VAT focus

Recent cases on the principle of abuse of law

**SPEED READ** The creation of the *Halifax* test afforded a specific mechanism to challenge VAT planning. However, case law demonstrates that successful reliance on this test has, to date, been limited. The recent decisions in *University of Huddersfield* [2013] UKFTT 429 (TC), *Paul Newey (trading as Ocean Finance)* (Case C-653/11), and *Pendragon* [2013] EWCA Civ 868 have been significant in restricting the application of the abuse of law principle. The court’s application of economic reality, however, may give HMRC an alternative basis for redefining planning transactions.

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**The Halifax test**

*Halifax* related to a tax planning structure designed to improve recovery of input tax on building costs that were largely non-recoverable. The matter came before the then VAT & Duties Tribunal, which was asked to consider whether the taxpayer had a right to deduct input tax where the transactions on which that right was based constituted an abusive practice. The matter was referred to the then European Court of Justice (ECJ), which established the now well-known two stage test to identify abuse (the *Halifax test*), namely:

- Applying the EU and national rules transposing the VAT directive to the facts, is there a tax advantage which is contrary to the purpose of the tax rules?
- Was the essential aim of the transactions to obtain a tax advantage?

If abuse did exist, the transactions involved had to be redefined to reestablish the situation which would have prevailed in the absence of the abusive transactions. Applied to the facts in *Halifax*, the ECJ found that it was contrary to the purpose of exemption to allow a bank to recover input tax in the context of ‘normal commercial operations’. The essential aim of the transaction was an evidential matter for the national court to consider, taking into account the nature of the links between companies involved in the transactions, and looking at whether the arrangements were purely artificial.

The result for *Halifax* was that input tax was blocked for entities which sought to deduct ‘abusively’.

The decision is memorable for the creation of the *Halifax* test. However, the ECJ also confirmed that a trader has a choice between taxed and exempt transactions, which may be based on a range of factors including tax. In addition, traders may structure business affairs so as to limit tax liability. It is these additional comments which have been applied in the more recent decisions and which put more defined parameters on the scope of the *Halifax*.

**Weald Leasing and RBS Deutschland**

On 22 December 2010, two contrasting decisions involving abuse were released by the ECJ. *Weald Leasing* (Case C-103/09) involved a lease/leaseback structure designed to avoid a heavily exempt business suffering the input tax restriction that would have occurred had it bought assets outright. The court supported the leasing of assets by an exempt business to avoid irrecoverable input tax, even where leasing transactions were not entered into in the context of its normal business arrangements. However, applying the *Halifax* test, the ECJ held that the use of artificially low rents through the imposition of a third party to avoid market rates could be ‘abusive’, but left that for the national courts to decide.

By contrast, *RBS Deutschland* (Case C-277/09) involved an arguably more aggressive arrangement, which worked as a result of an arbitrage between the operation of the different place of supply rules under UK and German VAT law. Essentially, the sale and leaseback of cars by the German subsidiary of a UK bank to another unconnected UK company was VAT free. The ECJ decided that the terms of the transactions did not constitute an abuse. They were ‘not artificial in nature and ... were carried out in the context of normal commercial operations’. This reiterated the ability of traders to choose the most tax efficient structure when faced with a number of business options.

Looking at both cases now, they appear to signpost where the ECJ considered the outer limits of the application of the *Halifax* test to be. Recent cases have honed this further.

**Huddersfield, Newey and Pendragon**

The decisions in *University of Huddersfield* [2013] UKFTT 429 (TC), *Paul Newey (trading as Ocean Finance)* (Case C-653/11), and *Pendragon* [2013] EWCA Civ 868 have been significant in restricting the application of the abuse of law principle.

*University of Huddersfield*: As a university, Huddersfield made largely exempt supplies of education. This significantly restricted its input tax recovery. When the university redeveloped its premises in 1996, in common with many similar organisations at the time, it entered into a lease/
leaseback of the premises with a third party trust. Both the university and the trust opted to tax the premises, which allowed the university to attribute the VAT incurred on the development directly to the taxable lease to the trust. Over the term of the lease, the university incurred VAT on the rents. This spread the cost of the irrecoverable VAT.

In 2002, the VAT & Duties Tribunal held the arrangements to be tax avoidance, and categorised the planning as a ‘deferral scheme with a built in mechanism to allow an absolute saving at a later date’. Such an absolute saving would crystallise if, as actually happened in 2004, the university or the trust terminated the leases before their term. The tribunal chose to refer the case to the ECJ, along with Halifax.

The ECJ rejected HMRC’s argument that the leases, which unlike Weald’s had been entered into on arm’s length terms, were not economic activities, but left it to the national court to apply the Halifax test to determine whether the arrangements were abusive. In doing so, the tribunal found that, for a tax advantage to be contrary to the purpose of the relevant legislation, it had to create an absolute saving. As long as the university continued to account for VAT on the rents paid by the trust, there was no abuse. It was the actual tax advantage obtained on termination of the leases that was abusive which HMRC had not assessed.

Although HMRC has appealed the decision, if the tribunal’s decision is upheld, tax deferral or mitigation should no longer be enough for the abuse of law principle to bite. The decision reinforces Weald; leasing arrangements entered into on arm’s length terms do not cease to be economic activities simply because they are entered into as part of a tax scheme. Following the early Halifax era cases, of which Huddersfield was the last to be determined, we saw HMRC try to use the Halifax test in place of a general anti-avoidance rule. The Huddersfield decision suggests a reining in of this approach by the tribunals and the CJEU.

Pendragon: The Pendragon case concerned a particularly complex scheme involving the creation of leases over cars which were then used as security for obtaining finance from a Jersey bank. The scheme allowed recovery of all the input VAT incurred on the purchase of new cars from the manufacturers. The application of the margin scheme on the eventual sale of the cars meant that VAT was only accounted for on the profit element. Notwithstanding certain contraindications identified by the Upper Tribunal, the Court of Appeal held that the arrangements were simply a tax efficient means of obtaining finance. Among the factors that would perhaps in the past have led to a finding of abuse were: (a) the availability of finance on cheaper terms from existing loans with UK banks; (b) the scheme had been marketed by advisors with a success fee based on the VAT advantage; (c) the £20m tax saving; and (d) the use of a Jersey bank.

The decision of the Court of Appeal is a strict application of the Halifax test. It again confirms that it is not abusive for a taxpayer to enter into commercial arrangements in a way which results in greater tax efficiency. Providing that those arrangements are not solely driven at gaining the benefit of the tax saving, and some other commercial purpose exists, then the court was clear that the Halifax test is not met. Given the highly contrived nature of the arrangements in Pendragon, and the Court of Appeal’s warnings to exercise caution in finding abuse, it sets a very different threshold than that which was imagined in the immediate aftermath of Halifax.

Newey: Although not decided on the basis of abuse of law, the decision of the CJEU in Newey is perhaps the next chapter in the story, charting a move away from abuse of law as a basis for striking down planning, towards the emerging concept of ‘economic reality’.

HMRC argued that the incorporation of a wholly owned Jersey loan broking company to mitigate irrecoverable input tax on advertising was abusive and artificial. The CJEU did not provide any further guidance on abuse of law, but instead suggested that, based on the economic reality of the business relationships, it was ‘conceivable that the effective use and enjoyment of the services took place in the UK’, so that it was the taxpayer that benefited from them. The CJEU held that the contractual relationships could be redefined to reflect the economic reality of the situation. While the abuse of law tide might be low, the tide of economic reality may just be starting to come in, to give HMRC an alternative basis for redefining planning transactions.

Where next for abuse?

In the light of the courts’ apparent reluctance to find abuse, it is disappointing that Supreme Court did not take the opportunity in WHA [2013] UKSC 24 to provide further guidance. Despite finding that a complex reinsurance structure was technically sound but nonetheless abusive, the Court of Appeal declined to consider how the different transactions should be redefined to reverse the abusive tax advantage. Rather than tackling the redefinition question, the Supreme Court held that the structure had not worked technically, so it was unnecessary to consider abuse. So where does this leave us? In relation to redefinition at least, we will have to wait for another case to come before the senior courts. Alternatively, a decision on redefinition may come in the context of ‘economic reality’.

Where next for VAT planning?

For the taxpayer, planning to do business in a VAT efficient manner remains an option so long as a few considerations are taken into account. Planning will very likely be challenged by HMRC; however, as long as the arrangements are clear as to the commercial benefits and evidenced, current case law suggests HMRC will struggle to succeed on an abuse argument. That said, we do not see the case law as having moved things on so far that another exempt business, looking to replicate Halifax’s structure solely with tax savings as its aim, could turn irrecoverable input tax into recoverable.