU held that the margin scheme nevertheless did not apply largely following the analysis set out by the Advocate General in his opinion.

128. The Advocate General noted, at [29], that article 314 PVD contains an exhaustive list of the situations when a dealer qualifies for the margin scheme on acquiring goods from taxable persons. At [30] he said that the common feature in the listed cases is the fact that the person supplying the second-hand vehicle to the taxable dealer "has borne the total VAT burden. In other words, that person has had no right to deduct input tax on the purchase of the vehicle". The conclusion was, at [31], that the situation in this case is "clearly not envisaged" by article 314 [PVD]; nor "may it be considered to be covered by that provision".

129. At [44] to [48] the Advocate General referred to comments made in *Jyske Finans* on the scope of the exemption in article 136(b) concluding at [48] that it does not extend to cases where, as here, the taxable person in question had only a partial right to deduct input tax; it concerns only supplies of goods the purchase of which was *completely* excluded, under national law, from any right of deduction.

130. He proceeded to consider further the purpose of the margin scheme which was described, at [50] and [51] as follows:

> ".…….a special scheme which makes it possible to prevent second-hand goods, on their reintroduction into commercial channels, from being taxed a second time - that is, it helps avoid double taxation - without the tax still included in their price being taken into account.
>
> When these second-hand goods are reintroduced into commercial channels subject to VAT, the special profit margin scheme is applicable only to cases where they were reintroduced by a non-taxable person (final customer) or, if they were reintroduced by a taxable person, only where this was done at a time when this reintroduction was completely exempt from VAT."

131. He said, at [52] and [53], that it follows that whenever a supplier has exercised a right to deduct input tax, albeit merely a partial such right, the margin scheme should

not be applied. It is incumbent on the Polish Republic to take the measures necessary to prevent the double taxation of taxable dealers such as Bawaria.

132. At [56] he said that to apply the margin scheme in these circumstances would, in any event, be contrary to the principles underlying the directive and would, therefore, be unjustified. At [57] and [58] he stressed that the VAT burden must have been borne in full for the margin scheme to apply:

> "The importance of avoiding double taxation is the reason why it is a common feature of the relevant provisions that the VAT burden must have been borne in full. That is obviously conditional on the supplier having absolutely no right of deduction in a case such as this - which means that the VAT needs still to be contained in total.
>
> If the profit margin scheme were applied in a situation such as that of Bawaria then the result would be a lack of taxation on the part where deduction was applied. That would be contrary to the principle of the universality of VAT, in so far as the turnover of the taxable dealer would not be taxed in full, whereas the supplier who supplied him the second-hand goods would have been able to exercise a partial right to deduction of the tax. It may be added that, at the same time, it would also be contrary to the principle of preserving competition."

133. He noted, at [59] and [60], that the principle of the universality of VAT is enshrined in article 1 of the directive and is manifest both at the personal level (every transaction is taxed independently of the person who carries it out - as long as that transaction is effected in the context of an economic activity) and at the material level (each supply of goods is, in principle, taxed). This case demonstrated precisely why it is necessary that a derogation from the rule of the universality of VAT must be treated as "wholly and exclusively exceptional" and that any such derogation must be based on the provisions of the directive.

134. As noted the CJEU accepted that there was partial double taxation on the basis the margin scheme did not apply. However, they said, at [41], that article 136(b) was not capable of any interpretation which would enable Bawaria to avoid partial double taxation and, at [42], that it falls to the Polish legislature to end such a situation. They noted that "the elimination of that situation should not be at the cost of an interpretation of [the directive] which is irreconcilable with the actual wording of that directive and its general scheme".

*Conclusion on double taxation issue*

135. As explained in detail in *Ireland*, VAT is a tax charged on each transaction in the production and distribution process on a proportional basis after deduction of the amount of VAT borne directly by the various costs components. It is not in accordance with that fundamental principle for a dealer to charge VAT on the full price received on the sale of goods which the dealer acquired from a person who has suffered irrecoverable VAT on the price that person paid for the goods where the dealer cannot obtain relief for that VAT cost.

136. Hence the scheme applies, for example, where the dealer acquires goods from a non-taxable person or from a taxable person under a supply which is exempt because the taxable person could not itself recover as input tax the VAT charged on its own

acquisition of the goods (under article 314(a) and (b) PVD). In those situations, there is an irrecoverable VAT cost "embedded" in the goods which cannot be relieved in the hands of the dealer under the general VAT regime. Under the general regime, as these persons do not charge VAT on the supply of goods to the dealer (because the person is non-taxable or makes an exempt supply), the dealer incurs no VAT charge for which it could claim credit as input tax against the output tax due on the sale of the goods. Under the margin scheme, therefore, in such circumstances the dealer is required to account for VAT only on its profit margin in recognition that, in effect, an irrecoverable VAT cost for which relief cannot be obtained has already been suffered on the price the dealer pays for the vehicle.

137. As held in *Jyske Finans*, the margin scheme, as a special arrangement which derogates from the general scheme of VAT, must be applied only to the extent necessary to achieve the scheme's objective. Similarly the CJEU said in *Bawaria* that a derogation from "the rule of the universality of VAT" as set out in article 1 PVD must be treated as "wholly and exclusively exceptional" and must be based on the provisions of the PVD. Hence it was held in that case that the scheme does not apply where the dealer acquires goods from a person who has suffered irrecoverable VAT only on part of its own cost of acquiring the goods.

138. To give an example of how the scheme operates I take the following scenario.

> (1) A consumer pays £120 for a vehicle. The price includes £20 of VAT which as a non-taxable person the consumer cannot recover.
>
> (2) The consumer sells the vehicle to a dealer for £50. As the consumer is a non-taxable person there is no VAT charge.
>
> (3) The dealer sells the vehicle at auction for a VAT inclusive price of £60.
>
> (4) Under the margin scheme, the dealer is liable to account for VAT on the sale of the vehicle at auction on £10 only (being the difference between the price of £50 it paid to the customer and the price it receives at auction of £60).

139. This result that the dealer pays VAT on £10 only is in recognition of the fact that a definitive VAT charge has already been suffered on the price of £50 which the dealer pays for the vehicle, which in effect is passed on by the consumer to the dealer and for which the dealer cannot obtain relief. The charge to VAT on the sale at auction is, therefore, confined to the "value added" on the sale at auction of £10. This is entirely in line with the principle that VAT is to be charged on a proportionate basis after deduction of the VAT borne on the cost directly attributable to that supply.

140. In my view, on the other hand, it would be contrary to the proportional basis of the VAT charge, as reflected in the aims of the margin scheme, for VWFS to obtain relief, whether under that scheme or under the de-supply provision, for the irrecoverable VAT suffered by the customer under the HP supply on the subsequent resale. In this case, whilst it is indisputable that the customer suffers an irrecoverable VAT cost under the HP supply, that simply does not represent a cost which needs to be relieved in the hands of VWFS under the scheme (or under the de-supply provision).

141. The VAT effects if the scheme applies to a resale and if it does not apply are best illustrated by an example as follows:

(1) A financier purchases a car from a car dealer for £100 plus VAT of £20.

(2) The financier agrees to provide the car to the customer under a HP transaction under which the customer is to pay a capital amount for the car of a total of £120 due in 10 equal instalments of £12 (plus interest costs and related fees). This represents the capital amount of £100 and VAT of £20 to be collected by the financier at £2 per instalment.

(3) At the outset the financier accounts for the VAT of £20 charged on its purchase of the car as input tax and for output tax of £20 in respect of the HP supply on the full amount of capital instalments due of £100.

(4) The financier has borrowed £120 to fund the total amount it pays for the vehicle of £120 (including VAT of £20). As noted, it recovers the output tax of £20 from the customer only over time when the capital instalments are paid.

(5) The customer terminates the HP transaction voluntarily at a point when it has paid £60 of the instalments due, comprising £50 representing the capital amounts and £10 representing output tax for which the financier has accounted on the HP supply.

(6) The financier's VAT account is adjusted under regulation 38 by treating the unpaid capital amount of £50 as a reduction in the consideration for the HP supply. On that basis it is liable to account for output tax of £10 only in respect of the HP supply on the reduced sum of £50. The financier, therefore, receives a refund of £10 of VAT overcharged on the HP supply. At that point the customer's irrecoverable VAT cost is fixed at £10.

(7) The financier takes back possession of the car and sells it at auction to a third party purchaser for a VAT inclusive price of £60 which includes VAT of £10. As established in the cases, this is a separate supply of goods for VAT purposes. Assuming the margin scheme does not apply, the financier accounts for output tax on the supply of £10, which it has to pay to HMRC. The purchaser at auction correspondingly has an irrecoverable VAT cost of £10.

(8) Overall, the financier incurs recoverable input tax of £20 (on its purchase of the vehicle) and accounts for output tax of £20 (£10 on the HP supply and £10 on the sale at auction). Correspondingly this gives rise to irrecoverable VAT costs of £20 in the hands of the consumers (£10 for the customer and £10 for the purchaser at auction).

(9) In cash terms the financier has received £120 in respect of the transactions undertaken which equals its original cash outlay of £120 (disregarding subsequent finance charges). It receives (a) £60 from the customer in respect of the HP supply (being the amount paid up to the date of termination), (b) £10 in respect of overpaid VAT (as a result of the

VAT adjustment on termination to reflect that £50 (and the related VAT) is no longer due) and (c) £50 on the sale at auction (£60 of the net sales proceeds received less £10 of output tax which the company has to account for to HMRC).

142. If VWFS' approach is instead applied, under the margin scheme the finance company would not be liable to account for VAT on the auction sale at all or for a minimal amount of VAT only.

(1) The financier again sells the vehicle at auction for £60 (that being the auction price regardless of any VAT charge).

(2) The profit margin under the scheme is the difference between (a) the purchase prince, being the amount the financier paid for the vehicle and (b) the selling price, being the amount it receives on the sale at auction. The selling price is, therefore, £60.

(3) On VWFS' analysis the customer supplies the vehicle to the financier in return for consideration equal to the instalments which are no longer due from the customer. I take that to be the purchase price. (I note that VWFS argues that the value of that consideration should be taken to be equal to the actual sums paid by the customer to the date of termination. I have addressed that argument below.) It is not clear to me whether, on VWFS' argument, that amount is to include the VAT element of the instalments or not. I have set out the position in each case.

(a) If the purchase price is £60 (including the VAT element of the instalments), the profit margin is zero so that no VAT charge is due on the sale.

(b) If the purchase price for the purposes of the scheme is £50 (leaving the VAT element of the unpaid instalments out of account), the profit margin is £10 (£60 received at the auction sale less £50). The resulting VAT is £1.67.

(4) The overall result in the scenario in (3)(a), therefore, is that the financier incurs recoverable input tax of £20 only and accounts for output tax of £10 only on the HP supply and no VAT on the repossession sale. In cash terms the finance company would receive £130 in respect of the transaction undertaken which exceeds its original cash outlay of £120 (disregarding finance charges). As before it receives £60 from the customer in respect of the HP supply and £10 in respect of overpaid VAT. However on the auction sale it receives an increased amount of £60 as it does not have to account for VAT out of the sales proceeds.

(5) In the scenario in (3)(b), the result is the same except that the financier is liable to account for a total of £11.67 of output tax and in cash terms realises £1.67 less overall.

143. I note that the overall result would be the same as in scenario (3)(a) above if the de-supply provision were to apply to require the sales proceeds on the sales proceeds to be left out of account for VAT purposes. The following comments on the result

under the margin scheme, therefore, apply equally to the result if instead, as is VWFS' alternative argument that provision were to apply.

144. In my view, according to the principles underpinning VAT regime and the aims behind the margin scheme it cannot be the intention that the margin scheme should apply to give the result VWFS argue for and it would be contrary to these principles for the de-supply provision to apply to that effect.

145. The key point is that the cost of the vehicle to VWFS is a direct cost component of both the HP supply and the separate (albeit related) supply on resale at auction. VWFS consumes or uses the supply of the vehicle to it to realise value from the vehicle under a HP transaction and, when that transaction terminates early, to realise, on sale at auction, whatever value remains following the period of use of the vehicle under the HP transaction. On the basis that VWFS is required to charge VAT on the price paid by the customer and the purchaser at auction, each suffers a definitive VAT charge, in effect, on the proportion of the value realised by VWFS from its total use of the vehicle which VWFS realises from each of them respectively. The vehicle can be said to enter "final consumption" under the HP supply, therefore, only partially by reference to the value received by VWFS for that supply. It enters final consumption partially also under the supplies made on the repossession sales by reference to the remaining value which VWFS then realises.

146. The margin scheme operates on the basis that a proportion of the cost component incurred by the consumer in making the supply of the vehicle to the dealer, on which the definitive charge to VAT is suffered, is in effect passed on to the dealer in the price charged for that supply. VWFS argument involves in effect that the consumer's cost under the HP supply, on which it suffers an undisputed definitive VAT charge, is passed on to VWFS on the basis that the customer supplies the vehicle back to VWFS on repossession or the handing back of the vehicle.

147. Even if it could be said there is a supply of that nature (and, as set out below, I do not consider that is the case) in economic and commercial terms there is no real passing of the customer's cost under the HP supply to VWFS in these circumstances. On VWFS' own analysis that cost is passed on to VWFS on the basis that it incurs, as consideration for the asserted supply, an amount equal to the sums which, as at the termination date, the customer no longer has to pay or which the customer is deemed no longer to be liable for (to the extent that the net sales proceeds are set off against the sums due). The fact is that VWFS receives full relief for the VAT otherwise due on those amounts by way of reduction to the consideration received under the HP supply under the adjustment provisions. If the margin scheme or the de-supply provision were to apply VWFS would obtain relief for those amounts a second time on the basis that VWFS has somehow incurred a further entirely notional cost.

148. I note moreover that VWFS further submits that this consideration is to be valued for the purposes of the margin scheme as an amount equal to the sums which the customer has paid under the HP supply; in its view that is the appropriate value to enable it to obtain relief for the full amount of the embedded VAT cost (see [236] to [243]). As HMRC submitted, the effect would be that the customer would be regarded as passing back to VWFS the full value which VWFS has received from it. I

can see no basis for VWFS' stance. It is simply a self-fulfilling justification for the application of the margin scheme to give the desired effect.

149. From whichever perspective this is viewed, it can be nothing other than double counting for VWFS to receive relief for the irrecoverable VAT cost incurred by its customer in respect of the part of the value of the vehicle which VWFS realises under the HP supply against the VAT due on the remaining value it realises from the vehicle on the resale. As HMRC submitted, if the margin scheme or the de-supply provision applies, VWFS recovers all of its input tax on the purchase of the vehicle but ultimately only accounts for part of the overall consideration it receives through its use of the vehicle under the HP supply and the subsequent sale. In effect, enabling VWFS to account for output tax on a lower amount than it actually receives on the supplies it makes through the cost component incurred in making those supplies (the purchase price it paid or the vehicle) enables VWFS to obtain relief for a proportion of the VAT it bears on that cost component twice over.

150. VWFS objected to HMRC's analysis on the basis that it ignores that the input tax incurred on the supply of the vehicle to VWFS from the dealer, is in effect consumed in making the HP supply to the customer. VWFS argued that such a supply, as a supply into final consumption, has precisely the same chain breaking effect as an exempt supply. It is impermissible to look through a supply into final consumption and indirectly attribute the input tax as HMRC seek to do. This breaches the principle that, as established in *NLB and GMAC 3,* each step in the chain is to be considered separately for VAT purposes.

151. I note that there is no direct correlation between the amount of input tax which can be recovered and the amount of output tax charged. A business can recover input tax incurred on the basis that it is attributable to the making of onward taxable supplies whatever the value of those onward supplies. However, I do not consider that this detracts from how the proportionality principle underpinning the VAT regime is to be applied in this case. The vehicle can only be said to enter partial final consumption under the HP supply in the manner explained above. There is no authority (and no reason as a matter of principle) that this partial final consumption should be regarded as "breaking the chain" to give a result which is clearly contrary to the intended effects of the EU VAT regime.

152. I also note that VWFS emphasised that accounting for the HP transactions as supplies of goods is burdensome because it has to account for output tax on the HP supply earlier than it would have done if the supplies were regarded as supplies of services. However, as HMRC argued, the fact that the taxable amount of a transaction is payable at an earlier point than if the supply had been characterised differently by the PVD (and VATA), does not require that the taxable amount of a separate subsequent supply must be reduced. There is no authority to support this.

153. Finally, VWFS argued, on the basis of the decision in *Bawaria*, that it is entitled to rely on what it asserts is the intended effect of EU law to relieve double taxation in these circumstances notwithstanding any shortcoming in UK law in giving effect to those provisions. As was held in *Bawaria*, it is for the national law to be put right. That may well be the case if there was any deficiency in the UK rules. However, for all the reasons given, there is no double taxation issue if the margin scheme or the de-

supply provision does not apply and the UK rules are entirely compatible with EU law.

*Conclusion*

154. I have concluded that VWFS' proposition that it must benefit from the margin scheme or the de-supply provision (disregarding the 2006 exclusion) in order to avoid double taxation is unfounded as a matter of EU law. It follows that equally there is no foundation for the view that, if the margin scheme is held not to apply to the resales, the 2006 exclusion is rendered incompatible with EU law and VWFS is entitled to rely on the de-supply provision disregarding its effects.

155. For all the reasons set out above, it is not in accordance with EU law for the margin scheme or the de-supply provision (disregarding the effect of the 2006 exclusion) to apply to the resales. As recognised in *GMAC 3* and as is illustrated if the margin scheme were to apply, there is under taxation if, on termination of a HP transaction, the financier benefits both from the adjustment provisions in respect of the HP supply and, on the resale, either from the de-supply provision (as it applied before the 2006 exclusion) or the margin scheme.

156. As explained below, I have found that in any event the conditions for the margin scheme to apply are not in fact met in relation to the resales. It follows from the above conclusion that VWFS' inability to benefit from the scheme is in line with the intended scope of the scheme and the operation of the VAT scheme generally.

**Discussion and decision – application of the margin scheme**

*General approach*

157. As set out above, the circumstances in which the margin scheme applies include where a taxable dealer sells second-hand goods which have supplied to him by a non-taxable person or, as it is put in the UK rules, of which he has taken possession under a supply on which no VAT is chargeable. The dispute was whether this requirement is satisfied on the basis that VWFS' customers, as non-taxable persons, make supplies of goods to VWFS on the handing back or repossession of the vehicles whether that occurs pursuant to a voluntary or forced termination.

158. The application and effect of article 14 is central to this debate, both as regards its application to the initial HP supply and whether there is any supply by the customer. To re-cap, there is a supply of goods (a) under article 14(1) where there is a "transfer of the right to dispose of tangible property as owner" and (b) under article 14(2)(b) on the "actual handing over of goods pursuant to a contract for the hire of goods for a certain period….which provides that in the normal course of events ownership is to pass at the latest upon payment of the final instalment". As set out in detail below, article 14(1) is interpreted by the CJEU to apply to "any transfer of tangible property by one party which empowers the other party actually to dispose of it as if he were the owner of the property of goods".

159. It was not disputed that under the general approach to analysis in a VAT context (as set out in particular in *Secret Hotels2 Ltd v HMRC* [2014] STC 937, SC and *HMRC v Airtours Holidays Transport Ltd* [2016] STC 1509, SC) it is necessary (1) to assess the contractual effect of the arrangements between VWFS and its customers under the applicable finance agreements and (2) in the light of the contractual nature

of the arrangements, determine whether there is a supply of goods effected for consideration under article 14, according to its correct interpretation as set out in the CJEU case law (a) by VWFS under the HP transaction and (b) by the customer when VWFS recovers possession of the vehicle. In making this assessment it has to be borne in mind that consideration of economic and commercial realities is a fundamental criterion for application of the common system of VAT (see for example *HMRC v Newey* (Case C-653/11) [2013] STC 2432, CJEU at [42] as also referred to in *Secret Hotels2* and *Airtours*).

160. In assessing the nature of the contract between VWFS and its customers, as set out in *Secret Hotels2*, the tribunal must consider the words used, the provisions of the agreement as whole, the surrounding circumstances in so far as they were known to both parties, and commercial common sense.

161. It was also common ground that a supply is effected for consideration only if there is "reciprocal performance" or, as it has also been put, if there is a direct link between the service or goods provided (see *Tolsma v Inspecteur der Omezetbelasting Leeuwarden* (C-16/93) [1994] STC 509 at [14]). If the consideration is in non-monetary form, it must be capable of being expressed in money. The taxable amount for the supply, on which VAT is charged, is represented by the consideration actually received. That consideration is thus the subjective value, that is to say, the value actually received, and not a value estimated according to objective criteria (see *Astra Zeneca UK Limited v Revenue and Customers Commissioners* (C-40/09) [2010] STC 2298).

*Submissions – does the customer make a supply of goods?*

162. VWFS argued that under article 14 there is a supply of goods by the customer when VWFS recovers possession of the vehicle as a matter of substance and as dictated by the fiscal consequences of article 14 in relation to the initial HP supplies.

(1) Under the finance agreements VWFS retains legal ownership of the vehicles merely as security for the loans which it thereby makes. It is only when it recovers possession of the vehicle that VWFS' legal title is "perfected" by it thereby re-gaining the right to dispose of the vehicle. VWFS drew support for this analysis from the decision in *Darlington Finance Ltd v CCE* [1982] VATTR 223. On the basis of the CJEU case law set out below, the recovery of possession equates to the transfer by the customer of the right to dispose of the vehicle as owner (or, failing that, under the terms of article 14(2)(b)).

(2) Moreover, it follows from the fact that the initial HP supply takes effect as a supply of goods, that the customer, as the fiscal owner of the vehicles must be regarded as making a supply of the vehicle to VWFS in these circumstances as otherwise VWFS would not itself be in a position to make an onward supply of the vehicle on the resale.

(3) VWFS considered that the HP transactions fall within both parts of article 14 but that the fiscal imperative for the customer to be regarded as making a supply are the same whichever part applies. The fact that the customer is the economic owner of the vehicle under the HP transaction (in its view, with the effect that article 14(1) applies) reinforces that the

customer must transfer that ownership back to VWFS when it recovers possession. However, it would be a breach of fiscal neutrality if different consequences were to apply if, as HMRC argued, the HP transactions fall within article 14(2)(b) only. That is reinforced by the fact that the courts elide the two provisions in their application to HP transactions.

163. VWFS said that it provides consideration for this supply in that it releases the customer from (a) on a forced termination, an amount equal to the net sales proceeds received on the resale of the vehicle and (b) on a voluntary termination, all further payments due under the finance agreement. In its view there is a direct link between this release and the supply made on the return or repossession of the vehicle. No longer having to pay these sums is plainly of value to the customer as Mr Watson explained. VWFS referred to a number of authorities support of its view as set out in the discussion section.

164. In VWFS' view this analysis reflects the principle that all supplies must normally be regarded as distinct and independent unless, broadly, two or more acts by a single taxable person are so closely linked that they objectively form a single indivisible economic supply. In this context this principle is reflected in the decisions in *GMAC 1*, *GMAC 3* and *NLB* which establish that the initial HP transaction and subsequent resales are usually to be treated as separate supplies.

165. HMRC submitted that in reality, VWFS retains ownership of the vehicle, entitling it to dispose of the vehicle as owner, until the resale takes place. In recovering possession of the vehicle on a forced or voluntary termination VWFS simply exercises a pre-existing right to do so under the terms set out in the finance agreement. Under the usual approach to VAT analysis, that does not constitute a supply as is consistent with the analysis in *British Credit Trust Ltd* [2014] UKFTT 744 (further details of which are set out below). HMRC said that in any event there is no consideration for any such supply.

(1) There is no express contractual term requiring VWFS to make a cash payment or provide non-monetary consideration to the customer in return for possession of the vehicle. Given the nature and express terms of the written agreement, there can be no basis for implying such terms.

(2) The reduction in the amount due from the customer is directly linked to the HP supply and cannot be taken into account both (a) as a reduction in the consideration for the HP supply and (b) as consideration for a supply by the customer to VWFS.

(3) The tribunal reached a conclusion that there is no consideration for any such supply in similar circumstances in the *Darlington Finance Ltd* case. The cases cited by VWFS do not support its assertion that there is consideration for a supply by the customer to VWFS.

166. HMRC said that the initial HP supplies fall within article 14(2)(b) and not article 14(1). On its plain meaning and having regard to its context and purpose, article 14(2)(b) does not go beyond treating the particular transactions, which it specifically describes, as supplies of goods rather than supplies of services, for the purposes of accounting for VAT on that supply. The fiscal fiction on which it operates cannot

alter, as is the effect of VWFS' stance, the character of any subsequent transaction or supply or create any supply where there would not otherwise be one, as determined according to usual principles. Moreover VWFS's analysis is divorced from both the contractual terms and economic and commercial reality.

167. VWFS emphasised that the tribunal is required to take account of all the surrounding circumstances in analysing the effect of the arrangements. The fact that the HP supply is taxed as a supply of goods, with resulting fiscal consequences, is a material circumstance. The position cannot be analysed simply by reference to the fact that VWFS remains the legal owner of the vehicles. By its very nature, a fiscal fiction of the kind created by article 14 is unlikely to reflect precisely the legal, economic and commercial reality of the underlying transaction. The same can be said of other fiscal fictions created by the VAT legislation such as the transfer of a going concern and the VAT group provisions. Fiscal fictions inevitably have fiscal consequences, namely, in this case, that the customer is taxed as the owner of the vehicles. In the context of a transactional tax, which applies separately to each supply, it is a direct consequence of this fiscal fiction that there must be a separate and distinct supply for fiscal ownership to be returned or passed on.

168. VWFS said that there is no double counting in respect of the release from sums otherwise due from the customer. The VAT adjustment on termination of the HP transaction merely finalises the value of the HP supply on final consumption thereby determining the amount of irrecoverable VAT embedded in the goods. Moreover again that argument ignores the transactional nature of the tax whereby the return or taking possession of the vehicle must be regarded as a separate and distinct transaction from the initial HP transaction.

169. VWFS said that by ignoring the fiscal consequences of article 14 HMRC in effect seek to re-characterise the HP supply retrospectively as a single supply of services in contravention of the principle that each supply must be treated as separate and distinct. VWFS asserted that HMRC are simply taking the stance necessary to achieve the outcome they wish to achieve which is not permissible (referring to *HMRC v Temple Finance Ltd and Temple Retail Ltd* [2017] UKUT 315, [2017] STC 1781).

170. HMRC added that the VAT grouping and other provisions VWFS referred to do not shed light on the correct analysis in this case; they are "radically different" from article 14(2)(b) in text, context and purpose. In their view VWFS' comments on single and multiple supplies add nothing to the debate; this cannot deflect from the application of the normal principles for determining VAT liability.

*Submissions - supply of services*

171. VWFS' fallback position was that the margin scheme applies even if, contrary to its view, there is only a supply of services by the customer on the repossession. This is based on the fact that the UK rules in article 8 of the Cars Order state that the scheme applies where a financier takes "*possession* of the motor car pursuant to a supply". Under the UK rules a supply of possession only of goods is usually treated as a supply of service.

172. As HMRC submitted, however, applying the well-established "*Marleasing*" principle (as set out in *Vodafone 2 v HMRC (No 2) [2009] STC 1480*) the UK

provisions can and must be interpreted consistently with article 314 PVD. That article clearly refers only to a supply of goods and, in line with the principles underpinning it, the scheme is clearly only intended to apply to such supplies. I cannot, therefore, see any scope for VWFS' stance even if there is a supply of services and have not considered further if there is such a supply.

173. The parties also made submissions on how the profit margin is to be calculated if the margin scheme is held to apply, which are set out below.

*Case law on article 14*

174. I have considered first the application of article 14 to the HP transactions before turning to whether there is a customer supply. As noted, the parties were both of the view that VWFS makes a supply of goods under the HP transactions but disagreed as to which part of article 14 applies.

175. It was established in *to Staatsecretaris van Financien v Shipping and Forwarding Enterprise Safe BV* (C-320/88) [1991] STC 627 that a "supply of goods" within article 14(1) does not refer to the transfer of ownership in accordance with the procedures prescribed by the applicable national law but covers:

> "any transfer of tangible property by one party which empowers the other party actually to dispose of it as if he were the owner of the property".

176. The CJEU confirmed that it covers any such transfer "even if there is no transfer of legal ownership of the property" (at [9]). That accords with the earlier opinion given by the Advocate General (at [13] of the opinion) that:

> "the transferee does not have to be the formal legal owner but need only obtain a right of disposal provided that he thereby acquires a position which is de facto analogous to that of the formal legal owner".

177. The CJEU was also asked if there is a supply of goods where the legal owner has entered into an agreement with another party under which the owner (a) has actually placed the property at the disposal of that party (b) agreed that any changes in the value of the property and all profits or outgoings are for the benefit or at the expense of that party (b) agreed to transfer legal ownership of the property to that party at any future time and to grant that party an irrevocable power of attorney to carry out any transactions necessary to execute that transfer of legal ownership.

178. The CJEU said, at [11], that in posing these questions the national court was in reality asking the CJEU to apply article 14(1) to the relevant contract but, at [13], that "it is for the national court to determine in each individual case, on the basis of the facts of the case, whether there is a transfer of the right to dispose of the property as owner…". The Advocate General gave a similar view, at [16], of his opinion but said it seemed to him that "at least" the other party acquires the right to dispose of the property as owner:

> "if the right of ownership retained by the original seller is so diminished that it is reduced to mere legal title."

179. In *Auto Lease Holland BV v Bundesamt fur Finanzen* (C-185/01) [2005] STC 598, the Advocate General interpreted *Safe* as focusing on economic ownership which

he interpreted as relating "more to the opportunity to make use of the goods than to the transfer of actual ownership".

180. In *Eon Aset Menidjmunt OOD v Direkto na Direktsia Obzhalvne I upravlenie na izpalniento - Varna Pri Tsentralno upravlenie na Natsionalnata agentsia za prihodite* (C-118/11) [212] STC 982 ("*Eon*") the CJEU examined the nature of a lease of a motor car for VAT purposes. At [33] and [34] the CJEU said that whilst as a general rule such a lease must be regarded as a supply of services a "financial leasing contract" may, nonetheless, "present features which are comparable to those of the acquisition of capital goods". Having referred, at [36], to the terms of article 14(2)(b), they noted, at [37], that in the case of a "financial leasing contract":

> "there is not necessarily any acquisition of the goods since such a contract may provide that the lessee has the option of not acquiring those goods at the end of the lease period."

181. However, at [38], they said that it is clear from the relevant international accounting standards that an operating lease must be distinguished from a finance lease:

> "the nature of the latter being that substantially all the risks and rewards of legal ownership are transferred to the lessee. The fact that a transfer of ownership is provided for on the expiry of the contract or the fact that the present value of the lease payments is practically identical to the market value of the property constitute, separately or together, criteria which permit a determination of whether a contract can be categorised as a finance lease."

182. They continued, at [39], to note the criteria for when there is a supply of goods within article 14(1) as set out in the *Safe* case and said that accordingly, at [40]:

> "where a financial leasing contract relating to a motor vehicle provides *either* that ownership of that vehicle is to be transferred to the lessee on the expiry of that contract *or* that the lessee is to possess all the essential powers attaching to ownership of that vehicle and, in particular, that substantially all the rewards and risks incidental to legal ownership of that vehicle are transferred to the lessee and that the present value of the amount of the lease payments is practically identical to the market value of the property, the transaction must be treated as the acquisition of capital goods." (emphasis added)

183. They said, at [41], that it is for the national court to determine, having regard to the circumstances, whether the criteria stated in the preceding paragraph of this judgment are applicable.

184. The parties also referred to the decision in *NLB* but that merely reiterates what was said in *Eon* in the different context of a property financing transaction (see [31]).

185. In *HMRC v Mercedes-Benz Financial Services UK Ltd (C-164/16)* ("*Mercedes-Benz*") the CJEU considered whether article 14(2)(b) applies to a lease of a motor vehicle with an option to purchase where, as set out at [16]:

> "monthly instalments are, as a rule, lower than under a [HP agreement]; total instalments thus represent only approximately 60% of the vehicle sale price, including the cost of financing. If the user

> wishes to exercise the option to purchase the vehicle, he must therefore pay approximately 40% of the sale price. That 'balloon' payment represents the estimated average residual value of the vehicle at contract maturity. The customer is asked, three months before the end of the contract, whether he wishes to exercise the option…."

186. HMRC argued that the agreement constituted a "supply of goods" within the meaning of article 14(2)(b). The question referred to the CJEU was (at [22]) whether:

> "… the phrase "in the normal course of events" [in article 14(2)(b)] require a tax authority to do no more than to identify the existence of an option to purchase which can be exercised no later than upon payment of the final instalment….[or]… to go further and to determine the economic purpose of the contract?"

187. If the authority has to determine the economic purpose of the contract, the further question was whether it is relevant to that exercise to look at (a) how likely the customer is to exercise such an option and (b) the size of the price payable on the exercise of the option.

188. The CJEU noted, at [25], that it:

> "is a particular feature of such agreements [which they said may be termed hire purchase or finance leases] that they serve as a substitute for the immediate acquisition of full ownership, the lessee having the use of the goods without being required to pay the full purchase price for them when they are handed over to him".

189. They said, at [26], that this type of contract:

> "may have features which are comparable to the acquisition of goods, or it may not, since it is open to the parties to provide that the lessee has the option of acquiring or not acquiring those goods at the end of the lease" (referring to *Eon* at [34] and [37]).

190. They referred, at [27], to *Eon* and *NLB* as authority that for the proposition that the fact that a transfer of ownership is provided for on the expiry of the contract or that the present value of the lease payments is practically identical to the market value of the property "constitute, separately or together, criteria which permit a determination of whether a contract can be categorised as a 'finance lease'".

191. They said, however, at [28] and [29], that the classification of a contract as a "finance lease" is not, in itself, sufficient for the actual handing over of goods pursuant to that contract to be categorised as a transaction subject to VAT. It is also necessary to determine whether the contract is a contract for "hire which provides that in the normal course of events ownership is to pass at the latest upon payment of the final instalment", within the meaning of article 14(2)(b). That legal classification requires two conditions to be satisfied.

192. The first condition, as set out at [30] to [33], is that the relevant agreement pursuant to which the goods are handed over must contain a "clause expressly relating to the transfer of ownership of those goods from the lessor to the lessee". They said that may be the case where the agreement contains an option to purchase the leased asset. They noted that the reference is not to the transfer of power to dispose of property as owner as under article 14(1) but, "more explicitly, to the 'passing of

ownership' of that property" and that the provision uses the term "instalments" which is familiar in credit agreements but uncommon in pure lease agreements, which generally refer to 'lease payments'.

193. The second condition, as set out at [34] to [36] is that:

> "..it must be clear from the terms of the contract, as objectively assessed at the time when it is signed, that ownership of the goods is intended to be acquired automatically by the lessee if performance of the contract proceeds normally, over the full term of the contract.
>
> The only inference to be drawn from [the relevant words]….is that the final payment of sums to be paid by the lessee under the terms of the contract results by operation of law in the transfer to that lessee of ownership of the goods to which the agreement relates."

194. They said, at [37], that this "this contractually determined outcome - of ownership being transferred - is incompatible with a genuine economic alternative for the lessee under which he may, at the appropriate time, opt either to acquire the goods, or to return them to the lessor, or to extend the lease, depending on his particular interests at the time when he is required to make that choice". However, that is not the case if exercising the option is the only economically rational choice:

> "The position would be different only if exercising the option to purchase, optional though it is in formal terms, appeared in fact, given the financial terms of the agreement, to be the only economically rational choice the lessee could make. That may in particular be the case where it is evident from the agreement that, when the possibility of exercising the option arises, the aggregate of the contractual instalments will correspond to the market value of the goods, including the cost of financing, and that the lessee will not be required, as a result of exercising the option, to pay a substantial additional sum."

195. The CJEU continued, at [41], that this approach is consistent with the VAT system's objectives of ensuring legal certainty and facilitating application of the tax by having regard, save in exceptional cases, to the objective character of the transaction in question. They noted, at [42], that it is for the national court to determine whether the contract satisfied the conditions they had set out. Their conclusion, at [43] was that the words used in article 14(2)(b) must be interpreted:

> "as applying to a leasing contract with an option to purchase if it can be inferred from the financial terms of the contract that exercising the option appears to be the only economically rational choice that the lessee will be able to make at the appropriate time if the contract is performed for its full term, which it is for the national court to ascertain."

*Decision on application of article 14 to the finance agreements*

196. I take from the above authorities that there is a supply of goods under a leasing or hire arrangement relating to vehicles where either of the following two requirements is satisfied:

> (1) During the term of the agreement, the lessee/hirer possesses all the essential powers attaching to ownership of that vehicle and, in particular,

substantially all the rewards and risks incidental to legal ownership of that vehicle as may be the case where the present value of the amount of the lease payments is practically identical to the market value of the property.

(2) It is clear from the terms of the contract, as objectively assessed at the time when it is signed, that ownership of the goods is intended to be acquired automatically by the lessee/hirer on the assumption that performance of the contract proceeds normally, over the full term of the contract (assuming the parties act in good faith in accordance with the principle that agreements must be kept). That will not be the case if, as inferred from the terms, at the end of the lease or hire term the lessee/hirer has a genuine economic alternative under which he may for example opt either to acquire the goods, or to return them to the lessor, or to extend the lease, depending on his particular interests at the time when he is required to make that choice.

197. There was some dispute between the parties in relation to the interaction between the two articles. VWFS argued that articles 14(1) and 14(2)(b) overlap in their application to HP transactions. In its view, there may plainly be cases where economic ownership is transferred at the outset of a HP transaction and where, in the normal course of events, legal ownership is to pass to the customer no later than on payment of the final instalment due. Article 14(2)(b) merely puts beyond doubt that a HP transaction is a supply of goods. VWFS submitted that the HP supplies are an example of a case which falls within both limbs.

198. HMRC said article 14(2)(b) is discrete from article 14(1). It is necessary because the EU has decided that certain transactions in which the supplier retains "the right to dispose of tangible property as owner" should also be treated as supplies of goods where the particular requirements specified in article 14(2)(b) are met. In their view article 14(1) does not apply but they did not dispute that the requirements are met for article 14(2)(b) to apply on the basis that that provision does not require a transfer of economic ownership

199. It seems to me that article 14(2)(b) must be aimed at circumstances where the requirements for article 14(1) are not satisfied. If article 14(2)(b) does not allow for a transaction to qualify as a supply of goods in circumstances where there is not a transfer of the right to dispose of the assets, the question arises as to why it was thought necessary to include this specific provision in the first place. I can see, however, that it cannot be ruled out that there could be situations where the two provisions overlap. It could be the case that the lessee/hirer acquires, on entering into the relevant agreement, the right to dispose as owner whilst the requirements of article 14(2)(b) are also satisfied.

200. In any event I have concluded that the HP transactions, whether effected under HP or PCP agreements, do not fall within article 14(1). Whilst the HP transactions effected under HP agreements plainly fall within article 14(2)(b), I do not consider that those effected under PCP agreements do so.

*Application of article 14(1)*

201. I am not satisfied that article 14(1) applies on the basis that the effect of the finance agreements is that the customer obtains all the essential powers attaching to

ownership of the relevant vehicle and, in particular, substantially all the risks and rewards incidental to legal ownership of the vehicle.

202. Under the contractual arrangements the finance agreements operate as a form of hire or leasing as follows (and as described in further detail in the facts section):

(1) The customer is entitled to the possession use and enjoyment of the vehicle during the term of the agreement and has an option to obtain legal title to the vehicle at the end of the terms having paid all instalments due. The instalments are in aggregate equal to the price paid by VWFS to acquire the car plus a financing/interest charge (and possibly excess mileage charges and other fees).

(2) In economic terms, therefore, the arrangement is equivalent to VWFS making a loan to the customer for the purchase of the vehicle which is repaid in instalments comprising the capital/loan balance due (plus interest over the term of the loan and the other charges noted). VWFS is in the position of a secured lender under a loan with the added benefit of retaining the legal title to the underlying asset.

(3) Under a HP agreement the instalments are of equal amount whereas under a PCP agreement lower initial amounts are due with a substantial balloon payment at the end of the term. The position is not wholly akin to a loan in that unlike under a bank loan, the customer has a range of consumer protections including an entitlement to terminate the arrangement and hand back the car on paying 50% of the total amount due, with no extra cost.

(4) Under the agreement there are a number of restrictions and obligations on the customer such as not to sell, hire out or otherwise dispose of or use the vehicle as security for a loan, as regards the circumstances in which the vehicle may be taken out of the UK, restrictions on commercial use, obligations to insure the vehicle and to keep it in good repair and to pay excess mileage charges.

(5) As noted the customer has the right under statute, as also set out in the terms, to terminate, with no extra cost, on paying 50% of the overall amount due and there are statutory restrictions on how VWFS can recover possession of the vehicle once the customer has paid more than one third of the overall amount due. Under PCP agreements the customer also has the right to hand back the vehicle prior to paying the balloon payment and to ask VWFS to act as its sales agent. If VWFS accepts the appointment, the balloon payment is satisfied from the sales proceeds (as are other any other amounts due from the customer). In those circumstances, if the sales proceeds are less than the outstanding amounts due from the customer, the customer does not have to pay the balance.

203. HMRC pointed to the various restrictions referred to in [201(4)] above as demonstrating that VWFS remains the legal and economic owner. I accept, however, that as VWFS argued these are largely commensurate with the restrictions a lender may expect to protect the value of the relevant asset, as security for the loan. Their presence in the agreement is not therefore in my view determinative of the position.

204. In my view, the key point in that context is that in all cases the customer can simply hand the vehicle back to VWFS on paying only 50% of the payments due under the agreement with no further cost or penalty. The ability to gain from or the corresponding risk of suffering the loss from the value of the relevant asset is an essential incident of ownership. Due to this ability for the customer to terminate when VWFS is yet to recoup 50% of the price it paid for the vehicle, the material risk of loss in value rests with VWFS.

205. In taking a contrary view, VWFS emphasised that in effect the right to terminate the HP transaction is within the customer's control. He can terminate the agreement exclusively at his election, once he has paid 50% of the sums due under the agreement and even in the event of breach is given every opportunity to remediate. However, to my mind this merely reinforces that the customer does not take the risk of loss. VWFS also noted that customer has sufficient legal title to dispose of the car to a purchaser acting in good faith without notice (under s 27 Hire Purchase Act). However, I cannot see that is a factor pointing towards the customer having the risks and rewards of ownerships. That provision would come into play only if the customer were to sell the vehicle in clear breach of the terms of the finance agreement which explicitly prohibits the customer from doing so. Nor can I see that the fact that VWFS cannot sell the vehicle without the prior termination of the agreement has any material relevance.

*Application of article 14(2)(b)*

206. It is clear that article 14(2)(b) applies to the HP transactions effected under HP agreements but it seems to me that it does not apply to those effected under PCP agreements.

207. Applying the approach set out in the *Mercedes-Benz* case, on an objective assessment of the position at the outset of the relationship between the parties, according to the terms of the finance agreements:

> (1) If an HP agreement were to be performed in full, the only economically rational choice for the customer would be to exercise the option to purchase it for a small fee (of around £60) given that by that time the customer would have paid the full amount due to VWFS as the price for the car.
>
> (2) At the end of a PCP agreement, however, for the customer to pay the balloon payment, which represents around 40% of the overall price due to VWFS, is not the only rational economic choice for the customer particularly given the alternative for the customer to terminate just before the balloon payment is due (given the customer will necessarily have paid 50% of the price by this time). In fact, depending on the value of the car at that point in time, it may make more economic sense for the customer not to proceed to pay the balloon payment.

208. In the *Mercedes-Benz* case the CJEU was specifically asked to consider a case where the balloon payment was due only on exercise of the option to purchase whereas in this case, as VWFS emphasised, the payment of the balloon is expressed to be mandatory under the contractual terms. However, it seems to me that the reasoning used by the CJEU applies equally in these circumstances. The ability to

terminate immediately before expiry of the term and before the final balloon payment is otherwise due (and the option is exercisable) provides a genuine financial alternative for the customer as much as the ability simply to elect not to exercise an option. Whilst the mechanics are different, the commercial and economic outcome is the same.

209. I note that the CJEU said that the required assessment must be made on the assumption that the agreement is performed in accordance with its terms. However, I do not think that precludes consideration of the ability to terminate which clearly can be used at the end of the term to give a genuine alternative to paying the final 40% instalment and proceeding to purchase the car.

210. If it is correct that the HP transactions effected under the PCP agreements do not take place as supplies of goods but as supplies of services, the margin scheme is clearly not in point in relation to re-sales made on termination of transactions effected under those agreements. However, HMRC did not dispute that article 14(2)(b) applies to those transactions. I have proceeded, therefore, to consider whether the margin scheme applies on the basis that article 14(2)(b) applies to all the HP supplies. I note that, in any event, my analysis and conclusion on the question of whether there is a supply by the customer when VWFS recovers possession of the vehicle is the same whether article 14(1) or article 14(2)(b) applies to the HP transaction.

*Discussion and decision on whether there is a supply of goods on repossession*

211. As set out above, the starting point in deciding whether there is a supply of goods by the customer is to examine the effect of the contractual arrangements under the usual approach as set out in *Secret Hotels2* and *Airtours*. In my view, on that approach, the customer does not make a supply of goods to VWFS in return for consideration on the handing back or taking back of the vehicle on termination of the finance agreements.

212. As HMRC submitted, as a matter of contractual interpretation and in accordance with the commercial and economic reality, on termination, VWFS merely exercises its pre-existing right to have delivered to it or re-take possession of its own asset in recognition that the contractual relationship is at an end. The effect of the ending of the relationship is that (1) VWFS is entitled to ownership of the vehicle unencumbered by any further obligations or rights of the customer under the finance agreement (save for those expressly relating to the termination and re-possession); and (2) the customer no longer has any contractual right to the possession or use and enjoyment of the vehicle or to purchase it.

213. In other words the recovery of possession of the vehicle simply puts VWFS in the position necessary to recognise and give effect to the intended position on termination of the contractual relationship between it and the customer, as provided for from the outset in the contractual terms, by restoring its physical possession and control of the vehicle. Of necessity, as the vehicle is in the possession of the customer, the customer must either deliver it up or VWFS must arrange collection of it from the customer in order to give effect to these pre-existing contractual rights.

214. The key point is that, the outcome and effect of a voluntary termination or forced termination is provided for as part of the bundle of rights and obligations governing the parties' contractual relationship. At the point of termination, VWFS'

right to re-gain possession of the vehicle is automatic in the sense that it does not depend on any additional agreement, consent or thing done or to be done by the customer in contractual terms in return for any consideration other than that provided for in the finance agreement from the outset subject to the provision for adjustment on termination. It follows that there is nothing which can be regarded as a supply which is separate from the HP supply which is made in return for consideration. In effect the consideration expressed to be due under the finance agreement is due in relation to the entirety of the rights and obligations arising under the agreement as adjusted in the event of early termination.

215. I note that, on a voluntary termination, the customer's obligation to pay the remaining part of the sums otherwise due following termination falls away as stated in the finance agreement and moreover, by law, by virtue of the statutory provisions in CCA. As the customer is entitled by law to terminate a finance agreement on paying 50% of the price due; when the customer elects to do so, VWFS has no legal right to collect the rest of the sums which otherwise would have fallen due. VWFS can hardly be said in any real sense to give up or release a right to future sums which by law it no longer has.

216. Nor can the customer be said to receive something of value in return for VWFS recovering possession of the vehicle. The fact that it no longer has to pay any further sums, which would have been due, had the finance agreement remained in place, is entirely commensurate with the fact that, at the customer's own election, the customer no longer has any entitlement to the possession and use and enjoyment of the asset. The customer has paid for what he or she has received; the hire of the asset for the period of time prior to termination.

217. As regards a forced termination, under the finance agreement VWFS can require possession of the vehicle so that it can sell it to use the proceeds to off-set the sums for which the customer would otherwise be liable. The situation is akin to that where a lender enforces its security under a loan, when the borrower is in default. Again the customer no longer has the right to possession, use and enjoyment of the vehicle due to its default and subsequent termination, as is clearly stated to be the outcome of default in the contractual terms. VWFS cannot be said to be providing value to the customer in protecting its position by exercising its pre-existing right to take possession of its own asset to realise the value in satisfaction or partial satisfaction of the amounts otherwise remaining due.

218. There is little direct authority in the case law on the correct VAT position on re-sales of vehicles in these circumstances but the little that there is in line with or does not detract from this analysis. In *British Credit Trust Limited v HMRC* [2014] UKFTT 744, [2015] SFTD 195 the tribunal adopted a similar analysis as regards the consequences of repossession of vehicles on a forced termination of HP transactions albeit that it did so in the context of addressing the question whether the financier made a separate supply of services to its customers on the repossession. As set out at [44], the financier argued that it provided a service in relieving the customer of its obligation to return the vehicle at his/her own expense, where the customer failed to do so. The financier argued that it could recover its costs of repossessing vehicles on the basis that they were attributable to such supplies.

219. The tribunal held that the company did not make an independent, free-standing supply of a service to a customer in these circumstances. They said, at [55], that in reality the company was protecting its position and realising its security:

> "In reality, BCT was exercising a right arising on a breach of contract under the original HP agreement. In doing so it was protecting its position and not supplying a service to the customer. It is true that the primary obligation under the HP agreement, on termination, was for the customer to deliver the vehicle to BCT and that BCT's right to repossession arose only when the customer was in breach of that obligation (BCT having first elected to terminate the agreement as a result of the customer's earlier failure to pay the agreed instalments). However, in reality, BCT was simply realising its security (the recovery of possession of the vehicle to which BCT had legal title) in the context of and under the terms of the HP agreement and doing so for its benefit."

220. The tribunal considered that they should follow a similar approach to that used to determine whether there is a composite single supply or multiple supplies. At the end of the above passage they said that, borrowing the language of the CJEU in *Card Protection Plan Ltd v Customs and Excise Commissioners* Case C-349/96 at [30], the company's "action in repossessing the vehicle under the HP agreement could not be regarded as being, for the customer, "an aim in itself"". They noted that when applying the CJEU's judgment in *Card Protection Plan* in the House of Lords ([2001] STC 174) Lord Slynn said the following at [22]:

> "It is clear from the Court of Justice's judgment that the national court's task is to have regard to the 'essential features of the transaction' to see whether it is 'several distinct principal services' or a single service and that what from an economic point of view is in reality a single service should not be 'artificially split'. It seems that an overall view should be taken and over-zealous dissecting and analysis of particular clauses should be avoided."

221. At [57] they said that following the same approach in this case:

> "It seemed to us artificial to split the right of BCT to repossess a vehicle from the rest of the rights and obligations under the HP agreement in order to treat it as a separate supply. BCT's repossession rights were simply ancillary to its other rights and obligations under the HP agreement and arose on a breach of contract by the customer. Accordingly, we conclude that BCT did not make a separate supply of repossession services to its customers."

222. In the *Darlington Finance Ltd* case resales made by a financier did not fall within the de-supply provision on the basis that they were not in the same condition as when repossessed (as the financier did substantial work on them prior to sale). Similarly to the argument in this case, the financier said that it was nevertheless entitled to tax the supplies under the margin scheme. The tribunal rejected the argument that the purchase price for the purposes of the scheme was to be taken to be the price at which the financier originally bought the car from the dealer for the purpose of the HP transaction (in which case no margin in fact arose).

223. The tribunal said that given that the vehicles acquired from the dealer had already been subject to an onward supply of goods to the hirer, they did not see how it is possible for the finance company "to revert to the original acquisition price which it paid to the dealer.....this became exhausted as the relevant consideration on the onward supply of the vehicle as goods". The tribunal concluded that, as there was no consideration for any supply in any event, there was no need to decide whether there was otherwise a supply on the repossession. They noted simply that there was a transfer of the possession of the vehicle from the hirer to the finance company whether the termination was forced or voluntary. They said that if anything there was a supply of a services.

224. VWFS nevertheless submitted that this case supports its position, in particular, on the basis that it was expressly recognised that it was *only* on repossession that the taxpayer was entitled lawfully dispose of the car which thereby *created* the title to sell as owner. At [14] the tribunal noted that:

> "it is only the repossession which destroyed the former right of possession of the hirer and enabled the Appellant lawfully to dispose of the vehicle on the open market. Such repossession therefore created the title of the Appellant to sell the car as owner."

225. In my view this statement is no more than a recognition that it is only on termination that the finance company can sell the car unencumbered by the HP agreement. That does not of itself lead to a conclusion that there must be a supply of goods by the hirer in those circumstances nor do I understand the tribunal to be saying that is the case.

226. I cannot see any support for VWFS' position that there is consideration for a supply by the customer in this case by reference any of the cases it referred to:

(1) In *Park Hale Ltd v CCE* [2000] STC 2008 Moses J (as he then was) held that cash compensation paid by the government under a scheme for the surrender of guns was consideration for the supply of the guns by the owners.

(2) In *Astra Zeneca UK Limited* it was held, at [29] and [30], that there was a direct link between the provision of retail vouchers by Astra Zeneca to its employees and the cash remuneration which each employee had to give up in return for the vouchers which was specifically deducted from the cash fund otherwise allocated to the employee.

(3) In *Naturally Yours Cosmetics Ltd v Customs and Excise Commissioners* (C-230/8) [1988] STC 879, it was held that there was a direct link between the supply by the taxpayer of beauty products to beauty consultants at a substantially discounted price and the service the consultant provided in agreeing to use it as a "reward" to induce friends and acquaintances to host parties for the sale of the taxpayer's products. The court noted, in particular, that if the consultant failed to find a hostess, the consultant was required to return the product or pay the usual price.

(4) VWFS also referred to *Empire Stores Ltd v Customs and Excise Commissioners* (C-33/93) [1994] STC 623, brief details of which are set out below.

227. Those cases all relate to very different circumstances. I cannot see that the fact that there was held to be a "direct link" between the supply and what was argued to be provided as consideration in those cases informs the analysis required in the specific context of a financier recovering possession of a vehicle on termination of a HP transaction.

228. In my view, VWFS's analysis is out of kilter with the legal, commercial and economic reality of the termination of the HP transaction. The customer does not, on termination, surrender its rights to the hire of the car (with the option to purchase it) in return for being released from further sums otherwise due. As provided for in the contractual terms concluded at the start of the contractual relationship, those rights fall away on termination, whether that occurs because the customer no longer wishes to continue with the arrangement or because the customer is in breach of the terms. To put it another way, as the tribunal said in *British Credit*, the repossession or handing back of the vehicles on termination of the HP transaction is not an aim in itself which should be taxed separately.

229. I note that VWFS argued that the effect of article 14, in treating the customer as the owner of the goods, has to be taken into account in analysing the effect of these arrangements; of necessity VWFS cannot be regarded as making a supply of the vehicles on the resales unless it has received a supply of them from the customer as owner. VWFS also argued that to hold there is no such supply by the customer is contrary to the principle that each distinct transaction has to be taxed separately, as it considers is reflected in the case law which establishes that the HP transaction and the subsequent sale are to be taxed as separate transactions.

230. However, I can see no basis in article 14 itself (whichever part of that article applies to the HP transactions) (or elsewhere in the VAT regime) or in the cases to which VWFS referred that detract from the above analysis. In my view the way that the High Court and CJEU have approached HP and similar transactions in fact supports the conclusion that there is no customer supply on repossession which should be taxed separately.

231. As the courts have applied article 14, in combination with article 90, in this context, those rules provide a comprehensive scheme for taxing the entirety of a HP transaction as a supply of goods. In effect the full bundle of rights and obligations comprised within the HP transaction is taxed as a supply of goods. Accordingly, the change in those rights and obligations on an early termination is catered for by the application of article 90. It is clearly established that article 90 applies to recognise the resulting change to the payments due as a reduction for the consideration for the supply of goods taking place under the HP transaction. As VWFS itself recognised, at that point the supply of goods made in respect of the HP transaction is complete in the sense that its full value for VAT purposes has been determined.

232. VWFS' position that, on recovery of the vehicle by VWFS, there is a separate customer supply of the goods is entirely out of kilter with this approach. In effect VWFS' argument requires the unpicking of the bundle of the rights and obligations

comprising the HP transaction which article 14, in combination with article 90, taxes in its entirety as a supply of goods. It cannot be the case that the amounts which are taken into account as a reduction in the consideration for the HP supply on termination also serve as consideration for a separate supply by the customer to VWFS.

233. As noted, VWFS said that this criticism of its approach ignores the need for each separate transaction to be taxed separately for VAT purposes. However, VWFS has not provided any substantive foundation for the view that there is such a separate supply. I cannot see that there is any reason why it must follow from the fact that a HP transaction is taxed as a supply of goods that, in order for the underlying assets to be the subject of any further supply of goods, the customer/hirer who receives the HP supply must make an onward supply. Nor can I see that to hold that there is no customer supply on VWFS recovering possession of the vehicle somehow results in the HP transaction being improperly re-categorised retrospectively as a supply of services.

234. The effect of article 14 in this context, as VWFS fully accepts, is to tax the HP transaction itself definitively, once and for all, as a supply of goods. That treatment is not compromised or affected in any way by the fact that there is no supply of goods by the customer on VWFS recovering possession of the vehicle. Article 14 simply does not go beyond its stated remit according to its own terms of reference; it does nothing more than provide the means of taxing the HP transaction. Its function is fulfilled once, in combination with article 90, the taxable amount of the HP supply is determined. The fact that there are other provisions in the VAT regime which in a sense apply a fiscal fiction, such as the VAT group and TOGC provisions, adds nothing to the debate. The application of those rules in a wholly different context says nothing about how article 14 is to be interpreted.

235. In my view there is no imperative for there to be supply by a customer in these circumstances; the need for a supply appears simply to be driven by VWFS desire to benefit from the margin scheme. Moreover, for all the reasons set out below, I can see no support for the view that it is necessary for the margin scheme to apply to avoid double taxation.

*Ascertaining the profit margin if the margin scheme applies*

236. As I have decided that there is no customer supply, it is not necessary to decide what VWFS' profit margin is should the scheme apply. I have set out, however, a brief overview, should this be wrong (and as VWFS' stance on this is referenced in the discussion on whether the scheme should apply as a matter of principle (see [148] above).

237. VWFS's submitted that it is clear from *Sjelle Autogenbrug I/S v Skatteministeriet* (C-471/15) that it is for the national court to decide, in light of the national law, on the appropriate purchase price to be used for the purposes of the margin scheme where none is obviously ascertainable. The CJEU endorsed the view that practical difficulties in applying the margin scheme cannot justify exclusion from the scheme.

238. VWFS submitted that in this case there are a number of possibilities which the tribunal could adopt. These include taking as the price the monetary value of the sums collection of which is foregone on termination or using a wholly imputed price

calculated as a fixed percentage of the sales price or a proportionate calculation reflecting how far through the contract the customer is at termination. VWFS said, however, that such valuations do not fully reflect the embedded VAT and, therefore, using such a value would not meet the objective of the margin scheme of avoiding double taxation. For that reason, in its view, the best approach is to take as consideration for the supply the price the customer has actually paid under the finance agreement.

239. VWFS considered that there is support for this approach in the decision in *Empire Stores Ltd.* In that case the CJEU held, at [16], that there was a direct link between the supply of articles for no extra charge to existing and potential customers and the provision of an introductory service by the customers in agreeing themselves to purchase goods offered in the Empire stores' sales catalogue for the first time or for introducing others who did so. If the service was not provided no article was due from or supplied without extra charge by Empire Stores. The value of that supply of introductory services was equal to the price paid by *Empire Stores* for the goods. VWFS submitted that the court made clear, at [19], that it is the value placed on the consideration by the recipient of the consideration which drives the taxable amount. In effect in that case the supply was valued through the lens of the supplier by reference to the sum spent.

240. However, if, contrary to my view, the scheme does apply, I can see no reason why the purchase price should not be taken to be an amount equal to the sums which VWFS said is provided as consideration by VWFS in return for the supply of goods it argued is made by the customer to it (on the basis of which it said the scheme applies). I agree with HMRC's criticisms of VWFS' alternative approach.

241. HMRC said that VWFS's approach to valuation of the supply is contrived and unrealistic. The approach in *Empire Stores* is only permissible if no monetary value has been agreed between the parties; that is not the case if VWFS's analysis of the nature of the consideration is right, namely, that it is the release from sums otherwise due which constitutes consideration. If that is not consideration expressed in money, it is clearly closely analogous to monetary consideration; it is to be valued as the amount foregone by VWFS.

242. It is important, as the CJEU emphasised in *Empire Stores*, that the taxable amount of a supply is the consideration actually received and not a value estimated according to objective criteria. It is wholly unrealistic to regard the subjective value attached by either VWFS or the customer to the vehicle when VWFS recovers possession as equivalent to the amount paid by the customer under the finance agreement.

243. HMRC also noted that in *Empire Stores* the relevant goods were provided to the customer new and unused. In this case the cost of the goods to the seller (the customer) is not an appropriate value given that the vehicles have been in the customers' possession and use typically for a protracted period of time when it is argued the supply the customer makes takes place on repossession.

**Conclusion**

244. For all the reasons set out above, I have concluded that (1) the margin scheme does not apply to the resales and (2) VWFS is not entitled to rely on the de-supply

provision to give the result that the resales are neither supplies of goods nor services on the basis that the 2006 exclusion is unenforceable. The outcome is that VWFS is correctly required to account for VAT on the resales by reference to the sales proceeds received and the VAT refund claimed by VWFS in respect of the resales is not due.

245. The appeal is accordingly dismissed.

246. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

**HARRIET MORGAN**
**TRIBUNAL JUDGE**

**RELEASE DATE: 9 NOVEMBER 2018**