VAT focus
VWFS and partial exemption

SPEED READ **Historically, VAT recovery in the hire purchase sector was of interest only to practitioners in the asset finance industry. It was fairly anodyne. Then HMRC changed its approach, and it became the arena for a bitter battle over the most contentious pillar of HMRC's policy on VAT recovery – the 'incorporation in price' argument. It came to a head in the *Volkswagen Financial Services (UK) Ltd (VWFS)* litigation. Here, the Court of Appeal found no authority to justify HMRC's contention that the inclusion of the costs of an input transaction in the price of a taxable output transaction was a pre-condition to the recovery of the input tax. The judgment has implications beyond HP businesses, including for VAT recovery by holding companies.**

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Hire purchase (HP) is a singular creature in the VAT world. Where a typical transaction gives rise to only one supply for VAT purposes, a typical HP gives rise to two: one in relation to the asset; and the other in relation to the provision of finance. One is taxable and the other is exempt. This means that VAT incurred on the overheads of a typical HP is automatically attributable to both taxable and exempt supplies. Partial exemption is hardwired into its DNA.

PESM

In practice, a partial exemption special method (PESM) is necessary. The standard method is considered inappropriate because the value of the taxable component (the price of the asset) is so much greater than the value of the exempt component (the finance charges) that a high recovery rate is all but guaranteed. It is generally accepted that the standard method would overstate the extent to which overheads are used to make taxable supplies.

The problem is that there is no obvious proxy that better reflects taxable use. Looking to how overheads are 'physically' used in the real world is of limited assistance because, in the real world, there is only one commercial transaction – a hire contract with an option to buy. Overheads are not apportioned internally between the sale and finance components (because these are notional constructs that exist only for VAT purposes).

Between 1984 and 2000, Customs & Excise (as it then was; now HMRC) and the Finance House Association (now the Finance and Leasing Association) neatly sidestepped these complexities by agreeing to apply a flat recovery rate (of 15%) in relation to the residual input tax of HP businesses. This agreement was terminated in 2000, however, and since then both the taxpayer and HMRC have struggled to find a PESM that both sides would accept as fair and reasonable.

HMRC's perspective

The bugbear for HMRC is the lack of margin on the sale component.

Input tax is only recoverable to the extent it is attributable to a taxable supply. This can be framed in a number of different ways:

- the cost of the input supply must be a cost component of a taxable transaction;
- there must be a direct and immediate link between the input transaction and a taxable output transaction; and
- the input supply must be economically used for the purposes of a taxable transaction.

There is no mark-up on the sale component of a typical HP. With no mark-up, the output tax chargeable on the transaction is the same as the amount of recoverable input tax, even before overheads and residual input tax are taken into account. If the HP business is then able to recover a portion of its residual input tax as well, it would receive net VAT refunds on an ongoing basis. Although this is to be expected where a business makes zero rated or reduce rated supplies, a typical HP business makes no such supplies; and HMRC does not think this is right where the business is profit making (carrying no loss leaders) and makes standard rated and exempt supplies.

In its view, the absence of a mark-up on the sale means the overheads of an HP business are recovered only from the provision of finance. This, it argues, in turn means that such overheads:

- are not cost components of the (taxable) sale;
- have a direct and immediate link only with the (exempt) provision of finance (and none with the sale); and
- are economically used only for the purposes of the exempt (finance) transaction (and not the taxable transaction).

In short, HMRC does not think the input tax on overheads is attributable to the taxable sale where their costs are not included in the price of the asset. It considers that, in such a case, the sale should be left out of account when assessing how much residual input tax is recoverable. For a typical HP business, this would produce a very low recovery rate (often in the region of 0%).

The *VWFS* case

Whether HMRC is right, and whether a PESM based on its approach is, in principle, fairer and more reasonable than the alternative proposed by the taxpayer, were at the heart of the dispute in *Volkswagen Financial Services (UK) Ltd* (*VWFS*) [2015] EWCA Civ 832 *(VWFS)* (reported in *Tax Journal*, 7 September 2015).

The key issue was whether input tax recovery depended on the cost of the input supply being included in and recovered as part of the price of a taxable output supply.

In its judgment, the Court of Appeal noted the incongruity of HMRC accepting that overheads were residual inputs used to make both taxable and exempt supplies, while arguing that none of the input tax was attributable to the taxable supply. It considered that general costs (such as overheads) incurred by a business to maintain its economic activity as a whole were cost components of all the relevant supplies; and that once a supply (such as the supply of the asset on an HP) was found to form part of the economic activity, the direct and immediate link between the inputs and the output supply (required to support recovery) was established. The only issue was how to apportion the costs between the taxable and exempt supplies.

That the overheads in *VWFS* were, as a matter of fact, built into the finance charges, and did not form any part of the price of the asset, was not considered material to the analysis. Economic considerations such as profitability could not reduce the economic use of overheads for the purposes of the sale to nil. The court held that, notwithstanding the various references to 'price' (for example, in *Rompelman* (C-268/83), *Midland Bank* (C-98/98) or *SKF* (C-29/08)), there was simply no authority to justify the rule contended for by HMRC that the inclusion of the costs of an input transaction in the price of a taxable output transaction was a pre-condition to the recovery of the input tax.

HMRC invited the court to refer the issue to the CJEU, but the court declined, taking the view that such a reference was unnecessary.

The PESM that HMRC proposed was, therefore, found to be flawed as a matter of principle, and it could not stand. This left the PESM proposed by the taxpayer, which was fair and more reasonable (in effect) by default.

The impact for HP businesses

The Court of Appeal judgment in *VWFS* is clearly good news for HP businesses. Although it offers little guidance on how taxable use should be ascertained, or what makes an appropriate PESM, in the context of an HP business, it does dispose of one of the industry's main concerns, which is that the recovery rate on a partial exemption method should not be 0%. What the rate should be, however, remains elusive.

In *VWFS*, the choice was between 0% (as contended for by HMRC) and the rate produced by the taxpayer's own proposed PESM – a 'transaction count' method, under which recovery was based on the number of taxable transactions as a proportion of total transactions. The rate was 50% (on the basis that each HP gave rise to two transactions, one of which was taxable).

Whether HMRC sought to challenge the appropriateness of this is unclear: the First-tier Tribunal did not think so, and the Court of Appeal declined to revisit the question. In the circumstances, the judgment can hardly be taken as an endorsement for the use of the rate beyond the parameter of the case, and in practice, it is doubtful that HMRC would accept 50%. What is more likely – assuming it does not appeal further – is that HMRC will shift its focus from what should and should not be included in a PESM to how the factors that are taken into account should be weighted against each other. It may, for example, accept a 'transaction count' method where the exempt transaction is given (say) four or five times the weight given to the taxable transaction (which would produce a recovery rate somewhere between 16.67% and 20%). Or it may choose to proceed on a different basis altogether, moving away from values and transaction counts to (say) some measure of time.

It is difficult to see how HMRC can continue with its construction of 'direct and immediate link', for example

The wider impact

HMRC's argument in *VWFS* is that in order for input tax to be recoverable, the cost of the input supply should be included in the price of a taxable output supply. This is not restricted to HP. For example, HMRC states the following (in its *VAT Input Tax Manual* at VIT40600) when discussing VAT recovery by holding companies:

'the VAT incurred on … costs are recoverable provided the costs have a direct and immediate link to one or more taxable supplies … For there to be a direct and immediate link, the costs incurred must be components of the price of the taxable supplies – VAT will only be recoverable to the extent that this is the case. Costs are components of the price of a taxable supply if they support the making of that supply and it is intended, at the time the costs are incurred, that the expenditure will be recouped from the income resulting from that supply.'

It is difficult to see how HMRC could continue with the above construction of 'direct and immediate link', following the judgment in *VWFS*.

As for the intention to recoup, this was included in the submissions made by the UK in *Sveda* (C-126/14). Although the CJEU has yet to deliver its ruling on the case, in her opinion, the Advocate General specifically rejected the UK's contention that input tax recovery depended on the taxpayer having the intention to incorporate the costs of the input supply in the price of a taxable transaction.

Assuming the CJEU will follow the Advocate General's opinion, *Sveda* will be yet another case that (together with *VWFS* and *Larentia + Minerva* (C-108/14)) challenges the basis of HMRC's approach on VAT recovery generally.

Watch this space. ■

Note: An HP only gives rise to an exempt supply where a separate charge is made for the provision of finance and disclosed to the customer (see VATA 1994 Sch 9 Group 5 item 3). Only HPs where such a charge is made are discussed in this article.

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