Indirect tax update

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Summary

Welcome to this week's Indirect Tax Update.

The Court of Justice has not published any VAT judgments or opinions this week so we turn to the UK for our indirect tax news.

In a case that seems to have been around for years, the First-tier Tax Tribunal (FTT) has issued its latest decision in the case of Newey t/a Ocean Finance. The case began its journey through the courts in 2010 and was heard initially in the FTT then appealed by HMRC to the Upper Tribunal which then referred the case to the Court of Justice. The Upper Tribunal dismissed HMRC's appeal and HMRC then appealed to the Court of Appeal which determined that the Upper Tribunal's judgment was flawed. The Court could have remade the decision but it preferred to remit the case back to the FTT. So, after 10 years of litigation, the FTT has issued a second decision.

Also this week, HMRC has issued Revenue & Customs Brief 14/2020 which concerns the method of apportionment between taxable and exempt supplies by dispensing opticians and suppliers of hearing aids. The Brief sets out a new policy for affected businesses.

There is also growing concern with regard to the impact of HMRC's change of policy in relation to the VAT treatment of termination and similar payments (see our ITU 29/2020 dated 11 September 2020).

The change of policy follows two Court of Justice cases (MEO Telecoms and Vodafone Portugal) where the Court determined that early termination payments should not be regarded as compensation (outside the scope of VAT) but as further consideration for the (taxable) underlying supply.

The concern arises from HMRC's insistence that UK businesses should correct the historic VAT treatment even though they followed HMRC's published policy and guidance. For many UK businesses, this is a significant issue.

First-tier Tax Tribunal – Paul Newey t/a Ocean Finance

Whether VAT arrangements were abusive

There is a long and protracted history to this case. In simple terms, the taxpayer put arrangements in place to mitigate the impact of irrecoverable input VAT. One of the (many) golden rules of the VAT system is that input VAT incurred by a business cannot be reclaimed by that business if it relates (or is attributable to) the making of exempt supplies. Ocean Finance arranged loans – a service which is exempt from VAT. This meant that without anything further, any VAT incurred by the business could not be reclaimed. The business sought to mitigate that VAT cost and it put in place arrangements which, in effect, meant that no VAT would be incurred on its advertising costs. The arrangements involved establishing a company based in Jersey (outside the EU VAT territory) which meant that no VAT was chargeable and thus, no VAT was lost by being irrecoverable.

Not surprisingly, HMRC considered that the arrangements conferred a tax advantage on the company. HMRC considered that the correct position was that VAT was due on the advertising services and that VAT represented irrecoverable input tax in the hands of Ocean Finance. The sum at stake for the periods from July 2002 to December 2004 was £10.7 million.

At the original hearing of the taxpayer's appeal in 2010, the FTT allowed the appeal. Whilst the arrangements were undertaken to provide a tax advantage, neither the scheme or arrangements involving the Jersey company, nor any part of them, was contrary to the purposes of the Sixth Directive. HMRC appealed to the Upper Tribunal which, in 2011, referred the case to the Court of Justice for guidance in relation to the interpretation of EU law. The Court of Justice provided its judgment in 2013 and, in 2015, the Upper Tribunal dismissed HMRC's appeal finding no error of law in the FTT's original 2010 decision. HMRC then appealed to the Court of Appeal which considered that the Upper Tribunal's judgment was flawed. The Court decided that the Upper Tribunal had erred because it had based its judgment on facts established by the FTT that turned out to be incorrect. The Court of Appeal could have remade the decision itself but, as the issue rested on facts established at the FTT, it felt that the best way of dealing with the case was to refer it back to the FTT.

The latest decision published this week is the FTT's decision after the case was reheard and the correct facts established. The FTT has concluded that having applied the correct test, the business relationships actually entered into between Mr Newey, the Jersey company, the lenders and the advertising agency reflect the economic and commercial reality, and do not constitute a wholly artificial arrangement which does not genuinely reflect economic reality. In other words, whilst the arrangements put in place by Ocean Finance were designed to give it a tax advantage, the arrangements were not artificial and were not an abuse of rights granted by EU law.

Having spent more than a decade in litigation, it will be interesting to see whether HMRC will have the appetite to litigate the matter further.

Comment – there is an unwritten principle of EU law that prevents the abuse of rights. In this case, the taxpayer set up an 'offshore' arrangement which had the effect of removing a significant VAT charge (irrecoverable VAT incurred on advertising costs). It has taken ten years for the courts to decide that, even though it was clear that the arrangements put in place were intended to obtain a tax advantage, those arrangements were genuine and were not a sham. The advertising services were supplied to the Jersey company and not to Ocean Finance and the arrangements did not abuse the law. HMRC has 56 days from 14 September to lodge a further appeal.

Revenue & Customs Brief 14/2020

Changes to the methods used by opticians and sellers of hearing aids to account for VAT on their supplies

HMRC has issued Revenue & Customs Brief 14/2020 which relates to opticians and sellers of hearing aids.

In 1995, the UK courts decided that when an optician supplies an eye test and spectacles to a patient, the optician makes two separate supplies for VAT purposes. The first supply – the eye test – is an exempt supply of services (medical care) whereas the second supply – the supply of the spectacles or contact lenses – is a taxable supply of goods.

As a consequence, opticians became partially exempt – in other words, opticians were required to apportion their input tax on general overheads so that no input VAT relating to the exempt supplies was reclaimed. The same principles apply to sellers of hearing aids. Affected businesses were required to apportion their input tax by reference to the value of the separate supplies (which had to be disclosed to the customer at the point of sale) or by reference to a formula agreed with HMRC.

Revenue & Customs Brief 14/2020 announces changes to these requirements. From 1 October 2020, the processes will be simplified. HMRC states that there is currently no uniform standard of evidence required from businesses to show that they are making separately disclosed charges. From 1 October 2020 therefore, businesses will be required only to hold a till slip or similar evidence to demonstrate that they are making two separate charges to the customer at the time of supply, and that this information is being conveyed to the customer.

Those businesses using a method of apportionment will no longer have to seek prior approval from HMRC before operating a method. This will bring opticians and dispensers of hearing aids into line with other businesses that apportion VAT on their sales.

Comment

Opticians and suppliers of hearing aids should take note of the changes announced n this Brief.

The 'default' method of input tax apportionment is known as the 'standard' method and is based on the ratio between the value of taxable supplies and the value of taxable plus exempt supplies. In many cases, however, this method does not produce an accurate result and, in such cases, businesses are entitled to adopt a 'special' method of apportionment that must be agreed with HMRC.

Opticians and hearing aid dispensers may wish to consider adopting a special method if they consider that the standard method does not produce an accurate result.

VAT on early termination and similar payments

Concern over HMRC's change of policy and retrospective implementation.

As reported in our Indirect Tax Update 29 of 11 September 2020, HMRC announced a change to its policy on the VAT treatment of early termination and similar payments. This change in policy followed the Court of Justice judgments in two cases (MEO Telecoms and Vodafone Portugal) where the court determined that the early termination payments were not compensatory in nature nor were they damages for any breach of contract. In fact, the payments were additional consideration for the provision of the underlying service (telecoms in those cases). The court considered that the requirement to pay early termination charges was a fact that was known to the customer at the outset of the contract. As such, the customer knew that an early termination payment would be due if he chose to terminate the contract early. In such circumstances, the court considered that the termination payment was not, therefore, to compensate the supplier for any loss and nor was it damages for a breach of contract.

HMRC announced in September that it was to change its existing policy (which treated such payments as compensation which was outside the scope of VAT) to fall in line with the Court's judgments. However, HMRC also stated that it expected businesses to make four-year retrospective adjustments unless the business had a specific written ruling that payments should be treated as outside the scope. This has caused great concern to many businesses that have, hitherto, implemented HMRC's published policy and guidance but who have not obtained a written ruling confirming the VAT treatment. We understand that HMRC was to discuss the matter at a recent Joint VAT Consultative Committee (JVCC) but withdrew the item from the agenda. However, we understand also that HMRC is planning a written response to the many queries and concerns raised on the policy change.

Comment

It is, of course, right that HMRC should change its policy in relation to the VAT liability of early termination and similar payments following the two judgments of the Court of Justice.

However, any change to the policy must, in our view, be implemented prospectively and not retrospectively. Taxpayers have relied on published policy and guidance and cannot now be expected to correct their VAT positions retrospectively.

HMRC should reconsider its position in relation to this matter. Any requirement for businesses to make retrospective adjustments would be unconscionable.

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