[2019] UKUT 18 (TCC)

Appeal number: UT/2017/0174

VALUE ADDED TAX – Points based loyalty programme – whether operator of programme receives services from third parties who provide rewards under the programme – whether payments third party consideration for provision of rewards – appeal dismissed

UPPER TRIBUNAL
(TAX AND CHANCERY CHAMBER)

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

- and -

TESCO FREETIME LIMITED **Respondents**
TESCO PLC

TRIBUNAL: MR JUSTICE ZACAROLI
JUDGE JONATHAN RICHARDS

Sitting in public at The Royal Courts of Justice, Rolls Building, Fetter Lane, London on 27 to 29 November 2018

Alison Foster QC and Andrew Macnab, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Appellants

Jonathan Peacock QC and Hui Ling McCarthy QC, instructed by Freshfields Bruckhaus Deringer LLP for the Respondents

DECISION

Introduction

1. This appeal concerns the proper VAT treatment of one feature of the loyalty scheme operated by the well-known supermarket, Tesco, which we will refer to as the "Clubcard Programme".

2. In the simplest form of the scheme, participating customers (known as "Clubcard members") who purchase goods (referred to as "premium goods") from Tesco's stores (or, under an extended element of the scheme, from other participating retailers known as "Clubcard Partners") are provided with Clubcard points. Provided the Clubcard member has accumulated sufficient points, his or her points are translated, at three-month intervals, into vouchers, which can be used by the customer to obtain a discount against purchases of goods (referred to as "redemption goods") in Tesco stores or online.

3. The feature of the Clubcard Programme with which this appeal is concerned is known as the "Partner Boost" scheme. This operates (from the Clubcard member's perspective) as follows. Clubcard members may exchange their vouchers (acquired in the manner described above) with a separate company in the Tesco group, Tesco Freetime Limited ("Freetime"), for tokens, known as "Reward Tokens". Reward Tokens may in turn be used by Clubcard members to acquire goods or services from third parties, such as museums, cinemas or restaurants. The third party suppliers are referred to as "Deal Partners" and the goods or services supplied by them to Clubcard members are referred to as "Rewards". Typically a Reward Token will have a face value higher than the voucher for which it is exchanged so, for example, a Clubcard member may be able to exchange a voucher conferring an entitlement to a £2 discount in Tesco stores for a Reward Token that gives the holder a £4 discount on a meal at Pizza Express.

4. Freetime pays Deal Partners a sum calculated as a percentage of the face value of the Reward Tokens redeemed (the "Deal Partner Fee"). The question raised by this appeal is whether Freetime is entitled to deduct the VAT paid on the Deal Partner Fee as input tax. The Commissioners of Her Majesty's Revenue and Customs ("HMRC"), pursuant to a series of assessments to VAT and refusals of claims to deduct VAT, have refused to permit Freetime to do so[1].

5. Freetime appealed those decisions to the FTT. The FTT (Judge Bishopp), in a decision dated 4 August 2017 (the "Decision"), allowed Freetime's appeals. HMRC appeal to this tribunal against that decision.

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[1] For part of the period in dispute, Freetime was a member of a VAT group whose representative member was Tesco plc. In those circumstances, all taxable supplies made to, or by, members of that VAT group would be treated as made to, or by, Tesco plc so that Tesco plc, rather than Freetime, would be entitled to any input tax credit. However, in the interests of brevity we will refer to supplies being made to, or by, Freetime and to Freetime's entitlement to input tax credit as a shorthand.

The legislative framework

6. As noted by the FTT at paragraph 23 of the Decision, there is no dispute as to the relevant legislation. The Sixth VAT Directive (77/388/EEC) applies to the Clubcard Programme for part of the relevant period, but the Principal VAT Directive ("PVD") applies for the majority of the period. There is no material difference between the relevant provisions in the respective Directives. We will, like the FTT, focus on the provisions of the PVD.

7. The starting point is Article 1(2) of the PVD:

> "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."

8. Article 2(1) defines the scope of VAT:

> "The following transactions shall be subject to VAT:
>
> (a) the supply of goods for consideration within the territory of a Member State by a taxable person acting as such;
>
> (b) [immaterial]
>
> (c) the supply of services for consideration within the territory of a Member State by a taxable person acting as such …."

9. The meanings of "supply of goods" and "supply of services" are to be found in Articles 14(1) and 24(1) respectively:

> " 'Supply of goods' shall mean the transfer of the right to dispose of tangible property as owner."
>
> " 'Supply of services' shall mean any transaction which does not constitute a supply of goods."

10. Article 73 defines the "taxable amount":

> "In respect of the supply of goods or services … the taxable amount shall include everything which constitutes consideration obtained or to be obtained by the supplier, in return for the supply, from the customer or a third party …."

11. The critical provision for the purposes of this appeal is Article 168:

> "In so far as the goods and services are used for the purposes of the taxed transactions of a taxable person, the taxable person shall be entitled, in

> the Member State in which he carries out these transactions, to deduct the following from the VAT which he is liable to pay:
>
> (a) the VAT due or paid in that Member State in respect of supplies to him of goods or services, carried out or to be carried out by another taxable person …."

The issue to be determined on this appeal

12. This appeal turns on the application of Article 168. To the extent that the Deal Partner Fee consists of consideration for supplies of services to Freetime, Freetime is entitled to deduct the VAT element of the Deal Partner Fee as input tax.

13. It is HMRC's contention that the Deal Partner Fee is paid by way of third party consideration for supplies of Rewards made by the Deal Partners to Clubcard members (and not to Freetime). Accordingly, it is not consideration for a supply of anything to Freetime and no part of the VAT element of the Deal Partner Fee can be deducted by Freetime as input tax. Alternatively, HMRC contend that the Deal Partner Fee is to be apportioned, so that as to (the smaller) part, it is payment for a service provided by the Deal Partner to Freetime and as to (the greater) part, it is payment for the supply of Rewards by the Deal Partner to Clubcard members. On this alternative case, Freetime would be entitled to deduct as input tax only the VAT paid by it on that part of the Deal Partner Fee that was apportioned towards the service provided by the Deal Partner to it.

14. Freetime contends that the whole of the Deal Partner Fee is paid in respect of supplies of services by the Deal Partner to it. Importantly, it contends that the provision by the Deal Partner of, for example, a cinema ticket or pizza to a Clubcard Member constitutes the supply of a "Fulfilment Service", as described in paragraph 31 below, to Freetime. Accordingly, it is entitled to deduct as input tax the whole of the VAT element of the Deal Partner Fee.

The decision of the FTT

15. The FTT reviewed the various contractual arrangements between the participants in the Clubcard Programme and received evidence from Mr Rob Graham, a director of Freetime and a senior manager in the Tesco group with responsibility at the relevant time for the Partner Boost scheme. The network of contracts between the various parties is of central importance to this appeal and we summarise the contractual position in the next section.

16. In paragraphs 6 to 23 of the Decision, the FTT explained how both the Clubcard Programme and the Partner Boost feature worked.

17. None of the FTT's factual findings was in dispute for the purposes of this appeal, though the parties had very different perceptions on the conclusions that should follow from those facts. We will not, therefore, summarise all of the FTT's factual findings but will simply highlight the following:

(1) The Clubcard Programme as a whole, including the Partner Boost aspect of it had from Tesco's perspective the purpose of increasing Tesco's sales and generating and maintaining customer loyalty (see paragraphs 8 and 21 of the Decision).

(2) There was no change in the way the Clubcard Programme was operated during the period relevant to this appeal that has any bearing on Freetime's entitlement to input tax credit (see paragraph 19 of the Decision).

(3) Overall, the Clubcard Programme was under the direction of Tesco Stores Limited ("Stores"), the principal retailer in the Tesco group. Although Freetime was a member of the Tesco group, it was managed, as nearly as may be in those circumstances, as an independent operation and operated Partner Boost with a substantial degree of autonomy (see paragraph 20 of the Decision).

(4) The amount of Deal Partner Fee that Freetime pays each Deal Partner is directly linked to the extent that Clubcard members have used Reward Tokens to acquire goods and services from that Deal Partner and the amount that Freetime receives from Stores is directly linked to the aggregate use by Clubcard members of Reward Tokens during the relevant month.

18. A large part of the Decision is taken up with an analysis of the decisions in long running litigation involving the "Nectar" rewards scheme (the Tesco Clubcard programme's nearest rival) of, respectively, the European Court of Justice (*Revenue and Customs Commissioners v Loyalty Management UK Ltd , Baxi Group Ltd v Revenue and Customs Commissioners (Joined cases C-53/09 and C-55/09)* [2010] STC 2651, [2010] ECR I-9187, which we will refer to as "*LMUK-ECJ*") and the House of Lords (*Revenue and Customs Commissioners v Loyalty Management UK Ltd* [2013] UKSC 15, [2013] STC 784 , which we will refer to as "*LMUK-SC*"). That was because much of the argument before the FTT related to the similarities and differences between the Tesco Clubcard programme and the Nectar scheme. It will be necessary to consider the *LMUK* cases in detail when dealing with HMRC's arguments. For present purposes, we merely note that while it is necessary to have regard to previous authorities for any principles of law laid down in them, there is limited utility in analysing how those principles were applied in those authorities to different fact patterns in order to draw comparisons with the facts of this case.

19. In addition, in paragraphs 77 to 94 of the Decision, the FTT explained why it considered that the costs to the Tesco group of operating the Clubcard Programme, including Partner Boost, were met out of the group's revenues from making taxable supplies to its customers.

20. The essence of the FTT's conclusion is contained within paragraph 96 of the Decision:

> "…the Deal Partner is making a supply to Freetime of redemption services which are necessary to Freetime if it is to discharge its own obligations to the Clubcard Members, of making good the rewards to which they have become entitled, and to Stores of providing the Partner Boost element of the Clubcard scheme. In my judgment it necessarily

> follows that the VAT it incurs when paying for the redemption services is recoverable input tax in its hands."

The contracts between the parties

21. Freetime and HMRC agree that the relevant contracts provide an important starting point when deciding whether Deal Partners provide services to Freetime. The relevant contracts are as follows:

> (1) the arrangement between Stores/Freetime and Clubcard members containing the terms of the Clubcard Programme;
>
> (2) the contract between Stores and Clubcard Partners (under which Clubcard Partners are permitted to issue Clubcard points);
>
> (3) the contract between Stores and Freetime dated 1 June 2003 (the "Stores/Freetime Contract") under which Freetime provides services to Stores relating to the "Partner Boost" aspect of the Clubcard Programme;
>
> (4) contracts between Freetime and Deal Partners under which Deal Partners agree, among other matters, to redeem Reward Tokens. (Freetime's payment of the Deal Partner Fee under these contracts gives rise to the input VAT which is in dispute.)
>
> (5) contracts between Deal Partners and Clubcard members under which goods and services are provided when Reward Tokens are redeemed (for example the standard terms and conditions of Pizza Express that apply when a Clubcard member orders a pizza and tenders a Reward Token in payment).

The arrangement(s) with Clubcard members constituting the Clubcard programme

22. The Clubcard programme is operated, overall, by Stores, the principal retailer of the Tesco plc group. When a Clubcard member joins the Clubcard Programme he or she agrees to a standard set of terms and conditions. There was some dispute between the parties as to whether a Clubcard member entered into a separate arrangement with Freetime in relation to the Partner Boost aspect of the Clubcard Programme or whether, in reality, there was just a single arrangement between Clubcard members and Stores. However, neither Freetime nor HMRC suggested that anything turned on this point.

23. The terms and conditions set out the procedure and mechanism we have already summarised at paragraphs 2 and 3 above. Therefore, the terms and conditions set out how Clubcard members could earn points, how points would be converted into vouchers and, in respect of the Partner Boost aspect of the Clubcard Programme, how vouchers could be converted into Reward Tokens.

24. In their skeleton argument, Ms Foster QC and Mr Macnab submitted that the arrangement between Stores/Freetime and Clubcard members did not constitute an enforceable contract as a matter of English law and referred to aspects of the FTT's conclusions in paragraphs 28 to 34 of the Decision in support of that argument. However, while as we note below, HMRC attached considerable significance to their argument that, prior to provision of a Reward by a Deal Partner, there was no taxable

supply of the right to that Reward, they have not suggested that it matters greatly whether there was some contract in place between Stores/Freetime and Clubcard Members or not. Indeed, it was common ground that in practice, throughout the period in dispute, the Clubcard Programme (including the Partner Boost feature) had been operated in accordance with its terms and conditions. We need not, therefore, make any determination as to whether the arrangement with Clubcard members was, as a whole, an enforceable contract or not.

25. Some aspects of the arrangement between Stores and Clubcard members have been the subject of previous litigation. In *Tesco plc v Customs and Excise Commissioners* [2003] EWCA Civ 1367, the Court of Appeal had to determine whether, when Stores provided vouchers to Clubcard members who had earned sufficient points, those vouchers were issued for a consideration (consisting of part of the price paid for premium goods that resulted in the issue of points). The Court of Appeal held that no such consideration was given for the vouchers.

The contract between Stores and Clubcard Partners

26. As we have noted, Clubcard Partners are third parties outside the Tesco group who are permitted to issue points to Clubcard members. Some 20% of points are issued by Clubcard Partners. The terms under which they are permitted to do so are set out in a separate contract between each Clubcard Partner and Stores. Pursuant to these contracts, Clubcard Partners were authorised to issue points and Stores agreed to honour the redemption of points in accordance with the Clubcard Programme. The Clubcard Partner paid Stores a fee for being allowed to participate in the Clubcard Programme that was typically calculated as a price per point issued.

The Stores/Freetime Contract

27. The Stores/Freetime Contract sets out the terms on which Freetime operates the Partner Boost aspect of the Clubcard Programme. Pursuant to the Stores/Freetime Contract, Freetime is obliged to provide "Services" to Stores. Under this contract:

(1) "Services" are defined as:

> "the marketing, sourcing, order fulfilment services, management services and call handling services associated with the procurement of provision of Rewards provided by Freetime to [Stores]".

(2) "Fulfilment services" are in turn defined as:

> "Services provided to Freetime by a third-party supplier [i.e. a Deal Partner] pursuant to a Freetime Partner Agreement to include provision by such third party of Rewards to Clubcard [members]."

(3) "Rewards" are defined as:

> "the leisure and travel products identified by Freetime".

(4) Stores is obliged to pay Freetime:

> "the Fees and an amount equal to that paid by Freetime under any Freetime Partner Agreements as part of the Clubcard Scheme."

(5) "The Fees" are defined as:

> "The money paid by [Stores] to Freetime in consideration of providing the Services".

28. Pursuant to Clause 9.1 of the Stores/Freetime Agreement, Freetime assumed an obligation to procure that orders for Rewards were fulfilled. This clause, therefore, required Freetime to enter into arrangements with Deal Partners under which Deal Partners would provide Rewards to Clubcard members. Freetime was, as noted above, entitled to recover the costs of paying Deal Partners from Stores.

29. Freetime invoices Stores for the amounts due to it under the Stores/Freetime Contract plus VAT. Stores deducts the VAT paid by it as input tax. Freetime accounts for the VAT due on the supply as output tax.

The contracts between Freetime and Deal Partners

30. Freetime contracts separately with each Deal Partner (of which there are more than 500). The wording of the standard terms in operation prior to 2004 was different from that used after 2004. However, as we have noted, the FTT considered that the essential features of the contracts with Deal Partners were broadly the same throughout the period in dispute. We will focus, therefore, on the terms that have been in existence since 2004. However, while not urging us to conclude that a different VAT analysis applies to the pre-2004 contracts, Ms Foster QC and Mr Macnab did, in both their written and oral submissions, explain why HMRC consider the pre-2004 contracts shed a light on the true nature of the services being supplied and we will, therefore, highlight some aspects of the pre-2004 contracts.

31. Under each post-2004 contract with a Deal Partner, under the heading "Fulfilment Services", it was stipulated:

> "The [Deal Partner] shall supply to Tesco Freetime the services (to include provision of Rewards to Tesco Clubcard Members) as required by Tesco Freetime to enable Tesco Freetime to perform and discharge its obligations to provide or procure the provision of Rewards to Tesco Clubcard Members in accordance always with the Terms and Conditions printed overleaf (Fulfilment Services)."

32. The Terms and Conditions referred to dealt with usual matters such as invoicing and the use of intellectual property rights. They also stipulated that, unless referred to otherwise in the agreement[2], the Deal Partner would provide Rewards to Clubcard members on the same terms as the Deal Partner uses when dealing with members of the public generally.

[2] An example of an exception to this obligation is where Freetime agrees with a particular Deal Partner that Reward Tokens could not be presented in particularly busy "blackout periods". Such exceptions would be negotiated individually with a Deal Partner and would have an effect on the Deal Partner Fee that Freetime would pay.

33. To give a flavour of the kind of terms included in post-2004 agreements with Deal Partners, we were shown a contract with Pizza Express operative from 1 February 2009 which contained the following provisions:

> "Ticket Information
>
> In exchange for their Clubcard Vouchers (the rate of such exchange being entirely at the discretion of Tesco Freetime), Tesco Freetime shall provide to Clubcard Members Tokens which shall be accepted by the Supplier in full or part payment against the dining bill excluding beverages within PizzaExpress Restaurants. Where the face value of such Tokens is less than the cost for the goods & services, the Supplier shall collect the balance from the Clubcard Member. No change need be given by Supplier where the face value of the Tokens exceeds the cost for the goods & services.
>
> Price
>
> In consideration for the Supply to it of the Fulfilment Service Tesco Freetime shall pay to the Supplier an amount equivalent to [a specified percentage] of the face value of all tokens accepted by the Supplier for Rewards and surrendered to Tesco Freetime. Such amount shall include VAT."

34. Pre-2004 contracts with Deal Partners made no reference to Deal Partners providing "Fulfilment Services" to Freetime. By way of example, an agreement entered into in 1999 between First Call (Leisure) Limited (the previous operator of the Partner Boost aspect of the Clubcard Programme) and the Channel Tunnel Group defined the price payable as follows:

> "Price
>
> The Supplier will receive [a specified amount] for every £40 travel token redeemed and [a specified amount] for every £60 travel token redeemed. The minimum order will always be the £40 travel token."

The contracts between Clubcard members and Deal Partners for the provision of Rewards

35. In her oral submissions, Ms Foster QC suggested that it was significant that Freetime made few references to these contracts in their submissions. We do not agree. When a Clubcard member uses a Reward Token to obtain a Reward from a Deal Partner, he or she would enter into a contract with the Deal Partner based on the Deal Partner's standard terms. Since there were so many Deal Partners, and since Rewards took a number of forms, there would necessarily be much variation in the detailed terms of those contracts. However, a unifying theme runs through all contracts between Clubcard Members and Deal Partners namely that Deal Partners would accept Reward Tokens as full or part payment for specified services up to the face value of the Deal Tokens tendered.

HMRC's arguments on this appeal

36. HMRC accept that Freetime has made payments to Deal Partners pursuant to binding contracts and they also accept that, from 2004, those contracts have described the payments as being made in consideration of Deal Partners' provision of "Fulfilment Services" to Freetime. However, while HMRC accept that Deal Partners provided *some* services to Freetime pursuant to these contracts (for example the provision of some data) they do not accept that the entirety of the sums that Freetime paid Deal Partners was for services provided to Freetime despite that being the express labelling in the post-2004 contracts. HMRC were not asserting that the contracts with Deal Partners were shams and they accepted that those contracts were operated in accordance with their terms. However, HMRC argue that to determine the extent to which Deal Partners were supplying services to Freetime, it is necessary to apply established VAT principles and an analysis of economic reality to the position as set out in the contracts. An application of those principles, in HMRC's submission, leads to the conclusion that Deal Partners are not providing services to Freetime only.

37. Ms Foster QC and Mr Macnab made a number of detailed points as to why, viewed correctly, not everything that Freetime paid Deal Partners was in consideration of a service supplied to Freetime. We consider the essence of those points to be the following:

> (1) It is necessary to "pull the camera back" and focus on the core of the arrangement. That core involved Deal Partners providing a Reward to Clubcard members on terms that the Clubcard members had to pay nothing for that Reward with payment coming from Freetime instead. Therefore, at least in part, the consideration that Freetime paid Deal Partners was not in return for services that Deal Partners provided Freetime. Rather, Freetime was providing third party consideration for a supply of goods and services to Clubcard members. That reflects the conclusion reached by the ECJ in *LMUK-ECJ* which is particularly resonant given the similarities between "Partner Boost" and the loyalty scheme of Baxi Group Limited ("Baxi") which the ECJ considered involved the provision of third party consideration and which the Supreme Court in *LMUK-SC* did not doubt. The Clubcard Programme is not an atypical loyalty scheme, it contains none of the features that Lord Reed identified that enabled him to depart from the ECJ's analysis and the Partner Boost arrangements should be analysed in the same way as the ECJ analysed Baxi's arrangements.
>
> (2) The contractual arrangements with Deal Partners reinforce the conclusion at (1). Deal Partners received a payment that was linked to the face value of the Reward Tokens redeemed. Therefore, if Deal Partners did not provide a Reward to Clubcard members, they would receive no payment from Freetime. Moreover, the FTT had found as a fact that the amount of payment that Deal Partners received was "directly linked" to the use by Clubcard members of Reward Tokens.
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> (3) Fundamental principles of VAT law also demonstrate that the conclusion at (1) is the correct way to regard the arrangements. VAT is a general tax on consumption. On Freetime's analysis there would be final

consumption of a Reward but there would be no "sticking tax" on that final consumption because Freetime would be entitled to credit for input VAT. That conclusion demonstrated the fallacy of Freetime's analysis.

(4) The position might be otherwise if, prior to a Deal Partner's provision of a Reward, there had been a prior taxable supply of a contractual right to that Reward (which was referred to during the hearing as the "logically prior supply"). In such a case, there would be no second supply of the Reward itself (much as, if a person buys a theatre ticket in advance conferring a right to a seat at a performance, there is no second supply when the patron attends the performance itself) and so no question of the sums that Freetime pays constituting third party consideration for the provision of the Reward. However, in the circumstances of this appeal, there was no logically prior supply of the right to a Reward which further demonstrated that Tesco's analysis could not be correct as it would result in no "sticking tax" being collected, at any stage, in relation to the Reward or any right to receive it.

(5) The FTT had impermissibly based its conclusion on its finding that the economic costs of the Clubcard Programme (including Partner Boost) were ultimately borne by Tesco's customers and met out of Tesco group's revenue received in consideration for making taxable supplies to those customers.

Decision

38. There is no real dispute between the parties as to the basic propositions relating to VAT so far as they relate to this appeal. We cannot improve on the exposition of the Upper Tribunal (Henry Carr J and Judge Ghosh QC) in *Marriott Rewards LLC v HMRC* [2018] STC 1144, at [21] which, without footnotes, was as follows:

> "(i) VAT is a tax on consumption: art 2 of First Council Directive 67/227/EEC ('the First Directive'); LMUK CJEU para 58; LMUK SC [14], [95];
>
> (ii) VAT is proportional to the price paid for the supply of goods and services (that is, VAT output tax is payable on the 'taxable amount') (ibid);
>
> (iii) the burden of VAT should fall on the final consumer who suffers irrecoverable VAT ('sticking tax'): LMUK SC [75];
>
> (iv) VAT is only chargeable if a supply of goods and services is for consideration; for a supply to be for a 'consideration' for VAT purposes there need not be a legal relationship between the parties (the payment may be binding 'in honour only') but the payment on the one hand and the goods or services on the other must be the function of a relationship of 'reciprocity': *Town and County Factors Ltd v Customs and Excise Comrs* (Case C-498/99) EU:C:2002:494, [2002] STC 1263, [2002] ECR I-7173 ('Town & County Factors'), paras 18, 24; LMUK CJEU para 51, LMUK SC [81];
>
> (v) VAT is chargeable on the value added in the chain of production and distribution, so that a trader is entitled to a deduction of input tax for

consideration paid for goods and services supplied which are used in the course or furtherance of its business (that is, the payment is a cost component of the paying trader's business): LMUK SC [73], [74], [75], the Principal VAT Directive, art 168;

(vi) It follows that 'third party consideration', paid by a VAT trader, for goods and services supplied to another party, where those goods and supplies are not used by the paying trader, in its trade, cannot give rise to a deductible input tax in the hands of that paying trader. It is convenient to explain, at this stage, what is meant by 'third party consideration'; this is the circumstance where one person (A) pays the price for goods and services supplied to another person (B) by the supplier (C);

(vii) As to when A might do this, in circumstances in which A is a trader and it is no part of A's business costs to be paying C for its supplies to B, this would include, for instance, where A had an outstanding liability to B and A simply discharged this liability by paying off B's liability to C. In such circumstances, where A did not receive anything from B, except a discharge of A's liability to B and A did not receive anything from C which was used by A in the course or furtherance of A's business (because the goods or services supplied by C to B were consumed by B and B alone), it is easy to see why the payment by A is not any sort of cost component of A's economic activity. However if the payment by A is, in the light of 'economic reality', a cost component of A's business, any VAT element comprised in A's payment to C ought, at least prima facie, to be deductible input tax in A's hands (ignoring complications of VAT exemption, in relation to A). As Lord Reed observed at [67] of LMUK SC: 'Economic reality being what it is, commercial businesses do not usually pay suppliers unless they themselves are the recipient of the supply for which they are paying (even if it may involve the provision of goods or services to a third party), but that possibility cannot be excluded a priori. A business may, for example, meet the cost of a supply of which it cannot realistically be regarded as the recipient in order to discharge an obligation owed to the recipient or to a third party. In such a situation, the correct analysis is likely to be that the payment constitutes third party consideration for the supply';

(viii) The same transaction may yield two simultaneous supplies; so if a builder, in order to promote sales of houses the builder has constructed, pays an estate agent to market houses currently owned for prospective buyers of a house constructed by that builder, the estate agent makes supplies both to the prospective buyer and to the builder: *Redrow*, discussed and applied by LMUK SC at [65], [109];

(ix) The nature of a supply, the identity of the parties to that supply and the nature and quantum of the consideration for a particular supply are all matters for determination by the national court, to be ascertained by reference to the contractual documentation, informed by an acknowledgment of 'economic reality', taking account of all circumstances: LMUK CJEU para 39, LMUK SC [38]."

39. When considering the central issue in this appeal, namely the extent to which sums Freetime pays to Deal Partners constitute consideration for a supply of services to Freetime, then (as indicated by the ninth proposition set out in the above extract from the decision in the *Marriott* case) regard is to be had both to the terms of the contracts between Freetime and Deal Partners and to the commercial and economic reality of the arrangement as a whole. As to this, in *Revenue and Customs Commissioners v Newey* (Case C-653/11) [2013] STC 2432, the CJEU commented as follows:

> "42. As regards in particular the importance of contractual terms in categorising a transaction as a taxable transaction, it is necessary to bear in mind the case law of the court according to which consideration of economic and commercial realities is a fundamental criterion for the application of the common system of VAT ….
>
> 43. Given that the contractual position normally reflects the economic and commercial reality of the transactions and in order to satisfy the requirements of legal certainty, the relevant contractual terms constitute a factor to be taken into consideration when the supplier and the recipient in a 'supply of services' transaction within the meaning of articles 2(1) and 6(1) of the Sixth Directive have to be identified.
>
> 44. It may, however, become apparent that, sometimes, certain contractual terms do not wholly reflect the economic and commercial reality of the transactions.
>
> 45. That is the case in particular if it becomes apparent that those contractual terms constitute a purely artificial arrangement which does not correspond with the economic and commercial reality of the transactions."

40. The relationship between the contractual terms and economic reality was further explained in *WHA Ltd v Revenue and Customs* [2013] UKSC 24, [2013] STC 943, at [27] where Lord Reed said:

> "[t]he contractual position is not conclusive of the taxable supplies being made as between the various participants in the arrangements, but it is the most useful starting point."

41. In *HMRC v Airtours Holidays Transport Ltd* [2016] UKSC 21, Lord Neuberger, at [47], said:

> "when assessing the VAT consequences of a particular contractual arrangement, the court should, at least normally, characterise the relationships by reference to the contracts and then consider whether that characterisation is vitiated by [any relevant] factors."

42. In practice, on the facts of this case, the approach may be broken down into the following steps: first, to identify what obligations are imposed by the terms of the contracts, in particular by way of performance from the party said to be supplying services; second, to enquire whether the parties in practice performed the obligations in accordance with the contractual terms; third, to analyse the extent to which the performance of those obligations constituted, as a matter of economic reality, the supply of services to the taxpayer. This third stage is important because the mere fact that the

parties to a contract, A and B, have described performance by B as services supplied to A cannot be determinative of the question whether, in accordance with the autonomous meaning of Article 168 of the PVD, the performance of obligations by B in fact amounts to the supply of services to A. It is always necessary to answer that question by reference to the economic realities of the arrangement.

43. Freetime accepts that it is open to this tribunal to review the FTT's conclusion that, both by reference to the contractual arrangements and to the economic realities, the Deal Partners' provision of Rewards to Clubcard members constitutes the supply of services to Freetime, but contends that we should be slow to interfere in its findings. We agree, but in any event conclude that the FTT's conclusion in this regard is unassailable.

44. We note, first, that the mere fact that the substantive obligation imposed on Deal Partners undoubtedly involved the supply of services to Clubcard Members (whether it be admission to a cinema or museum, or provision of a pizza) does not preclude the finding that it also amounted to the supply of services to Freetime. It is clearly established that a single event can constitute two different supplies to two different recipients. *Customs & Excise Comrs v Redrow* [1999] STC 161, [1999] 1 WLR 408 (referred to in the extract from the *Marriott Rewards* case at paragraph 38 above) is a clear example of this. Both the reasoning and conclusion in *Redrow* were held by the Supreme Court in *LMUK-SC* to be correct, notwithstanding the decision of the ECJ in *LMUK-ECJ* (see Lord Reed at [65], Lord Hope at [109] and Lord Walker at [117]). Other applications of this principle are *LMUK-SC* itself, *HMRC v Plantifor Ltd* [2002] STC 1132 (also approved in *LMUK-SC*), *WHA Ltd v HMRC* [2013] UKSC 24 and *Marriott Rewards LLC v HMRC* [2018] UKUT 129 (TCC). The first four of these cases are binding on us and the fifth we should follow unless we concluded it was plainly wrong.

45. So far as the economic reality is concerned, the comment of Lord Reed in *LMUK-SC*, at [67], is particularly apposite:

> "Economic reality being what it is, commercial businesses do not usually pay supplies unless they themselves are the recipient of the supply for which they are paying (even if it may involve the provision of goods or services to a third party), but that possibility cannot be excluded a priori."

46. The first two stages of analysis set out at [42] can be dealt with briefly. The contractual arrangements outlined at [30] to [34] involved Freetime making payments to Deal Partners in return for Deal Partners agreeing to provide Fulfilment Services. It is accepted that the contracts were operated in accordance with their terms throughout the period relevant to these appeals. Therefore, the contractual position indicates that Freetime received services from Deal Partners in return for payment. Only if it is not consistent with economic or commercial reality would that conclusion not follow.

47. In our judgment, the contractual arrangements in this case do indeed reflect economic reality. The whole purpose of the Partner Boost scheme is to benefit Stores, by promoting customer loyalty. It is accepted that Freetime operates its own, separate,

business. (We reject HMRC's contention that Freetime is in a materially different position to that of LMUK, because LMUK was wholly separate from all of the retailers involved in the Nectar scheme, whereas Freetime is a corporate entity within the Tesco plc group, with no independent staff of its own. The corporate connection between Freetime and the Tesco plc group does not undermine the fact that it carries on a separate business to that of Stores.) Freetime's business consists of procuring Deal Partners to accept Reward Tokens in exchange for the provision of Rewards. Freetime is required to do this in order to fulfil its contractual obligations to Stores. To borrow from the language of Lord Reed in *LMUK-SC* at [80], the only economically rational explanation of Freetime's behaviour is the value to Freetime itself of the Deal Partner's acceptance of Reward Tokens in exchange for the provision of goods and services to Clubcard Members.

Addressing HMRC's arguments

48. HMRC's arguments principally fall under two broad headings: first, points going to the economic reality of the Tesco Clubcard programme and, second, arguments relating to respectively the similarities between, and distinction from, the loyalty schemes under consideration in the *LMUK* litigation.

Economic reality

49. HMRC contend that, when considering the economic reality of the contractual arrangements that make up the Partner Boost scheme as a whole, the starting point is to identify where there is final consumption of a taxable supply or supplies and to ask, in respect of those supplies, whether "sticking" VAT is being paid on the consideration for those supplies. (HMRC agree, in this respect, with Freetime, that VAT is more accurately seen as a tax on the consideration for consumption, not a tax on consumption itself.) In this case, HMRC argue that there is consumption on redemption of Rewards (for example when a Clubcard member receives a pizza supplied by a Deal Partner), but there is no sticking tax paid in respect of the part of the price that is satisfied by Reward Tokens. That, it is submitted, is a powerful indicator that as a matter of economic reality the payment from Freetime to the Deal Partner is to be regarded as third party consideration because, otherwise, there would be final consumption without sticking tax.

50. We reject this analysis, for the following reasons.

51. First, there is binding authority that the starting point is to look at the transaction from the standpoint of the person who is claiming the deduction by way of input tax. In *Redrow*, Lord Hope, at pp.412-413 said:

> "The matter has to be looked at from the standpoint of the person who is claiming the deduction by way of input tax. Was something being done for him for which, in the course or furtherance of a business carried on by him, he has had to pay a consideration which has attracted value added tax? The fact that someone else — in this case, the prospective purchaser — also received a service as part of the same transaction does

> not deprive the person who instructed the service and who has had to pay for it of the benefit of the deduction."

52. Lord Millett, at p.418 said:

> "In my opinion, these two factors compel the conclusion that one should start with the taxpayer's claim to deduct tax. He must identify the payment of which the tax to be deducted formed part; if the goods or services are to be paid for by someone else he has no claim to deduction. Once the taxpayer has identified the payment the question to be asked is: did he obtain anything — anything at all — used or to be used for the purposes of his business in return for that payment? This will normally consist of the supply of goods or services to the taxpayer. But it may equally well consist of the right to have goods delivered or services rendered to a third party. The grant of such a right is itself a supply of services."

53. As we have noted above, the conclusion and the reasoning in *Redrow* were approved in *LMUK-SC*.

54. Second, as Mr Peacock QC submitted, the fact that there is found to be no sticking tax when a Clubcard member receives (or consumes) a Reward is neither here nor there when considering the question whether the economic reality of the arrangement between Freetime and Deal Partners is a supply from the latter to the former. He points out that when points are redeemed in-store upon the acquisition of redemption goods there is no sticking tax in relation to that part of the consideration for the redemption goods which consists of vouchers. It is not surprising to find that the redemption of points via the different route of receipt of a Reward produces a similar result. It is certainly not a reason to question whether the economic reality of the arrangement between Freetime and Deal Partners is different from that which the contract between them might suggest. Ms Foster QC accepted that whether there is, or is not, sticking tax in relation to a taxable supply found within an arrangement cannot be determinative of the answer to the question raised by this appeal, since it is a fact that some mechanisms do, and some do not, result in sticking tax. Put another way, one would only expect "sticking tax" to arise on consumption of the Reward if consideration is given for that consumption. Therefore, HMRC's arguments relating to the absence of "sticking tax" are essentially circular and assume what they seek to prove, namely that the sums that Freetime pays Deal Partners are third party consideration for the supply of the Reward to Clubcard Members.

55. Third, if the fact no sticking tax is payable in respect of the receipt of a Reward by a Clubcard member is a reason to conclude that the payment from Freetime to the Deal Partner is third party consideration, then the same must have been true of the arrangement in *Redrow*. In other words, the fact (as was the case) that no sticking tax was payable in respect of the receipt by the homeowner of a service provided by the estate agent would have been a reason for concluding that the payment from Redrow to the estate agent was third party consideration for a supply by the estate agent to the homeowner. That was, however, not the conclusion reached by the House of Lords. The decision in *Redrow* is thus inconsistent with HMRC's submission in this case.

56. Fourth, to the extent that this point was framed as a broader argument that "the appropriate analysis under VAT law should produce a result where the tax does stick", we consider that it is met by an argument broadly similar to that set out by the FTT at paragraphs 85 to 94 of the Decision. Ms Foster QC's argument involves, as she put it, pulling back the camera so as to see the wider picture. If that is done, she submitted that the critical feature which emerges is the Clubcard member's consumption of (as the case may be) a free pizza or trip to the cinema. But why stop there? If the camera is pulled back to encompass the entire Tesco Clubcard programme, then the picture presented is one in which, while the cost of the programme is borne by Tesco in the first instance, it is merely one component of its overall business costs, all of which costs are factored into the prices at which its goods are offered to the public. Thus the apparently free gift, either by way of redemption goods and Rewards, is in economic reality paid for by Tesco's customers as a whole. Tesco accounts for the output tax received on such payments. Accordingly, taking this broad view of the Tesco Clubcard programme, there is sticking tax in the sense that VAT is accounted for by Tesco on the totality of the payments received from customers by Tesco as consideration for the totality of the goods and services supplied (directly or indirectly) by it to its customers.

57. HMRC object that this argument is itself flawed, being inconsistent with the decision of the ECJ in *Kuwait Petroleum (GB) Ltd v Customs and Excise Commissioners* (Case C-48/97) [1999] STC 488. That case concerned a sales promotion scheme whereby customers buying fuel at a service station operated by Kuwait Petroleum ("KP") were offered vouchers which they were entitled to exchange for redemption goods listed in a catalogue. It was common ground that KP was entitled to deduct the VAT paid on acquiring the redemption goods. The issue was whether the provision of redemption goods to customers constituted a "disposal … free of charge" within the meaning of Article 5(6) of the Sixth Directive, such that KP was required to account for VAT on a deemed taxable supply of the redemption goods (at cost price, thus neutralising the input tax deducted on the purchase of the redemption goods). Article 5(6) provided as follows:

> "The application by a taxable person of goods forming part of his business assets for his private use or the use of his staff, or the disposal thereof free of charge or more generally their application for purposes other than those of his business, where the value added tax on the goods in question or the component parts thereof was wholly or partly deductible shall be treated as supplies made for consideration. However, applications for the giving of samples or the making of gifts of small value for the purposes of the taxable person's business shall not be so treated."

58. KP's argument was that the supply of fuel and the later supply of the redemption goods were two interdependent contracts and the payment made for the fuel under the first contract included payment for the later supply of the redemption goods. The ECJ concluded, first, that on the true construction of Article 5(6) a disposal free of charge of goods forming part of a taxable person's business assets was to be treated as a supply made for consideration where input tax credit had been allowed on the purchase of the goods. Second, the ECJ concluded that "goods are supplied 'for consideration' within the meaning of Article 2(1) of the Sixth Directive only if there is a legal relationship

between the supplier and the purchaser entailing reciprocal performance, the price received by the supplier constituting the value actually given in return for the goods supplied…" It was a matter for the national court to enquire whether, at the time of purchasing the fuel, the customers and KP had agreed that part of the price paid would constitute the value given in return for the vouchers or redemption goods. The ECJ nevertheless indicated its clear view that the documents before it indicated that there was no consideration paid for the vouchers or redemption goods. It noted in particular that the redemption goods were described as free gifts and that customers paid the same for fuel whether or not they accepted vouchers.

59. In our judgment, there is no inconsistency between the decision in *Kuwait Petroleum* and the conclusion we have reached at paragraph [56] above. The court in *Kuwait Petroleum* was concerned only with the question whether – for the purposes of Article 5(6) (a provision about output tax) – the payment by the customers for fuel was also "consideration" for vouchers or redemption goods. That is a different question to the one at issue on this appeal, and Article 5(6) is irrelevant here. It has no application to vouchers offered by way of discount against purchase of redemption goods. It has no application to services (which form the bulk of the Rewards), and it would in any event have no application to points, vouchers or Rewards provided to Store's customers by anyone other than Stores.

60. It is also important to remember that the only issue raised by this appeal is the extent to which Freetime receives "Fulfilment Services" from Deal Partners. A conclusion on this issue will not be determined by reference to a finding that the price paid by Clubcard members upon the acquisition of premium goods is in any technical sense "consideration for" the points issued upon that acquisition, for the vouchers into which those points are later converted, or for the Reward Tokens, for which those vouchers may later be exchanged (although later in this decision, we will consider the parties' respective arguments on the significance or otherwise of the "logically prior supply" referred to at [37(4)]).

61. Nor do we consider that the FTT erred in attaching weight to its conclusion that the economic burden of the entire Tesco Clubcard programme is met by the customers of Tesco. That aspect of the FTT's reasoning, properly understood, was not suggesting that any part of the consideration that Clubcard members give for premium goods should be treated as consideration for a taxable supply of points, vouchers or Reward Tokens. Any such conclusion would have been inconsistent with the Court of Appeal's decision in *Tesco plc v HMRC*. Rather, the FTT made these points as part of its consideration of economic reality and as an answer to the objection that Tesco's analysis must be wrong because it results in unpaid sticking tax.

62. Finally, Ms Foster QC submitted that the FTT's own findings of fact at [18] of the Decision compelled the conclusion that the economic reality was that Freetime was giving third party consideration for a provision of rewards to Clubcard members rather than paying Deal Partners for services being supplied to it. The full text of the passage on which she relied was as follows:

> "Freetime meets the cost to it of running the scheme, including the payments it makes to Deal Partners, by invoicing Stores, monthly, for an agreed fee reflecting the cost of providing its service plus a charge determined by reference to the amount it has paid during the preceding month to Deal Partners. That amount is, of course, determined by the extent to which Clubcard Members have converted the vouchers they have received in respect of accumulated points to Reward Tokens, and have then used those tokens. The total amount invoiced exceeds the costs which Freetime incurs, and it therefore makes a profit. It follows that there is an arithmetical link between the amounts received by Stores from its own customers, the Clubcard Partners and Bank on the one hand, and the combination of the amounts it is obliged to forego when customers redeem vouchers against the price of goods and services and the amounts it pays to Freetime, on the other. I should also formally record, since it was a matter on which HMRC relied, that the amount Freetime pays to each Deal Partner is directly linked to the extent to which Clubcard Members have used Reward Tokens to acquire goods and services from that Deal Partner, and that the amount Freetime receives from Stores is directly linked to the aggregate use by Clubcard Members of Reward Tokens during the month."

63. That finding, however, is simply as to an arithmetic link between amounts that Freetime pays and use of Reward Tokens. That arithmetic link was certainly relevant to the questions that the FTT had to consider but was not determinative of them. The FTT was not, in our view, making any more substantive finding as to linkage between the Deal Partner Fee and the redemption of Reward Tokens by Clubcard members with Deal Partners.

64. Accordingly, while we agree with HMRC that, when undertaking an analysis of the VAT consequences of complicated arrangements such as "Partner Boost", it is necessary to have regard to all relevant principles of VAT law, we consider that those principles do not detract from the conclusion that under the contractual arrangements in this case, and as a matter of economic reality, the Deal Partner Fee was paid in consideration of the supply of services by the Deal Partners to Freetime.

The LMUK Litigation

65. HMRC contend that on a proper analysis, the Tesco Clubcard programme is materially similar to the "Baxi" loyalty scheme which was considered (pursuant to a parallel reference) by the ECJ in conjunction with the Nectar scheme in *LMUK-ECJ*, and that the Supreme Court in *LMUK-SC* endorsed the ECJ's conclusion in respect of the Baxi scheme.

66. Further, HMRC contend that the FTT fell into error in concluding that the Tesco Clubcard programme is materially the same as the Nectar scheme, such that the decision reached by the Supreme Court in *LMUK-SC* was determinative of the outcome here.

67. We preface our remarks in relation to HMRC's submissions as to the similarity and differences between the circumstances of this case and those in the *LMUK* litigation by reiterating the limited utility of seeking to determine the proper application of legal

principles in one set of circumstances by reference to another court's application of legal principle to a different set of circumstances. That applies equally, if not more so, to decisions of the ECJ whose function is to determine matters of EU law such as interpretation of Directives, but leaves the application of those principles to the domestic courts of each member state.

68. We will start with the points that HMRC made in relation to the "Baxi" loyalty scheme. We agree that the brief description of that scheme set out in *LMUK-ECJ* indicates that it had clear similarities with the Partner Boost aspect of the Clubcard Programme. Moreover, the ECJ concluded that payments Baxi made to @1, were in part consideration for services that @1 provided to Baxi (in respect of which Baxi was entitled to input tax credit) and in part third party consideration for goods that @1 supplied to consumers (in respect of which Baxi was not entitled to input tax credit). That is precisely the alternative analysis that HMRC submit should apply in this appeal. However, both European and domestic jurisprudence emphasise the factual nature of the enquiry as to whether a person is entitled to input tax credit in analogous situations to those of Baxi and the importance of "economic reality" which can only be ascertained by reference to the particular arrangements being examined. Therefore the fact that the ECJ reached a particular conclusion by reference to Baxi's loyalty scheme cannot, as a matter of either EU or domestic law, compel the same conclusion in the case of Tesco's loyalty scheme.

69. HMRC submit that the Supreme Court effectively endorsed the ECJ's conclusion on the analysis of the Baxi loyalty scheme. They point out that, at [56] of his judgment in *LMUK-SC*, Lord Reed said:

> "The Court of Justice's analysis of the legal issues focused in the reference, on the basis of the facts as it understood them, is not open to question."

The Supreme Court did not identify any failure by the ECJ to understand the complexities of Baxi's scheme (as distinct from the lack of understanding of key aspects of LMUK's scheme that the Supreme Court identified). Therefore, it was submitted, Lord Reed and the majority of the Supreme Court should be taken as agreeing with the ECJ's analysis of the Baxi reward scheme even if they did not agree with its analysis of the issues in the Nectar scheme.

70. We do not, however, accept that submission. At [56], Lord Reed was simply stating the general principle that the ECJ's decision on matters of interpretation of EU law are binding on national courts. That conclusion is emphasised by the next two sentences of paragraph [56] which read as follows:

> "This court is required by section 3(1) of the European Communities Act 1972 (as amended by section 3 of and the Schedule to the European Union (Amendment) Act 2008) to determine "any question … as to the validity, meaning or effect of any EU instrument" in accordance with "any relevant decision of the European Court". Nevertheless, this court's responsibility for the decision of the present case on the basis of all the relevant factual circumstances, and all the arguments presented, requires it to take into account all the facts found by the tribunal, including those

> elements left out of account by the Court of Justice, and to consider all those arguments, including those which were not reflected in the questions referred."

Therefore, Lord Reed was not, in our view, commenting on the correctness or otherwise of the ECJ's conclusions on the Baxi scheme (indeed, viewed in context, paragraph [56] of *LMUK-SC* seems to be referring to the ECJ's analysis of the Nectar scheme and not the Baxi scheme).

71. What matters, therefore, are the principles that the ECJ applied when considering Baxi's loyalty scheme. Those principles are no different from those we have referred to at [42]: it is necessary to assess all relevant circumstances having due regard to principles of VAT law and questions of economic reality. The analysis of Baxi's loyalty scheme in *LMUK-ECJ* does not contain any statements as to how economic reality should be determined and its analysis of this aspect is highly abbreviated. We respectfully agree with the Upper Tribunal's observations in *Marriott Rewards* that the ECJ reached its conclusion that amounts Baxi paid to @1 could be apportioned into a part qualifying for input tax credit and a part that amounted to third party consideration and did not qualify for input tax credit "without, seemingly, any express analysis". Therefore, even though there clearly are, on the face of it, similarities between Baxi's loyalty scheme and the Partner Boost scheme, *LMUK-ECJ* contains no guidance that is binding on us as to how we should analyse the "economic reality" of the Partner Boost scheme and still less does it compel the conclusion that the Deal Partner Fee is purely third party consideration for Deal Partners' supply of Rewards to Clubcard members.

72. Turning to the Nectar loyalty scheme aspect of *LMUK-SC*, Ms Foster QC submitted that: (1) there is a material distinction between the Tesco Clubcard programme and the Nectar loyalty scheme; (2) the feature that was present in the Nectar scheme, but is missing from the Tesco Clubcard programme, was critical to the Supreme Court's decision to disregard the ECJ's findings in relation to the Nectar scheme; and therefore (3) the ECJ's findings in relation to the Nectar scheme should be held to determine the outcome of this appeal in relation to the Tesco Clubcard programme.

73. In order to understand Ms Foster's submission it is necessary to set out something of the history of the LMUK proceedings. Initially, that litigation involved only the UK courts and tribunals and resulted in a sharp divergence of opinion. The VAT and Duties Tribunal concluded that LMUK was entitled to input tax credit. The High Court allowed HMRC's appeal and concluded that no credit was available. The Court of Appeal allowed LMUK's appeal and permission to appeal was given to the House of Lords. The House of Lords referred a number of questions in LMUK's appeal to the ECJ. Baxi's litigation had also been proceeding through the UK courts and tribunals but was never joined with that of LMUK in domestic proceedings. When Baxi's appeal came before the House of Lords, the House of Lords also referred questions in that appeal to the ECJ. The ECJ joined the references in Baxi and LMUK together and, in *LMUK-ECJ* released a judgment, without asking for an opinion from the Advocate General which dealt with both referrals.

74. LMUK's appeal then came back before the Supreme Court (which had, since the reference to the ECJ replaced the House of Lords as the UK's highest court) for final

determination in the light of *LMUK-ECJ*. Baxi's appeal never came back before the Supreme Court and we can only assume that, having received what it regarded as a dispositive decision from the ECJ, Baxi decided not to continue with its domestic appeal. By a 3-2 majority, and despite the ECJ's decision in *LMUK-ECJ* the Supreme Court determined that LMUK was entitled to input tax credit.

75. Ms Foster QC's principal submission is that Lord Reed (whose judgment is the only one with which a majority of the Justices were in agreement) was able to disregard the findings of the ECJ because it had in turn disregarded (or not had brought to its attention) the fact that there had been a prior taxable supply (of a contractual right to receive rewards) *to collectors* upon which VAT had been charged. She relies on various passages in the judgment of Lord Reed, in particular those at [31] and [77].

76. At [31], Lord Reed identified, as one of the matters not brought sufficiently to the attention of the ECJ, the fact that:

> "…the statement that 'the sponsors issue "points" to customers' was a very compressed, and potentially misleading, way of describing the arrangement under which the sponsor's computer communicates electronically with LMUK when a collector's card is swiped, LMUK then credits the collector's account with the rights represented by "points", and the sponsor pays LMUK for the grant of those rights".

77. He went on:

> "Nor was it explained that, unlike the position in a typical loyalty rewards scheme, where no identifiable consideration is given for the issuing of points (as, for example, in [*Kuwait Petroleum*]) the issuing of points by LMUK was accepted by both parties to be a taxable supply. Nor was it explained that LMUK therefore accounted for VAT on the consideration given for the *supply to collectors of the right to receive rewards*." (emphasis added)

78. At [77], Lord Reed said:

> "As I have explained, however, there is another dimension to the case, which the Court of Justice was not requested to consider, and which it therefore left out of account. The appeal before this court is concerned with the claim of LMUK, a taxable person, to deduct input tax. LMUK's business is of an unusual character. Through the Nectar scheme, it provides collectors with a contractual right to obtain goods and services from redeemers in exchange for points. It is common ground before this court that that is a taxable supply, and that the taxable amount is the whole of the consideration which is received by LMUK. The counterpart of the *right supplied to collectors* is an obligation on the part of LMUK to procure that redeemers provide goods and services in exchange for points. The payments made to redeemers constitute the cost of fulfilling that obligation, and are therefore a cost of LMUK's business." (emphasis added)

79. Mr Peacock QC, on the other hand, referred to a passage in the judgment of Chadwick LJ in the decision under appeal in *LMUK-SC*, at [8], in which he recorded

what appeared to be common ground as to the VAT treatment of the various elements in the scheme, including that:

> "[LMUK] treats as standard-rated supplies the supplies it makes *to the retailers* [information about customers, and the marketing, development and promotion of the scheme] in return for the payments made by retailers to [LMUK] (including the points price and the annual marketing fee). The retailers treat the tax on those supplies as input tax which is deductible to the extent they use the supplies to make taxable (not exempt) supplies." (emphasis added)

80. He also referred to a number of passages in Lord Reed's judgment in which although he referred to the "grant" of the points – and the rights represented by them – being to the collectors, and referred to this constituting a taxable supply, he did not indicate *to whom* that supply is made. He submitted that Lord Reed was likely to have been aware that it had been regarded as settled, at least before the Court of Appeal, that the element of the scheme consisting of supplies made by LMUK were treated as supplies *to retailers* and not to collectors. Accordingly, he said, in view of the various passages in his judgment where he drew a distinction between the concept of a "grant" of rights (which he said was "to collectors") and the concept of a "supply" on the other (where he did not identify the recipient of the supply), Lord Reed cannot have thought that LMUK had indeed "supplied" (in a VAT sense) the rights represented by points *to collectors*.

81. We find Mr Peacock QC's submission difficult to square with the express references in [31] and [77] of Lord Reed's judgment to the grant of rights represented by points to collectors as a "supply" made by LMUK to collectors.

82. We nevertheless reject Ms Foster's submission that Lord Reed considered that the existence of a prior taxable supply *to collectors* was a critical feature of the Nectar scheme such that, without it, he would have agreed with the ECJ's findings on the facts relating to the Nectar scheme.

83. First, and by way of preliminary comment, it was not Lord Reed's purpose, in identifying those parts of the Nectar scheme which had not been drawn to the attention of the ECJ, to identify features of the Nectar scheme that were essential pre-requisites to a finding that LMUK was entitled to deduct the payments made to redeemers as input tax. Instead, his purpose was to identify reasons why the ECJ's conclusions on the application of legal principles to the facts of the Nectar scheme were not binding on the domestic courts.

84. Second, we do not think it was a necessary part of Lord Reed's reasoning to distinguish to whom the supply was made. Rather, the important distinguishing feature was that there had been a prior taxable supply *by LMUK*, when points (conferring a contractual entitlement to receive goods) were awarded. Therefore, when referring to the logically prior supply, Lord Reed was making a point about symmetry: when the points were awarded, LMUK was making a taxable supply and that suggested that, when it incurred costs in connection with the redemption of points, it should be entitled

to credit for the associated input tax. That is made clear in the closing sentences of paragraph [77] of Lord Reed's judgment:

> The counterpart of the right supplied to collectors is an obligation on the part of LMUK to procure that redeemers provide goods and services in exchange for points. The payments made to redeemers constitute the cost of fulfilling that obligation, and are therefore a cost of LMUK's business.

If Lord Reed had regarded the recipient of the logically prior supply as the critical, distinguishing, feature, then it is surprising (1) that this was not expressly identified and (2) that on numerous occasions Lord Reed referred to the provision of points to collectors as the prior taxable supply, without identifying the recipient of that supply.

85. Further, there was an important reason to identify the fact of a prior taxable supply *by LMUK*, which was of direct relevance to the question whether LMUK could deduct payments made by it to redeemers as input tax. That is, that in order for a taxable person to deduct the VAT element of payments made by it, in respect of a supply of goods and services to it, it is necessary (under the opening words of Article 168) that the goods and services are "used for the purposes of the taxed transactions of a taxable person". This is more likely to have been the focus of Lord Reed's remarks in [77] of his judgment (quoted in full above), in which he highlighted the importance of LMUK receiving consideration pursuant to "a taxable supply", the counterpart of which was the obligation upon LMUK to procure that redeemers provided goods and services to collectors, such that the payments made to redeemers constituted the cost of fulfilling that obligation, and thus a cost of LMUK's business.

86. Understood in those terms, therefore, Freetime is making a logically prior supply of the kind to which Lord Reed attached significance. Freetime makes supplies to Stores pursuant to the Stores/Freetime contract. Those supplies are in principle taxable supplies (albeit, for a part of the relevant period, Freetime and Stores were members of a VAT group so that in practice the supplies are disregarded for VAT purposes). The Stores/Freetime contract, as we have noted, imposes a contractual obligation on Freetime to enter into arrangements with Deal Partners. Therefore, the symmetry that Lord Reed identified in relation to LMUK's business is present in Freetime's business as well: it makes taxable supplies by agreeing to procure that Rewards are honoured which points towards the conclusion that it should obtain credit for input tax it incurs in paying Deal Partners to honour Rewards. We do not consider that this conclusion is affected by the undoubted fact (following the decision of the Court of Appeal in *Tesco plc v HMRC*) that neither points, Clubcard vouchers nor (we infer) Deal Tokens should be treated as having been supplied for a consideration.

87. Finally in this context, we note the comments of Lord Reed at [84] and [85] of his judgment in *LMUK-SC*:

> "84. If one asks, what about taxation of the supply to the final consumer, the answer is that the Commissioners have decided to treat the issue of the points to the collectors – that is to say, the award of the right to obtain goods and services from redeemers – as a taxable supply. The taxable amount is agreed to be the whole of the consideration received by

> LMUK for the grant of those rights: an amount which exceeds the value received by the redeemers from LMUK when the rights are exercised. No question arises in this appeal as to whether that tax treatment is correct. Because of the principle of tax neutrality, however, that tax treatment has implications for the question in issue.
>
> 85.As the Court of Appeal pointed out, if the provision of goods or services by redeemers were treated as a taxable supply to the collector (other than to the extent to which any monetary consideration might be paid by the collector), the tax authorities would receive not only VAT on the amount received by LMUK for supplying the right to receive those goods and services, but also VAT on the amount which LMUK must pay to satisfy that right. If, on the other hand, the consideration paid by LMUK to the redeemers is regarded as the consideration for the supply of a service to LMUK (a service which encompasses the provision of goods and services to collectors), the tax authorities will still receive VAT from LMUK on the difference between the value of the supplies which it makes in the course of its business (ie its receipts from the supply of the right to receive such goods and services) and the value of the supplies which it receives for the purposes of that business (ie the cost to LMUK of satisfying that right). The tax authorities will thus recover VAT on the value added by the taxable transactions entered into by LMUK, taking the issue and redemption of points as a whole. That conclusion is in accordance with the basic principle of VAT."

88. In their skeleton argument, Ms Foster QC and Mr Macnab submitted that the existence of the logically prior supply, giving rise to sticking tax, was central to Lord Reed's reasoning in *LMUK-SC*. They put the point in the following way:

> "It was only because the rewards [*in LMUK-SC*] were already subject to sticking tax [when the contractual rights to rewards were supplied to collectors] that Lord Reed found himself unable to treat the provision of reward goods/services by redeemers as taxable supplies to collectors."

89. We consider that Ms Foster QC and Mr Macnab have overstated the significance of sticking tax resulting from the logically prior supply. In paragraphs [84] and [85] of his judgment, we consider that Lord Reed was stepping back and "sense-checking" the conclusions he had set out in earlier passages of his judgment. We agree with Ms Foster QC that he was attaching significance to the existence of a logically prior supply that consists of the grant of a contractual right to receive goods and services. However, at its highest, paragraphs [84] and [85] of Lord Reed's judgment indicate that where a grant of points as part of a loyalty scheme involves a taxable supply of a contractual right to receive goods and services, that tends to suggest that the redemption of points does not involve a further taxable supply to collectors. Paragraphs [84] and [85] of Lord Reed's judgment do not compel the conclusion that a logically prior taxable supply of points that gives rise to sticking tax is a necessary condition for Freetime to obtain credit for input tax in respect of the Deal Partner Fee.

90. We have considered HMRC's arguments carefully. However, we do not consider that they compel any conclusion other than that it is entirely consistent with both economic reality and applicable principles of VAT law that Freetime should obtain

credit for input tax that it incurs in paying Deal Partners to honour Rewards due under the Clubcard Programme.

Apportionment

91. Having concluded that Freetime does receive services from Deal Partners, the final relevant question is whether, as HMRC argue, Freetime should obtain credit for only some of the input tax that it incurs on the basis that, at least to an extent, some of the consideration that it pays is third party consideration for the provision of Rewards to Clubcard members.

92. We note that the burden is on Freetime to demonstrate that the entirety of the input tax it has claimed is creditable. Therefore, the burden is on Freetime to establish that no apportionment should be made.

93. We consider that Freetime has discharged that burden. Both the contracts and economic reality lead us to the conclusion that Freetime pays the Deal Partner Fee as consideration for Deal Partners agreeing to honour Rewards that Freetime has provided to Clubcard members in the course of its business. Neither the contracts nor economic reality suggest that only part of the sums that Freetime pays is consideration for services supplied to Freetime.

Disposition

94. For the reasons set out above, HMRC's appeal is dismissed.

MR JUSTICE ZACAROLI
JUDGE JONATHAN RICHARDS
RELEASE DATE: 24 January 2019