TC01401

Appeal number: LON/2008/2312

VAT – partial exemption special method – hire purchase transactions – taxable supplies of goods and exempt supplies of credit – whether a methodology attributing part of residual input tax to taxable supplies of goods is fair and reasonable – whether residual input tax is partly a cost component of taxable supplies of goods

FIRST-TIER TRIBUNAL

TAX

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

- and -

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

TRIBUNAL: JUDGE ROGER BERNER
MRS ELIZABETH BRIDGE (Member)

Sitting in public at 45 Bedford Square, London WC1 on 20 – 23 June 2011

Nicola Shaw and Michael Jones, instructed by KPMG LLP, for the Appellant

Owain Thomas, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents

DECISION

1. Volkswagen Financial Services (UK) Limited ("VWFS") appeals against an assessment to VAT in the sum of £498,866 for periods 10/07 to 3/08 issued by HMRC on 16 June 2008 and a decision letter dated 30 September 2008 by which, upon reconsideration of the assessment, HMRC upheld it.

2. The dispute between the parties concerns what is a fair and reasonable apportionment of residual input tax on costs incurred by VWFS in a particular sector of its business, the Retail sector, which is one of a number of sectors included in VWFS's approved partial exemption special method ("PESM"). Specifically, the dispute relates to the recovery of residual input tax in respect of hire purchase transactions which, it is accepted, involve both a taxable supply of the vehicle being financed, and an exempt supply of finance.

3. Whereas in relation to sectors of VWFS's business other than Retail the PESM operated in respect of residual input tax according to a formula taking the value of taxable transactions made by a particular sector in the relevant period as a proportion of the value of total transactions, no agreement could be reached on an appropriate formula for Retail. Instead, the issue was effectively postponed, to be subject to resolution of the dispute, by providing in the PESM that residual input tax was to be recoverable for the Retail sector:

> "to the extent that it is incurred on goods or services which are used to make taxable supplies, expressed as a proportion of the whole use or intended use."

4. This formulation does not of course answer the question how the proportion of use is to be ascertained. The parties put forward different methodologies for the Retail sector, which each claims is fair and reasonable. VWFS's preferred methodology is to quantify the ratio of taxable transactions to total transactions, counting every HP agreement as two transactions (one taxable, one exempt), every leasing transaction as two transactions (both taxable) and every fixed price service and maintenance contract as one (taxable) transaction. On this basis, 50% of the residual input tax referable to HP transactions is recoverable.

5. HMRC take a different approach. Their preferred method is to allocate input tax between HP transactions, leasing transactions and service and maintenance contracts on a contracts count basis and then to apportion the tax using the value of taxable and exempt outputs in each sub-sector. In relation to HP transactions, however, no account is taken of the value of the vehicle. This substantially eliminates the taxable value of the HP transactions, and results in most of the residual input tax apportioned to those transactions being irrecoverable.

6. Nicola Shaw and Michael Jones appeared for VWFS. Owain Thomas represented HMRC.

The facts

7. We had a helpful Agreed Statement of Facts, which we reproduce below. We also had witness statements from seven witnesses for VWFS: Graham Wheeler, managing director, David Maloney, business development director, Philip Wood, e-commerce director, David Heathfield, head of customer services and Norma Doherty, indirect tax accountant (all of whom also gave oral evidence and were subject to cross examination) and John Thirlwell, in-house solicitor and Robert Newbold, group finance director of the Vindis Group, a retailer of VW motor cars. For HMRC we had two witness statements from Jonathan Cannan, an indirect tax specialist with HMRC Large Business Service. We also had two bundles of documents.

Agreed statement of facts

8. We set out here the agreed statement of facts:

> 1. The Appellant is the representative member of the VWFS VAT group. The Appellant is a wholly owned subsidiary of Volkswagen Financial Services AG, which is ultimately owned by Volkswagen AG.
>
> 2. The Volkswagen AG Group owns a number of brands or marques of vehicle ("Group Brands"): these include Volkswagen Cars, Volkswagen Commercial Vehicles, Audi, SEAT and Skoda.
>
> 3. In the course of its business, the Appellant makes a number of taxable and exempt supplies. The Appellant is, therefore, a partially exempt trader.
>
> 4. The Appellant's business comprises a number of different sectors:
>
> (1) Retail – (i) entering into hire purchase ("HP") agreements with customers in respect of Group Brand vehicles; (ii) entering into leasing agreements with customers in respect of Group Brand vehicles; and (iii) fixed price service and maintenance contracts on Group Brand vehicles;
>
> (2) Wholesale – providing funding to dealers of Group Brand vehicles for the purchase of demonstrator vehicles and stock (new and used cars);
>
> (3) Volkswagen Insurance Services ("VIS") – the arrangement of insurance for owners of Group Brand vehicles and dealers of Group Brand vehicles;
>
> (4) Asset Backed Securitisation ("ABS") – servicing (and reporting on) securitised hire purchase contracts;
>
> (5) Contract Disposals – the disposal of previously leased and/or repossessed Group Brand vehicles; and
>
> (6) Catch All – miscellaneous items, such as the provisions of training programmes or the rental of signage to dealers of Group Brand vehicles.
>
> 5. In the course of its business, the Appellant incurs input tax, some of which is directly attributable to the making of either taxable or exempt

supplies and some of which is not directly attributable to the making of taxable or exempt supplies (ie is residual input tax).

6. The residual input tax in question relates to everyday overhead expenditure, such as: (i) temporary staff, staff training and recruitment; (ii) hotel accommodation, staff meals and drinks; (iii) travel, parking, road tolls and car hire, service and repairs; (iv) marketing and corporate hospitality; (v) IT maintenance and enhancement; (vi) heating, lighting, cleaning, security and other premises costs; (vii) furniture leasing; (viii) couriers, stationary, printing, photocopying and archiving; and (ix) legal, tax and accounting expenses.

7. On 11 September 1984 HMRC and the Finance Houses Association (now known as the FLA) agreed a partial exemption special method ("PESM") to establish the proportion of recoverable residual input tax incurred in relation to HP transactions. Pursuant to that agreement, the recoverable input tax in respect of HP transactions was as follows:

(a) all of the input tax incurred on the goods; plus

(b) 15% of the residual input tax.

8. On 4 August 2000, the Appellant agreed a PESM with HMRC in respect of its residual input tax. This PESM distinguished the HP part of the Appellant's business from the rest of its business. The recoverable proportion of the residual input tax allocated to the HP part of the business was restricted to 15% in accordance with an agreement between HMRC and the FLA and an additional 5.4% was allowed to reflect services provided to the Asset Backed Securitisation sector. The recoverable proportion of the remainder of the residual input tax was established by a values-based formula similar to the standard method, namely by reference to the ratio of taxable income to total income.

9. At some point in 2000, the FLA withdrew from the agreement of 11 September 1984.

10. Following a number of meetings between the parties to discuss updating the agreed PESM, on 2 February 2007, the Appellant wrote to HMRC to suggest a new PESM ("the New PESM") which apportions the residual input tax between sectors (1)-(5) above in proportion to the turnover of each sector and then applies the following methodologies to quantify the recoverable input tax for each sector:

(i) for Retail, the proportion of recoverable input tax is quantified by reference to the total number of taxable transactions to total transactions; and

(ii) for Wholesale, VIS, ABS and Contract Disposal, the proportion of recoverable residual input tax is quantified by reference to the ratio of taxable income to total income in the sector;

11. HMRC approved the New PESM suggested by the Appellant except in relation to the methodology proposed for Retail. In addition, HMRC suggested a Catch All sector where the proportion of recoverable residual input tax is quantified by reference to the extent to which it is incurred on goods and services used to make taxable supplies, expressed as a proportion of the whole use or intended use.

12. To enable the New PESM to operate pending the resolution of the dispute as to the appropriate method for Retail, the parties agreed to apply the same wording as for the Catch All sector, namely "input tax allocated to this sector is deductible to the extent that it is incurred on goods or services which are used or to be used to make taxable supplies, expressed as a proportion of the whole use or intended use".

13. The agreement of the New PESM is recorded in a letter of HMRC dated 6 December 2007.

14. The New PESM has been applied with effect from 1 October 2007. For VAT periods 10/07 to 07/08 the Appellant applied its preferred method to Retail and HMRC raised assessments based on its preferred method. The Appellant appealed against those assessments.

15. From VAT period 10/08 onwards, the Appellant has applied HMRC's preferred method to Retail and has submitted voluntary disclosures for under-claimed input tax. HMRC has rejected those voluntary disclosures and the Appellant has appealed against those rejections.

16. HMRC's preferred method for Retail is to allocate input tax between HP transactions, leasing transactions and service and maintenance on a contracts count basis and then to apportion the tax using the value of taxable and exempt outputs in each sub-sector. In relation to HP transactions, however, no account is taken of the value of the vehicle.

17. The Appellant's preferred method for Retail is to quantify the ratio of taxable transactions to total transactions, where every HP agreement is counted as two transactions (one taxable, one exempt), every leasing agreement is counted as two transactions (both taxable) and every fixed price service and maintenance contract is counted as one transaction (taxable).

Further findings of fact

9. From the evidence and from the documents produced to us we find the following further facts.

10. The retail sector of VWFS's business offers three types of what are termed "purchase products" to both businesses and individuals. Although they have different descriptions: hire purchase, "Solutions" and lease purchase, they all comprise types of hire purchase contracts that are the subject of the disputed element of the PESM.

11. In respect of each of the purchase products VWFS purchases the vehicle from the retailer and supplies it to the customer on deferred payment terms under an HP agreement. Under the HP contracts title to the vehicle does not pass to the customer until all payments due under the terms of the agreement have been paid. This business is fully regulated, including under the Consumer Credit Act 1974. VWFS is deemed to be the supplier of the vehicle under the HP agreement and as such a number of terms are implied by law into the HP agreement for the protection of the customer, including a condition that the vehicle is of satisfactory quality. Although

VWFS would nevertheless have its own recourse to the retailer in this respect, this liability has the effect that the service provided by VWFS is not limited to the provision of funding, but extends to the provision of support in terms of the vehicle itself, such as dealing with complaints regarding quality.

12. The three types of purchase product may be described as follows:

(1) *Hire purchase*. This is essentially a conventional HP agreement under which the customer pays a deposit and the balance is paid off by monthly payments divided equally over the term of the contract. On payment of the final instalment and an option to purchase fee, title passes to the customer.

(2) *Solutions*. This is essentially a personal contract plan under which a proportion of the cost of the vehicle is deferred until the end of the contract. A small sum is initially paid up front and then low monthly payments are made throughout the term of the contract, with a final "balloon" payment at the end. This final payment represents a significant proportion (which could be anything up to 90%) of the total value of the vehicle. When the contract reaches maturity (that is, when the final balloon payment is due to be paid), the customer has four options:

(a) pay the balloon payment and a small "option to purchase" fee to take title to the vehicle;

(b) return the vehicle to Volkswagen without any further payment;

(c) part-exchange the vehicle with Volkswagen and begin a new finance agreement in respect of another vehicle; or

(d) re-finance the balloon payment so that the customer can retain the car but further spread the cost.

(3) *Lease purchase*. This product was designed for business customers who want the option of owning a fleet of vehicles at the end of the finance term. The customer chooses the repayment schedule (which can be anything from one to four years) and a part of the cost of the vehicles is delayed until a balloon payment at the end of the agreement.

13. We were shown copies of typical HP agreements regulated by the Consumer Credit Act 1974. Such an agreement sets out the cash price of the vehicle, which is equal to the price paid by VWFS to the retailer, with no mark up. From this there is deducted any advance payment (such as a deposit), leaving an amount of credit to be financed over the relevant period. The total amount payable (which includes the advance payment) is specified, along with details of the monthly and other payments to be made. The difference between the cash price and the total amount payable is the total charge for credit, which is broken down in the agreement between interest charges, and acceptance fee and an option to purchase fee. The option to purchase fee and the acceptance fee are set at market rates.

14. The market or advertised rate of interest is determined by VWFS. It does this by applying a margin for overheads, a profit margin and an allowance for bad debts to its own cost of financing the vehicle. However, the VW brands use a range of incentives

to make their cars more attractive to consumers, including discounts and free specification upgrades. The incentives also extend to the finance options, including offers of low or zero rate finance and low deposit requirements. If the VWFS market rate is higher than the VW brands wish to offer to their customers, the brands can subsidise the difference by making subvention payments to VWFS. The brands pay the difference to VWFS up front out of their marketing budgets. The commercial risk of these incentives is therefore borne by the VW brands.

15. From the evidence we find that the overheads that are the subject of this appeal are built into the interest rate, the option to purchase fee and the acceptance fee. There is no separate fee charged to cover overheads. Overheads do not form part of the cash price for the vehicle, as that merely reflects the price paid by VWFS to the retailer.

16. We accept that the primary purpose of VWFS's finance packages is to aid the sale of Volkswagen brand cars. VWFS is an in-house finance arm that does not provide any finance other than in respect of VW brands. We also accept that the availability of finance packages forms an integral element to the sales of cars to consumers, by the VW brands and by the retailers. This is supported by VWFS in a number of ways, including by training of retailers' sales forces, and the use of an e-Learning system that retailers can access as part of the marketing and sale of VW brand vehicles. No separate charge is made by VWFS to VW brands or to the dealerships for its involvement and support of marketing campaigns, although some charges, principally for accommodation and out-of-pocket expenses, may be made for participation in e-Learning. In general the cost is amortised across VWFS's whole operating budget.

17. We heard, and we accept, that these systems, which VWFS has designed and implemented, are designed for the following purposes:

(a) to train, monitor and incentivise the retailer's sales force;

(b) to enable the retailer to configure a vehicle for his customer and to provide a series of quotes based on the different purchase products offered by VWFS (namely, hire purchase, Solutions and lease purchase); and

(c) to allow the retailer to prepare and submit a proposal to VWFS once the customer has selected a particular vehicle and finance package and, once the proposal has been accepted, to print out the customer agreement in the showroom

18. However, we also find that those sales activities, although supported by VWFS, are carried on by separate businesses to that which is the subject of this appeal. The same applies to the collection of data to encourage customer retention. Those separate businesses, even within the VW group, are not part of the same VAT registration as VWFS.

19. The involvement of VWFS in the sale of vehicles is limited to those cases where VWFS provides the finance. VWFS is not a car dealership, and does not sell cars for

cash. VWFS only acquires the vehicle as part of the financing arrangements, at a time when a customer has agreed to buy the car on those terms from the dealer.

20. The VWFS business is organised into eight departments. The following is a brief description of the functions and processes undertaken by each of them;

(1) *Treasury department*. VWFS's own funding requirements (that is, in respect of the funding of the vehicle from the dealer and the supply of credit to the customer) are met by a combination of internal borrowings (that is, from other VW group companies), external borrowings and from securitisation activities. Securitisation activities relate solely to the funding of the retail HP business.

(2) *Marketing and development department*. This department works very closely with the VW brands to develop joint marketing campaigns. VWFS's own external marketing budget is relatively low on account of the fact that the VW brands bear most of the cost, and reliance is placed on the existing dealer network. The external budget is reserved for the development of point-of-sale marketing materials for dealers and for direct marketing campaigns to existing customers. The hire purchase options are an integral part of the dealers' sales processes. Because the "route to market" for VWFS is through the VW brands dealership network, the marketing department focus is not primarily on the end consumer, but is on the VW brands and the dealerships. However, direct marketing to customers is also an important element: VWFS retains contact with the customer after the sale of the vehicle (for example, by collecting monthly payments or dealing with customer enquiries and complaints) and consequently collects and retains an extensive amount of information on its customers.

(3) *Sales department*. This department, through its business development managers, works with the retailers. This includes provision of training to the retailers' staffs in the use of the VWFS purchase products. The department is also responsible for defining the funding terms with a retailer. The funding terms include the basic rate of interest that the retailer can offer the customer and the level of retailer bonuses and commissions. There is some degree of flexibility with respect to price and funding structures that may be offered. The performance of the retailer is monitored and the bonuses and commissions paid by VWFS are administered accordingly.

(4) *New business department*. This department sets up the new contracts with customers. Once the retailer has agreed with the customer the specifications of the vehicle and the terms of the finance, he uses VWFS's web-based system (Connect Online) to apply for a credit agreement on behalf of the customer. Based on credit checks made through the system, an application may be "auto approved". If it is not so approved, VWFS staff will make the underwriting decision whether to approve or decline the application. Following signing of the agreement, VWFS checks, through an HPI registration check, that no other person has an interest in the vehicle; this is to ensure that the vehicle provides reasonable security for the financing. Following checking, VWFS purchases the vehicle from the retailer and enters into the HP agreement with the customer.

(5) *Customer services department.* This department is responsible for liaising with the customers and providing services to them during the currency of the contract with VWFS. This includes dealing with customer complaints. The department receives a significant number of telephone enquiries each month. These relate primarily to (i) early settlement of the contract, (ii) voluntary termination, (iii) processes, in particular balloon payments and part exchange and other options on solutions and lease purchase contracts, relating to the end of a contract, (iv) making payments, (v) clearance that VWFS no longer has an interest in the vehicle, (vi) data changes, such as change of address, and (vii) complaints about the service or the car.

Complaints about the quality of the vehicle are also received in writing. As VWFS is the supplier under the finance contract customers are entitled to make complaints about the quality of the vehicle direct to VWFS. However, complaints are generally passed on to VW brands or to the retailer, who typically bear the cost if a complaint is valid, although we heard, and we accept, that in practice VWFS bears an equal proportion of cost in certain cases.

(6) *Risk department.* This deals with cases where a customer falls into arrears, including, in appropriate cases, repossession of the vehicle. If a vehicle is repossessed it is taken by an agent of VWFS to an auction house for resale. The department is also responsible for setting the residual value of the vehicle in order to protect VWFS's asset, and for setting the amount of the balloon payment on an applicable contract.

(7) *Finance department.* This department comprises Tax, Shareholder Reporting, Controls (responsible for forecasting and budgeting) and Finance Operations. Its activities cover the traditional transaction processing activities of sales and purchase ledger, financial accounting, cash processing and controls. The work includes the processing of bank collection runs to receive money from retail customers and cash from the sale of vehicle disposals, the payment of suppliers and the payment of retailers for vehicles.

(8) *IT department.* This department is responsible for building, maintaining and developing all the IT systems used by VWFS across its business. This includes the bespoke Contract Management Systems (incorporating Finance Online and Connect Online), and other non-bespoke systems. It is also responsible for the maintenance and development of the web-based browser applications and the daily running of the desk top PCs within VWFS, working closely with other departments. Retailers have direct contact with the IT department if they have problems accessing or using the web-based platforms.

VWFS accounts

21. We were shown the accounts of VWFS for the year ended 31 December 2007, which were representative of accounting entries made for the relevant periods.

22. In the directors' report the principal activities of the company were described thus:

> "The principal activity of the company is the provision of retail, business user and fleet finance to the customers of the Volkswagen Group United Kingdom Limited franchised dealer networks. In addition to this the company provides various insurance and service and maintenance products, along with business development activities to the retailer networks."

23. The same report notes that in 2005 the company had undertaken a strategic review and had subsequently chosen to strengthen its position as an automotive captive finance supplier to the VW group brands. Closer relationships had been developed with the VW group to achieve common goals.

24. The notes to the accounts, in the description of principal accounting policies, describe the use of lessor accounting for finance leased assets, including hire purchase and lease purchase. Interest income is included in turnover. However, turnover does not include that part of the payments under the hire purchase and lease purchase contracts that relates to the purchase price of the vehicle. Only the finance charge is included in turnover.

The agreed PESM

25. The PESM divides the business into six sectors (Retail, Wholesale, Volkswagen Insurance Services, Asset Backed Securitisation, Contract Disposal and "Catch All"). The first stage for the attribution of input tax ignores the division into sectors. It is to identify all supplies, acquisitions and imports used, or to be used, exclusively in making taxable supplies; the input tax thereon is recoverable. The same process is performed in relation to exempt supplies or activities other than the making of taxable supplies; that input tax is not recoverable. Input tax which cannot be directly attributed in this way is dealt with as follows:

> (a) First, all supplies etc which are used, or to be used, exclusively within a single sector are identified; the input tax thereon is allocated in full to that sector.
>
> (b) For input tax which cannot be directly attributed or allocated in full to a single sector, a proportion of the residual input tax is allocated to each of the sectors and the corresponding recovery rate is then ascertained by applying the appropriate methodology. This allocation is done on a value basis: the input tax is allocated between the sectors in the same ratio as the value of supplies made by each sector bears to the total value of supplies made by all the sectors. However, in making these apportionments the value of vehicles sold on under hire purchase agreements is excluded.

26. For each of the sectors other than Retail and Catch All, the recoverable input tax is ascertained by applying a formula to the residual input tax apportioned to that sector. In each case the formula compares the value of taxable transactions in the sector with the value of total transactions for the relevant period. For each of Retail and Catch All, non-attributable input tax allocated to the sector is deductible to the extent that it is incurred on goods and services which are used or to be used to make taxable supplies, expressed as a proportion of the whole use or intended use.

Retail sector: VWFS methodology

27. The starting point for the methodology put forward by VWFS as fair and reasonable in relation to the Retail sector is that within the Retail sector there are both taxable and exempt supplies. The supplies in relation to contract hire and service contracts are taxable. But in relation to hire purchase transactions there is no single supply; the sale of the car is a taxable supply, and the provision of finance is an exempt supply. The VWFS methodology accordingly identifies these supplies and weights each transaction within the sector with the aim of ensuring that the computation accurately reflects the extent to which the various transactions use the overheads to which the residual input tax relates.

28. On this basis the VWFS methodology proposes that hire purchase transactions are treated as two transactions (one taxable, one exempt). Contract hire transactions are taxable transactions, but the method proposes that they be given an equal weighting to hire purchase transactions on the basis that they consume the same amount of overheads as those transactions; contract hire transactions are accordingly also given a weighting of two (both taxable). Service contracts are not regarded as using as much of the overhead cost, and so are counted as one (taxable) transaction.

29. A simple calculation is then made by applying to the residual input tax allocated to the Retail sector the proportion which the number of taxable transactions (calculated according to the weighting given) bears to the total number of transactions (so calculated). The number of transactions is not related to the number of contracts, but to the payments, usually monthly, made under those contracts.

HMRC methodology

30. HMRC's methodology applies a transaction-count basis to apportion the residual input tax attributable to the Retail sector between the three activities of contract hire, hire purchase and service contracts. Each deal is treated as one transaction, not weighted in the manner of the VWFS methodology, which has the effect that an equal amount of input tax is allocated to each.

31. Each amount of input tax so allocated is then apportioned between taxable and exempt supplies based on the value of those supplies, but excluding the value of the initial supply of the vehicle under a hire purchase contract. Despite the value of this initial supply being excluded (with the result that the value of the hire purchase transaction will largely be attributable to the exempt supply of finance), some of the residual input tax allocated to hire purchase contracts is recoverable because recovery is given against the other taxable supplies made under such contracts, such as settlement charges and option to purchase fees.

The law

32. Article 2 of the First Council Directive of 11 April 1967 (67/227/EEC) ("the First Directive") provides as follows:

> "The principle of the common system of value added tax involves the application to goods and services of a general tax on consumption exactly proportional to the price of the goods and services, whatever the number of transactions which take place in the production and distribution process before the stage at which tax is charged.
>
> On each transaction, value added tax, 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 value added tax borne directly by the various cost components.
>
> The common system of value added tax shall be applied up to and including the retail trade stage."

33. Articles 167 to 177 of EU Council Directive of 28 November 2006 (2006/112/EC) ("the Principal VAT Directive") provide for the deduction of input tax in so far as it is used in the making of taxable supplies. Article 173 provides:

> "In the case of goods and services used by a taxable person both for [taxable and exempt transactions], only such proportion of the value added tax as is attributable to [taxable] transactions shall be deductible."

34. Articles 173 to 175 establish the method by which the deductible proportion is to be determined. The standard method (in Article 173(1)) is that the deductible proportion is equivalent to the ratio of taxable turnover to total turnover. However, Member States are permitted to derogate from the standard method and can authorise alternative methods of establishing the deductible proportion including on a sector by sector basis (Article 173(2)(a)) or a "use method" basis (Article 173(2)(c)).

35. The right to deduct input tax is implemented in UK law by s 26 VATA. That provides that the amount of credit for input tax is that which is allowable under regulations as attributable to, relevantly, taxable supplies made by a taxable person in the course or furtherance of his business. Section 26(3) provides for HMRC to make regulations for securing a fair and reasonable attribution of input tax to taxable supplies.

36. The method for establishing the fair and reasonable attribution of input tax to taxable supplies and, in a case where goods and services are used for both taxable and exempt supplies, a fair and reasonable proportion of input tax attributable to taxable supplies, is prescribed by regulations 101 and 102 of the Value Added Tax Regulations 1995 (SI 1995/2518) So far as material, regulation 101 provides:

> "(1) … the amount of input tax which a taxable person shall be entitled to deduct provisionally shall be that amount which is attributable to taxable supplies in accordance with this regulation.
>
> (2) … in respect of each prescribed accounting period—
>
> …
>
> (b) there shall be attributed to taxable supplies the whole of the input tax on such of those goods or services as are used or to be used by him exclusively in making taxable supplies,

(c) no part of the input tax on such of those goods or services as are used or to be used by him exclusively in making exempt supplies, or in carrying on any activity other than the making of taxable supplies, shall be attributed to taxable supplies,

(d) … there shall be attributed to taxable supplies such proportion of the residual input tax as bears the same ratio to the total of such input tax as the value of taxable supplies made by him bears to the value of all supplies made by him in the period,

(e) the attribution required by subparagraph (d) above may be made on the basis of the extent to which the goods or services are used or to be used by him in making taxable supplies, …"

37. Regulation 102 provides for the approval or direction by HMRC of a method other than that specified in regulation 101. Approval was given to the special method of VWFS that is the subject of this appeal.

Discussion

38. The dispute in this case is on the methodology which VWFS has adopted, and wishes to adopt, under its special method, in determining a fair and reasonable proportion of the input tax it incurs on its overhead expenses which is attributable to the taxable supplies it makes in the supplies of vehicles under HP agreements, and should consequently be recoverable.

39. We have described earlier the method which VWFS proposes to achieve such an attribution. It does not look to the value of the respective taxable and exempt supplies; it is common ground that such a values-based method would not give a fair and reasonable result. Instead it adopts a transaction count method, giving equal weight in an HP transaction to the taxable supply of the vehicle and the exempt supply of the finance. Thus, VWFS's method provides for 50% of that part of the overheads input tax that is apportioned to HP transactions to be recovered.

40. HMRC dispute that this method is fair and reasonable. They do so on the basis that this is contrary to their published policy (and, as argued before us, contrary to fundamental principles of VAT law). HMRC's policy – which is now expressed in Revenue & Customs Brief 82/09 - allows recovery of input tax allocated to HP transactions in respect of taxable supplies such as the option to purchase fee, but not to allow recovery in respect of the supply of HP goods (the vehicles in this case) that are resold at cost without any margin to cover overhead costs. As Business Brief 82/09 describes it, as there is no margin on the HP goods, the cost of the overheads will normally be built into the price of the supply of credit. HMRC's view is that the overheads in these circumstances are purely cost components of the exempt supply. They point to the fact that, if recovery is otherwise enjoyed, a business would continually enjoy net VAT refunds despite charging a total consideration under the HP agreement that fully recovers its costs and an element of profit. HMRC say that their method reflects this policy.

41. That is the full extent of the dispute. Other aspects of what amounts to a fair and reasonable attribution, such as ease of audit and operation, are not at issue. Nor,

although the Tribunal itself asked for clarification, is the 50/50 weighting that VWFS proposes as between the taxable supplies of the vehicle and the exempt supplies of finance under the HP agreements. The evidence of Mr Cannan for HMRC shows that the weighting is accepted as realistic; indeed he concedes that it may be more realistic than that adopted by HMRC's method. The dispute is not on the weighting, but on whether any part of the residual input tax should be attributed at all to the taxable supply of the vehicle.

42. At its essence the dispute is on whether any part of the overhead costs with which this appeal is concerned represent cost components of the supply of the vehicles under the HP agreements. That must be considered against the background of the clear fact, which we have found, that overhead costs are built into the price (namely the interest charge) for the supply of credit, and fees, such as the acceptance fees and the option to purchase fees, and are not factored into the cash price of the sale by VWFS of the vehicles, for which there is no mark up on the price paid by VWFS to the retailer.

43. It is convenient at this stage for us to address, if only to dismiss as immaterial to our decision, a dispute that arose between the parties as to the effect of the Consumer Credit (Agreements) Regulations 1983 ("the Agreements Regulations"). The difference arose in relation to the meaning of "cash price" in relation to goods sold under HP agreements as defined by reg 1(2) of the Agreements Regulations. It is that cash price that must be included in the agreement by virtue of para 4, column (2) in Schedule 1 to the Agreements Regulations. VWFS say that the cash price is the price at which its customer could buy the vehicle for cash from the dealer, and accordingly the price at which VWFS purchases the vehicle from the dealer. This, it is submitted, means that, because the cash price must be stated on the face of the agreement, it is a determined amount, and it is not open to VWFS to apply a mark-up and insert a higher cash price into the agreement.

44. Furthermore, it is said, any additional amount that VWFS might attempt to charge in excess of the cash price would be treated as a charge for credit. This is the effect of the Consumer Credit (Total Charge for Credit) Regulations 1980, which by virtue of reg 4(b) includes in the total charge for credit (in addition to interest) other charges (apart from excluded items) payable under the transaction by the debtor or a relative of his, whether to the creditor or any other person.

45. Regulation 1(2) of the Agreements Regulations provides:

> " 'cash price' in relation to any goods, services, land or other things means the price or charge at which the goods, services, land or other things may be purchased by, or supplied to, the debtor for cash"

46. Mr Thomas argued that this definition of cash price did not have the effect that VWFS were precluded from selling the vehicle under the HP agreement at a profit. He submitted that VWFS was free to insert in the agreement the price at which VWFS itself was prepared to sell the vehicle to the debtor, and that this could be a price greater than that paid by VWFS to the dealer. He argued that this followed from the fact that "debtor" was itself defined by s 189 of the Consumer Credit Act 1974 as the individual receiving credit; the debtor was the debtor of VWFS and not of the dealer.

47. As we have indicated, we do not consider the resolution of this issue as material to our decision. Whatever reason there might be for the fact that the vehicle is supplied under the HP agreement at its cost to VWFS, whether that be due to regulation or commercial decision, what we have to consider is the nature of the actual supply, not the reason why it has its particular characteristics. However, as the issue was raised, we ourselves consider VWFS's analysis to be the correct one. In our view the rationale for requiring the cash price to be restricted is to ensure that the total cost for credit is properly identified. If a mark-up from the dealer price were to be permitted, this would distort the charge for credit, and render the regulations in that respect ineffective. We do not consider that the fact that the customer is the debtor of VWFS is relevant; that merely identifies the person whose position in relation to the cash acquisition must be considered. Where a dealer arranges a sale to that person through hire purchase arrangements which involve a sale of the vehicle to the finance company, and the on-sale on finance terms to that person, we are satisfied that the agreement cannot provide for any price other than that paid by the finance company to the dealer. Any other amount charged in that respect must be included in the total charge for credit.

48. We turn now to the authorities on the question of input tax recovery. We start with common ground. The right to deduct arises only in respect of goods and services which have a direct and immediate link with taxable transactions. This follows from the ECJ decision in *BLP Group plc v Customs and Excise Commissioners* (Case C-4/94) [1995] STC 424. In that case BLP, a holding management company, disposed of certain shares it held in a German subsidiary. It sought to deduct input tax incurred on professional services in connection with the share sale. BLP claimed a deduction on the basis that, although the share sale was an exempt transaction, the purpose of the sale was to pay off debts that had arisen directly from its taxable transactions. The Court of Justice held that there was no entitlement to deduct input tax on services used for an exempt transaction, even if the ultimate purpose of the transaction was the carrying out of a taxable transaction.

49. *BLP* thus makes clear that the intention of the taxable person is not material. The test of linkage to taxable transactions is an objective one. Regard must be had to the objective character of the transaction in question (*BLP*, para 24). Whilst in BLP's case the professional services could have represented cost components of the underlying taxable transactions if finance had been raised other than by means of an exempt transaction, that was simply a consequence of the choice that a trader could exercise between exempt and taxable transactions (paras 25-26).

50. What we must consider therefore are the objective characteristics of the HP transactions in issue in this appeal. We do not therefore consider that the purpose of VWFS in increasing sales of VW brand cars can play any part in this analysis. Those sales are not by VWFS, but by other traders, either connected to VWFS but not part of its VAT registration, or unconnected. VWFS does, however, make its own supplies of vehicles as part of the HP transactions, and it is those transactions that we must objectively consider.

51. For the same reason, and as we have already said, we do not consider that the reason why the vehicles are sold at cost price under the HP agreements is material. Whether there are regulatory constraints, or simply commercial reasons, those are only examples of the range of factors to which the ECJ referred in *BLP* (at para 26) as influencing the trader's choice of taxable or exempt transactions. What matters is the result of that choice, in terms of the transactions actually carried out, not the reason for it.

52. The requirement for a direct and immediate link with taxable transactions presupposes that the expenditure incurred is part of the cost components of the taxable transaction. But in cases where there is no direct and immediate link, but the cost components of the services in question form part of the taxable person's overheads, those are as such cost components of the products of the business as a whole. In *Abbey National plc v Customs and Excise Commissioners* (Case C-408/98) [2001] STC 297, there was a sale of certain leasehold interests on which the rent was chargeable to VAT. The sale itself was, however, not subject to VAT as it constituted a transfer as a going concern. The company sought to deduct the professional fees incurred in connection with the transfer. Having found that the services did not have a direct and immediate link with transactions giving rise to the right to deduct, the Court went on (at para 35):

> "However, the costs of those services form part of the taxable person's overheads, and as such are cost components of the products of a business. Even in the case of a transfer of a totality of assets, where the taxable person no longer effects transactions after using those services, their costs must be regarded as part of the economic activity of the business as a whole before the transfer. Any other interpretation of art 17 of the Sixth Directive would be contrary to the principle that the VAT system must be completely neutral as regards the tax burden on all the economic activities of a business provided that they are themselves subject to VAT, and would make the economic operator liable to pay VAT in the context of his economic activity without giving him the possibility of deducting it (see, to that effect, *Gabalfrisa SL and ors v Agencia Estatal de Administración Tributaria* (*AEAT*) (Joined Cases C-110/98 to C-147/98) [2000] ECR I-1577, para 45)."

53. There is thus a distinction between the direct and immediate link with particular output transactions in the sense of *BLP*, and costs which are part of general costs and which accordingly have a direct and immediate link with the taxable person's business as a whole. In that case the right to deduct depends on the nature of the supplies made in the business as a whole. In *Midland Bank plc v Customs and Excise Commissioners* (Case C-98/98) [2000] STC 501, the bank incurred legal fees in a dispute concerning a proposed takeover by one of the bank's clients. The bank claimed that the input tax was deductible as attributable to its supply of taxable services to its client. The commissioners took the view that the input tax was also attributable to the bank's business generally, and as the bank made both taxable and exempt supplies, only a proportion of the input tax should be deductible. The Court said (at paras 29 - 31):

> "29. It should be borne in mind that, according to the fundamental principle which underlies the VAT system, and which follows from art 2 of the First and Sixth Directives, VAT applies to each transaction by way of production or distribution after deduction of the VAT directly borne by the various cost components (see, to this effect, *BP Supergas Anonimos Etairia Geniki Emporiki-Viomichaniki kai Antiprossopeion v Greece* (Case C-62/93) [1995] STC 805 at 821, [1995] ECR I-1883 at 1913, para 16).
>
> 30. It follows from that principle as well as from the rule enshrined in the judgment of *BLP Group plc v Customs and Excise Comrs* (Case C-4/94) [1995] STC 424 at 437, [1995] ECR I-983 at 1009, para 19 according to which, in order to give rise to the right to deduct, the goods or services acquired must have a direct and immediate link with the taxable transactions, that the right to deduct the VAT charged on such goods or services presupposes that the expenditure incurred in obtaining them was part of the cost components of the taxable transactions. Such expenditure must therefore be part of the costs of the output transactions which utilise the goods and services acquired. That is why those cost components must generally have arisen before the taxable person carried out the taxable transactions to which they relate.
>
> 31. It follows that, contrary to what the Midland claims, there is in general no direct and immediate link in the sense intended in *BLP Group*, between an output transaction and services used by a taxable person as a consequence of and following completion of the said transaction. Although the expenditure incurred in order to obtain the aforementioned services is the consequence of the output transaction, the fact remains that it is not generally part of the cost components of the output transaction, which art 2 of the First Directive none the less requires. Such services do not therefore have any direct and immediate link with the output transaction. On the other hand, the costs of those services are part of the taxable person's general costs and are, as such, components of the price of an undertaking's products. Such services therefore do have a direct and immediate link with the taxable person's business as a whole, so that the right to deduct VAT falls within art 17(5) of the Sixth Directive and the VAT is, according to that provision, deductible only in part."

54. This link with the whole economic activity of the taxable person, and the apparent exception to the ordinary rule of a direct and immediate link to a particular transaction, was considered by Carnwath LJ in *Mayflower Theatre Trust Ltd v Revenue and Customs Commissioners* [2007] STC 880. He concluded that this was justified by the need to ensure that the VAT system is completely neutral (see [28]). Lord Justice Carnwath referred to *BLP* and *Abbey*, and then (at [29]) to *Kretztechnik AG v Finanzamt Linz* (Case C-465/03) [2005] STC 118. He said:

> "… In that case it was decided that a share issue leading to a listing was not a 'supply' for VAT purposes. The question then arose whether VAT paid on services received in connection with the issue was deductible. It was argued for the company (supported by the UK Government) that those inputs could be regarded as 'part of the

overheads of the company' and thus 'components of the price of the products marketed by it' (see para 32 of the judgment). The Court of Justice accepted this argument:

'34. The deduction system is meant to relieve the trader entirely of the burden of the VAT payable or paid in the course of all his economic activities. The common system of VAT consequently ensures complete neutrality of taxation of all economic activities, whatever their purpose or results, provided that they are themselves subject in principle to VAT …

35. It is clear from the last-mentioned condition that, for VAT to be deductible, the input transactions must have a direct and immediate link with the output transactions giving rise to a right of deduction. Thus, the right to deduct VAT charged on the acquisition of input goods or services presupposes that the expenditure incurred in acquiring them was a component of the cost of the output transactions that gave rise to the right to deduct …

36. In this case, in view of the fact that, first, a share issue is an operation not falling within the scope of the Sixth Directive and, second, that operation was carried out by Kretztechnik in order to increase its capital for the benefit of its economic activity in general, it must be considered that the costs of the supplies acquired by that company in connection with the operation concerned form *part of its overheads* and are therefore, as such, component parts of the price of its products. Those supplies have *a direct and immediate link with the whole economic activity* of the taxable person [emphasis added] …' "

55. A similar conclusion can be drawn from *Cibo Participations SA v Directeur regional des impost du Nord-Pas-de-Calais* (C-16/00) [2002] STC 460, to which Carnwath LJ also referred. There is a clear contrast between the normal *BLP* rule and the special rule for overheads. The ECJ held there that expenditure on services purchased by a holding company in connection with its acquisition of a shareholding in a subsidiary did not have a direct and immediate link with any output transaction in respect of which VAT was deductible. The amount of the VAT paid on that expenditure did not directly burden the various cost components of those output transactions. Nevertheless, the costs were part of the taxable person's general costs and were, as such, cost components of an undertaking's products (*Cibo*, judgment, paras 32-33; cited in *Mayflower Theatre*, at [31]).

56. In *Mayflower Theatre* itself, it was held that the case was not about overheads, but about specific attribution of costs to particular supplies. The special treatment of overheads (or, an alternative description, "general costs") serves only a particular and limited purpose in the VAT system, for those inputs which would not otherwise be brought within the calculation, and should not be extended beyond that purpose (see [33]).

57. The references to cost components flow from article 2 of the First Directive, and are repeated in the cases to which we have referred. We see also reference, in para 31 of *Midland Bank* and para 36 of *Kretztechnik*, to the components of the *price* of an undertaking's products. Mr Thomas argued that in relation to the HP transactions the

overheads are used economically for the supply of credit and not the supply of goods (the vehicles) since they do not form a component of the price of the goods. He relied in particular on the fact that the overheads are reflected solely in the charge for credit and in the fees (acceptance and option to purchase), and not in the price at which VWFS supplies the vehicle.

58. Mr Thomas referred us to *Rompelman v Minister van Financiën* [1985] ECR 655 where at para 16 the ECJ said:

> " … a basic element of the VAT system is that VAT is chargeable on each transaction only after deduction of the amount of VAT borne directly by the cost of the various components of the price of the goods and services …"

Mr Thomas also referred us to the French text:

> "… qui a grevé directement le coût divers éléments constitutifs du prix …"

59. Mr Thomas likewise took us to the French text of paragraph 21 of *Midland Bank* (which in the English version refers to Article 2 of the First Directive, and to "cost components of a taxable transaction being capable of being deducted") and of paragraph 30, which likewise refers to cost components of the taxable transactions. In each case the French version refers to "éléments constitutifs du prix".

60. Reliance on foreign language texts of decisions of the Court of Justice poses evidential problems for a UK tribunal. Even if the tribunal has knowledge of the language in question, such knowledge is unlikely to be sufficient to appreciate the nuances of language that are likely to be present. A straight word-by-word translation is not adequate. Where reliance is placed on a foreign language version in an attempt to elucidate, or even contradict, the ordinary meaning of the English language text, the tribunal must be given expert evidence to support any such submission. Absent such evidence, no reliance can be placed on the foreign language text.

61. The use of the phrase "éléments constitutifs du prix" does not in any event appear to shed any light on the words used in the English language versions of the judgments referred to. Those words are used in the French language version of article 2 of the First Directive, the English version of which refers simply to "various cost components". There is no argument that the English version of article 2 is wrong. Furthermore, the original language of *Rompelman* was Dutch, and the original language of *Midland Bank* was Italian. We accordingly place no reliance on the French texts.

62. Nonetheless, we do find references to price in the English language texts. Mr Thomas referred us also to *Skatterverket v AB SKF* (Case-29/08) [2010] STC 419. In that case SKF proposed to dispose of all its shares in a wholly-owned subsidiary and its minority shareholding in another company. The reason for the disposals was to obtain funds to finance other activities of the group. The question concerned the deductibility of VAT on services acquired to carry out the disposals. The CJEU referred to the principle of equal treatment and the need to avoid a taxable person

being burdened with the cost of VAT in the course of his economic activity without giving him the possibility of deducting it (judgment, paras 69-70). Case law, including the ECJ judgments we have referred to, was cited in support of the accepted principle that a taxable person has a right to deduct even where there is no direct and immediate link between a particular input transaction and an output transaction or transactions giving rise to the right to deduct, where the costs of the services in question are part of his general costs and are, as such, components of the price of the goods and services which he supplies. Such costs do have a direct and immediate link with the taxable person's economic activity as a whole (para 58).

63. The CJEU continued (at paras 60-62):

> "60. It follows that whether there is a right to deduct is determined by the nature of the output transactions to which the input transactions are assigned. Accordingly, there is a right to deduct when the input transaction subject to VAT has a direct and immediate link with one or more output transactions giving rise to the right to deduct. If that is not the case, it is necessary to examine whether the costs incurred to acquire the input goods or services are part of the general costs linked to the taxable person's overall economic activity. In either case, whether there is a direct and immediate link is based on the premise that the cost of the input services is incorporated either in the cost of particular output transactions or in the cost of goods or services supplied by the taxable person as part of his economic activities.
>
> 61. In the present case, the referring court describes the costs linked to the services acquired by SKF, first, as 'directly attributable' to the disposal of shares and, second, as forming part of the general costs associated with SKF's overall economic activities.
>
> 62. In that regard, it must be held that it is not possible from the case file submitted to the court to determine whether those costs have a direct and immediate link, within the meaning of the case law cited in paras 57 and 58 of this judgment, with the envisaged share disposals or with SKF's overall economic activity, given that, according to the referring court, the purpose of those transactions was to secure funds to finance other activities of the group. In order to establish whether there is such a direct and immediate link, it is necessary to ascertain whether the costs incurred are likely to be incorporated in the prices of the shares which SKF intends to sell or whether they are only among the cost components of SKF's products."

64. The reference to price at para 62 of the CJEU's judgment relates to the question of direct attribution to the sales of shares. There is no such reference in the context of the general costs which could be regarded as cost components of SKF's products. In our view, when one is looking at overhead costs, what the cases say is that because these are overhead, or general, costs, they are, by virtue of that fact, cost components of the price of the taxable person's products. There is no separate test or hurdle of incorporation into price that has to be met or overcome. Those costs are then directly and immediately linked with the taxable person's economic activity as a whole.

65. Mr Thomas submitted that the issue in this case is not whether the costs in question are residual at all – it is common ground that they are – but whether the methodology put forward by VWFS is fair and reasonable despite the fact that the input tax on those costs is not a cost component of the price (or even the intended price) of the taxable output represented by the sale of the car. He argued that the input tax in making the HP transaction should either be passed on to the consumer as part of the supply of the vehicle (in respect of which value VWFS has a liability to account for output tax) or consumed by VWFS as the final consumer in making the supply of exempt credit.

66. Mr Thomas further submitted that the plain result of VWFS's methodology is that there is a third category of input tax which is incurred in making the supply of goods, but is not passed on to the consumer as part of the value of the supply of goods but is passed on as part of the value of the supply of exempt credit but in respect of which it nonetheless enjoys a right to deduct. He argues that such an outcome frustrates the normal operation of the tax. It is illogical, he says, and artificial as it assumes that one element of a single transaction (which has two component VAT supplies) cross-subsidises the remainder of the same transaction.

67. Miss Shaw submitted that HMRC's argument in this respect proceeded on the fallacious basis that an input must be a cost component of the price of an onward taxable transaction before it can be recovered by the trader. She referred to *Revenue and Customs Commissioners v London Clubs Management Limited* [2010] STC 2789 where (at [36] – [38]) Proudman J in the Upper Tribunal (Tax and Chancery) had rejected HMRC's submission that the supplies in question in that case were made at a loss and could not support the costs attributed to them in the proposed partial exemption special method. The learned judge held that this submission conflated the issue of profitability with the costs of making it. As Etherton J had observed in *Banbury Visionplus Limited v Revenue and Customs Commissioners* [2006] STC 1568 (at [68]):

> "… the issue of profitability or loss is of no significance … The critical issue is the use of inputs in the provision of outputs. There is no obvious or necessary correlation between that issue and the issue of profitability or loss."

68. We have concluded that, in relation to overheads, there is no requirement that the input tax referable to those expenses should be reflected in the price of the products of the overall economic activity to which the expenses are related. It is not necessary to trace the costs into the price of particular products. What is needed is a fair and reasonable proxy for the use by VWFS of the relevant costs in making both taxable and exempt supplies. Whilst it is clear that the use in question is economic use, and not physical use (see *St Helen's School Northwood Ltd v Revenue and Customs Commissioners* [2007] STC 633, per Warren J at [75]), that is not directed at profitability, but at the true nature and characterisation of the taxable person's business.

69. There is no direct attribution of any part of the input tax in question to either the taxable or exempt supply components of the HP transactions. The costs are, to the

extent attributable to those transactions, cost components of that economic activity as a whole. It is accepted that the input tax incurred by VWFS on its acquisition of a vehicle from a dealer is directly and immediately linked to the onward supply of that vehicle under the HP transaction, and is accordingly recoverable. But overhead costs are, to the extent that they are apportioned to the HP transactions, used for those transactions as a whole. It follows therefore, in our view, that the overhead costs are cost components of each of the supplies that make up those transactions. We agree therefore with Miss Shaw that the individual supplies comprised in the HP transactions must be respected so as to allow recovery to the extent that a cost component of the whole transaction can be regarded as a cost component of a taxable supply.

70. Accordingly, in our view, any method that has the effect of treating the overhead costs as solely cost components of a particular element, or elements, of the transactions, to the exclusion of another element, or other elements, cannot be fair and reasonable. The relevant economic activity is the carrying out of the HP transactions. This is simply a reflection of the way in which the business of VWFS is carried on. We do not agree with Mr Thomas when he seeks to apply the label "finance business" to VWFS, pointing to the way in which VWFS accounts for the HP transactions, to argue that such a business ought not to recover the vast majority of its input tax. The observable features of the HP transactions are that they comprise not only exempt supplies of finance but also taxable supplies of the vehicles.

71. What HMRC's argument amounts to, in essence, is that there is a limit to the amount of cost that can be a cost component of a supply, and that because the supply of the vehicle is at cost, and so reflects only the price paid by VWFS to the dealer, and input tax on the acquisition of the vehicle by VWFS is directly attributable to that supply, the cost component capacity of the vehicle supply has been exhausted, with the result that no other costs can be cost components of that supply. We consider that to be wrong in principle. The mere fact that only particular costs are recovered by a supplier in the price he charges for the making of a particular supply does not lead to the conclusion that no other costs are cost components of that supply. Unrecovered costs not directly attributable to a particular supply, or such costs recovered in other ways, for example by marking up other supplies, are nonetheless cost components of transactions of the business in general, and to the extent that those transactions include taxable supplies, the input tax incurred on those costs is deductible.

72. Mr Thomas argued that the system for deduction of input tax reflected the principle of fiscal neutrality which underpins the VAT system. As a general matter taxable persons, unlike final consumers, do not themselves bear the burden of VAT. Although VAT is charged on every supply made by a taxable person, it is intended to be a neutral tax with the result that goods and services should bear the same tax burden whatever the length of the production and/or distribution chain. But where a person makes exempt supplies, that person is not entitled to deduct VAT in respect of those transactions and is therefore treated as a final consumer of such exempt goods or services. Mr Thomas argued that the principle of fiscal neutrality is relevant to the determination of what is a fair and reasonable attribution of input tax and that,

because the VWFS methodology operates regardless of where the burden of tax falls, it does not reflect that principle.

73. We accept Mr Thomas' description of the basic way the VAT system operates, and that it is underpinned by the principle of fiscal neutrality. However, that principle does not mean that deductibility is dependent on the burden of input VAT incurred having itself been passed on through incorporation into the price of the relevant goods or services. It would not be consistent with fiscal neutrality for a trader who has incurred costs in making taxable supplies not to be able to deduct the referable input tax merely because the price charged for those taxable supplies does not reflect, or does not wholly reflect, that input tax, or because the trader has chosen to recover such costs through other pricing means. As we have earlier noted, when considering *Mayflower Theatre* (per Carnwath LJ at [28]), the conclusion that overhead costs are cost components of the economic activity as a whole (which in this context means the HP transactions, and thus both the taxable supply and exempt supply components of those transactions) is itself an expression of the principle of fiscal neutrality. It is not a breach of that principle for a methodology that attributes residual input tax on those overhead costs to both the taxable supply and exempt supply components of the HP transactions to which residual input tax can be apportioned to be regarded as fair and reasonable.

74. Nor do we agree with Mr Thomas' submission that to allow a trader in the position of VWFS to recover a substantial proportion of input tax attributable to the HP transaction on the basis that the provision of security for the credit happened to be in contractual form which entailed retention of title in VWFS and a supply of goods as opposed to other forms of finance transaction for the purchase of cars where overhead VAT is rightly irrecoverable does not respect the principle of equal treatment. We accept, of course, that according to that principle different types of economic operators in comparable situations be treated in the same way in order to avoid distortion of competition within the internal market (*NCC Construction Danmark A/S v Skatteministeriet* (Case C-174/08) [2010] STC 532, at para 44). However, we do not consider that a transaction which involves a taxable supply can be compared to one that does not, so as to give rise to any breach of the principle of equal treatment. Furthermore, as we have described, *BLP* also makes clear that deductibility may depend on a trader's choice as between taxable and exempt supplies. It is accordingly not contrary to any principle if input tax is deductible for a trader who finances vehicles through HP transactions, even if it would not be deductible if the trader instead provided simple loan finance.

75. Mr Thomas also referred us to *Levob Verzekeringen BV and another v Staatssecretaris van Financiën* (Case C-41/04) [2006] STC 766, at para 24 where the ECJ referred to the economic purpose of a transaction in determining whether the transaction was a single supply or multiple supplies. We agree that economic purpose, objectively ascertained, is an important element in such cases, and also in a fair and reasonable attribution under a partial exemption special method (*St Helens School*, at [77]). However, we do not accept that the purpose of the supply of the vehicle in an HP transaction is, as Mr Thomas submitted, to give rise to a supply of credit. The economic purpose of VWFS is not simply to supply credit; it is to supply

credit on hire purchase terms. It may be the case that, according to those terms, the supply of the vehicle cannot take place without the supply of the credit, and that the supply of the vehicle lacks the normal characteristics of a simple sale of goods, but that does not in our view change the essential economic characteristics of an HP transaction, objectively ascertained, namely that it is one indivisible transaction that comprises, for VAT purposes, two supplies, one taxable and one exempt.

76. We do not regard the objection that the business of VWFS would consistently be in a repayment position for the HP transactions as leading to the conclusion that a fair and reasonable attribution must avoid this result. Mr Thomas argued that VAT should not produce a long term repayment at any stage in the transaction chain unless either a reduced rate applies to the supplies made by the trader or a loss is made in the income stream. We agree that it is artificial to attempt to characterise the supply of the vehicle as being at a loss, but that is not the reason for the deduction of the input tax. That deduction arises because the input tax is a cost component of the HP transactions, and is thus a cost component of each of the constituent supplies. The consequence of a repayment does not arise solely because of that attribution; it arises because of a combination of the agreed direct attribution to the sale at cost of a vehicle of input tax incurred on its acquisition and the attribution of part of the overheads input tax. In considering a fair and reasonable method of attributing the input tax referable to overheads, we do not regard the consequence of VWFS being in a repayment position in this respect as compelling the exclusion of the taxable supply of the vehicle from the equation, when the proper analysis is that input tax on overhead costs is a cost component of the hire purchase transactions, and so in part a cost component of that taxable supply.

77. Our conclusion therefore is that a partial exemption special method that provides for the partial attribution of the residual input tax incurred by VWFS to the taxable supplies of vehicles that it makes under the HP transactions is fair and reasonable, whereas one that does not so provide is not fair and reasonable. As this is the only dispute on the methodology adopted by VWFS, it follows that we decide that VWFS's methodology is fair and reasonable, and HMRC's proposed methodology is not.

Decision

78. For these reasons, we allow this appeal.

Costs

79. Any application in respect of costs must be made within 28 days of the date of release of this decision.

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.

ROGER BERNER

TRIBUNAL JUDGE
RELEASE DATE: 18 August 2011