VAT focus

The curious case of *VCS*

Speed read

It has been settled law for close to ten years that where a taxable person carries out both economic and non-economic activities, he can only deduct residual input VAT to the extent that the input tax is attributable to his economic activities. In *Vehicle Control Services*, the Upper Tribunal held that the position is the same where the taxable person carries out both economic activities that give rise to supplies and economic activities that give rise to income that falls outside the scope of VAT – the taxable person is required to apportion between the two. Is this consistent with EU jurisprudence?

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Vehicle Control Services (VCS) is a car park operator deriving most of its income from the issue of parking permits and (where users of its car parks are in breach of the rules) parking charge notices. In March 2013, the Court of Appeal ([2013] EWCA Civ 186) held that the income from the issue of parking charge notices constituted damages (for either breach of contract or trespass) and, as such, fell outside the scope of VAT. The question before the Upper Tribunal in June 2016 was whether (residual) input tax incurred by VCS for the purposes of both making in-scope taxable supplies (i.e. issuing parking permits) and carrying on outside-the-scope activities (i.e. issuing parking charge notices) was deductible in full (as VCS argued) or whether such input tax had to be apportioned (as HMRC argued).

The Upper Tribunal (*Vehicle Control Services Ltd v HMRC* [2016] UKUT 316) found in HMRC's favour and held that the input tax had to be apportioned between the two types of activities. As the split between the two types of income was 8% from parking permits and 92% from parking charge notices, revenue-based apportionment would mean much of the input tax was irrecoverable.

On its face, there is nothing remarkable about the Upper Tribunal judgment. It has been settled law since *Securenta* (Case C-437/06) that where a taxable person simultaneously carries on economic and non-economic activities, he is required to carry out an apportionment to exclude VAT incurred for the purposes of carrying on outside-the-scope activities (i.e. the non-economic activities).

What makes *Vehicle Control Services* curious is that, there, it was common ground that VCS only carried on economic activities. The judgment is not, therefore, a simple application of the *Securenta* principles. The apportionment the Upper Tribunal required was not between economic and non-economic activities (as in *Securenta*), but between two types of economic activities – 'taxable' and 'out-of-scope' (i.e. economic activities that give rise to taxable supplies and economic activities that give rise to out-of-scope income).

HMRC argued that this requirement flowed from the proper construction of PVD article 168. The Upper Tribunal agreed, noting that HMRC's construction was consistent not only with the 'context and purpose' of the provision, but CJEU jurisprudence as well (not to mention domestic case law).

Article 168

Article 168 provides that input tax is deductible '[i]n so far as goods or services are used for the taxed transactions of a taxable person'. HMRC's reading of this is that:

- it requires 'an apportionment of input tax incurred on supplies used for both taxed and non-taxed transactions'; and
- 'it makes no difference whether the non-taxed transactions are not taxed because they are exempt or because they are outside the scope of VAT'.

It would appear from the judgment that the only contentious point on article 168 was whether the words 'in so far as' meant 'where' (as VCS argued) or 'to the extent that' (as HMRC argued, and the Upper Tribunal accepted). The more important question, of course, is whether partial recovery (where apportionment is required) is as black and white as HMRC claimed, with transactions that give rise to taxable supplies on one side and all other transactions (whether exempt or out-of-scope) on the other, or whether the position is more nuanced.

In its judgment, the Upper Tribunal cited passages from the advocate general's opinion from *Český rozhlas* (Case C-11/15), including the following:

> 'goods and services used in connection with taxable transactions confer a right to deduct (unless those transactions are exempt) and goods and services used in connection with transactions falling outside the scope of the VAT system do not confer a right to deduct'; and
>
> 'the provisions of the Sixth Directive contain no rules for determining the extent of the right to deduct enjoyed by taxable persons who carry out both taxable (and taxed) activities and non-taxable activities'.

In these statements, the advocate general is clearly using 'taxable' to refer to transactions that are economic in character; he is not referring to transactions that give rise to taxable supplies. This is particularly clear where he refers to 'those [taxable] transactions [that] are exempt'.

It is arguable in light of the above that partial recovery is a two-stage process, under which there is a distinction between apportionment under the *Securenta* principles and apportionment in accordance with the partial exemption rules in PVD article 173. Apportionment under the *Securenta* principles is to determine the extent to which VAT incurred by a taxable person was incurred for the purposes of economic activities. Any VAT incurred for the purposes of non-economic activities is excluded from deduction at this (first) stage. Once the proportion of VAT attributable to transactions that are economic in character, i.e. input tax within the VAT system, has been identified, the second stage is engaged, and input tax is excluded from deduction at this stage not through a 're-run' of the *Securenta* principles, but by application of, and in accordance with, article 173, and article 173 only distinguishes between economic activities that give rise to taxable supplies and those that give rise to exempt supplies (i.e. it ignores economic activities that give rise to out-of-scope income).

The question the Upper Tribunal judgment in *Vehicle Control Services* raises, therefore, is whether a requirement to apportion between taxable and out-of-scope economic activities – which is not envisaged by article 173 – can

be justified simply on the basis that there is no 'logic in distinguishing between transactions which are outside the scope of VAT because the activity in question is not economic activity and transactions which are outside the scope of VAT because, although the activity in question is economic activity (or at least of a business nature), it does not amount to the making of supplies of goods or services'.

CJEU jurisprudence

The answer may lie in two CJEU cases: *Cibo Participations* (Case C-16/00) and *Larentia + Minerva* (Cases C-108/14 and C-109/14).

Both these cases concern holding companies. For VAT purposes, there are two types of holding companies:

- 'passive holding companies' that merely acquire and hold shares; and
- 'management holding companies' that, in addition to holding shares, are involved in the management of the companies it has been acquired, making supplies for consideration to such companies.

Passive holding companies do not carry on economic activities; management holding companies do.

The taxpayer in *Cibo* was a management holding company. It derived its income from fees (from supplying services to its subsidiaries) and dividends (from the same subsidiaries). The French tax authorities argued that, in considering the taxpayer's ability to deduct input tax, the dividends had to be taken into account (on the basis they represented exempt income). The CJEU disagreed, ruling that the dividends were not exempt income –they fell outside the scope of VAT – and, because they were out-of-scope, there was no need for the taxpayer to take them into account for partial recovery purposes.

The taxpayer was not, therefore, required to apportion between its holding and management activities (i.e. between its out-of-scope dividend income and its taxable fee income).

This was confirmed in *Larentia*. There, the CJEU referred to two scenarios:

- one in which the holding company is involved in the management of all its subsidiaries; and
- one in which the holding company is only involved in the management of some of its subsidiaries.

The CJEU considered that input tax incurred by the holding company in the first scenario 'must, in principle, be deducted in full, unless certain [output] economic transactions are exempt from VAT under the [PVD], in which case the right to deduct should have effect only in accordance with the procedures laid down in article [173] of that directive'.

In contrast, input tax incurred by the holding company in the second scenario 'may be deducted only in proportion to that which is inherent to the economic activity, according to the criteria for apportioning defined by the member states'.

The CJEU did not explain the difference in treatment between the two holding companies. However, it is clear that, in being a management holding company to some of its subsidiaries and a passive holding company to others, the holding company in the second scenario is carrying on both economic and non-economic activities. That it is required to apportion when considering its ability to deduct input tax is, therefore, simply a straightforward application of the *Securenta* principles.

The position of the holding company in the first scenarios is more difficult. As a management holding company, it is clearly carrying on economic activities. Although, like the holding company in *Cibo*, and the holding company in the second scenario, it receives dividends from its subsidiaries, it would appear that this in itself does not cause it to be regarded as carrying on non-economic activities. (It is difficult to see how *Cibo* and *Securenta* can be reconciled otherwise). It is still, however, receiving out-of-scope income (or, to pirate terminology used in *Vehicle Control Services*, income that does not amount to consideration for supplies of goods or services). That the receipt of such income has no impact on its ability to deduct input tax (as confirmed by the CJEU in both *Cibo* and *Larentia*) supports the analysis that, once it has been established that there is no apportionment under the *Securenta* principles (between what the advocate general in *Český rozhlas* referred to as taxable and non-taxable activities), there is no need (under article 168 or 173) to take out-of-scope income received in the course of an economic activity into account when considering a taxable person's ability to deduct input tax.

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Although neither *Cibo* nor *Larentia* addresses the lack of 'logical distinction between the case where some of a taxable person's revenue arises from exempt supplies and the case where some of a taxable person's revenue arises from transactions outside the scope of VAT', they do raise their own conundrum – is it logical that a holding company that only carries on economic activities can receive substantial out-of-scope dividend income (as in *Cibo*) with no adverse effect on its ability to deduct input tax while a car park operator that only carries on economic activities suffers significant input tax leakage simply because it receives out-of-scope fine income (as in *Vehicle Control Services*)?

This question did not arise in *Vehicle Control Services* because (it would appear) neither *Cibo* nor *Larentia* was considered by the Upper Tribunal. Nor, it would appear, was *Abbey National* (Case C-408/98), a case where the taxpayer transferred a business as a going concern (outside the scope of VAT), and the UK argued that: 'since the costs incurred in order to effect the transfer were used for the purposes of a transaction which was not taxable, there is no right to deduct the input VAT paid on those costs. A contrary interpretation would jeopardise the neutrality of VAT, as the taxable person would then, in respect of the same transaction, have the financial benefit of a deduction of the input VAT without the corresponding obligation to account for the output VAT'.

This argument (which, it would appear, HMRC also ran in *Vehicle Control Services*) was rejected by the CJEU, as was a similar argument in *Kretztechnik* (a case that was discussed in *Vehicle Control Services*, but with no mention of this aspect).

HMRC is understandably encouraged by the outcome of *Vehicle Control Services*, but, as can be seen from the above, any claim it represents the final word on the impact of out-of-scope income on VAT recovery is premature. ■

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