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Court of Justice of the EU rules Agility hire purchase contracts are a supply of goods for VAT purposes

HMRC v. Mercedes-Benz Financial Services UK Limited
C-164/16

Article by David Bowden

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Executive speed read summary

Mercedes-Benz Financial Services provided finance to customers by way of a hire purchase product called '*Agility*' to enable them to buy new or used vehicles from its main dealers. A deposit was paid and the balance paid by instalments over 2 to 5 years. There was an option to purchase fee of £95 if a customer wanted to acquire title at the end of the term. About 50% of customers exercised the option to purchase. The instalments under Agility were lower than under a conventional hire purchase agreement because 40% of the vehicle price was deferred as a balloon payment. HMRC raised assessments against the taxpayer for £10million saying that these Agility contracts were contracts for the supply of goods and VAT was due under the 2006 Principal VAT Directive. The taxpayer's 1st appeal to the First Tier Tribunal was dismissed but allowed by the Upper Tribunal. The Court of Appeal referred to the CJEU a number of questions of construction. Following a hearing in May 2017 Advocate General Szpunar gave his opinion that hire purchase contracts were a supply of goods and, unlike leasing contracts, not a supply of services. The First Chamber of the Court of Justice of the EU has now handed down its judgement in which it agrees with the opinion of its Advocate General. The CJEU ruled that if it can be inferred from the financial terms of the hire purchase agreement that exercising the option to purchase appears to be the '*only economically rational choice'* that the customer will be able to make at the appropriate time where the contract runs its full term, then it will be a supply of goods (rather than a supply of services) under Article 14(2)(b) of the Principal VAT Directive. This case will now go back to the Court of Appeal to apply the CJEU ruling and ascertain whether the Agility customers had only this '*economically rational choice'* or not.

HM Revenue and Customs v. Mercedes-Benz Financial Services UK Limited
The Governments of the United Kingdom, the Kingdom of the Netherlands and the European Commission intervening
C-164/16 *4 October 2017*
Court of Justice of the European Union, First Chamber (Judges Silva de Lapuerta, Bonichot and Arabadjiev. Advocate-General Maciej Szpunar)

What are the facts?

This case concern's the taxpayer's '*Agility*' contracts and the interpretation of Article 14 of the Principle VAT Directive. The issue for the CJEU is whether for VAT purposes the Agility contract falls to be treated as a supply of services or a supply of goods. The CJEU and the European Commission have had difficulty with this issue in the past given that hire purchase as a product appears to be unique to the UK and Ireland with few other EU member states having such a mixed contract for financial services and supply of goods.

What are the features of the taxpayer's 'Agility' contracts?

Customers who want to acquire a new or used car from a Mercedes-Benz main dealership could finance it by an Agility hire purchase agreement that Mercedes-Benz Financial Services UK Limited offered. This usually required the payment of a deposit and the balance to be paid by monthly instalments over a number of years. Under Agility contracts monthly instalments were lower than under a conventional hire purchase. The total instalments payable by customers were around 60% of the vehicle sale price (including interest). Where a customer wanted to exercise the option to buy the vehicle, there was a balloon payment to be made of the outstanding 40% of the vehicle sale price. This balloon payment represents the estimated average residual value of the vehicle at contract maturity. The taxpayer asked the customer 3 before the end of the contract whether he wanted to exercise the option to buy or not. The fee to exercise this option is £95. About 50% of customers exercise this option.

What assessments did HMRC raise on the taxpayer?

HMRC raised backdated VAT assessments on the taxpayer in the total sum of over £10million.

What does the Principal VAT Directive provide?

Article 14 of EU Council Directive of 28 November 2006 **2006/112/EC** ('the Principal VAT Directive') provides:

> '***14.1****. "Supply of goods" shall mean the transfer of the right to dispose of tangible property as owner.*
> *2. In addition to the transaction referred to in paragraph 1, each of the following shall be regarded as a supply of goods:….*
>
> > *(b) the actual handing over of goods pursuant to a contract for the hire of goods for a certain period, or for the sale of goods on deferred terms, which provides that in the normal course of events ownership is to pass at the latest upon payment of the final instalment;…*'

In addition Article 24(1) provides that '*supply of services'* means '*any transaction which does not constitute a supply of goods*'.

Article 63 provides that the '*chargeable event shall occur and VAT shall become chargeable when the goods or the services are supplied*.' Finally Article 64 provides that where '*it gives rise to successive statements of account or successive payments, the supply of goods, other than that consisting in the hire of goods for a certain period or the sale of goods on deferred terms, as referred to in point (b) of Article 14(2), or the supply of services shall be regarded as being completed on expiry of the periods to which such statements of account or payments relate.'*

How has the UK implemented these VAT provisions?
These EU rules are found in section 5 and schedule 4 paragraph 2(b) to the Value Added Tax Act 1994

What does the Consumer Credit Act 1974 provide about hire purchase contracts?
There are 3 provisions which are relevant which define the nature of this product:

- **Section 189** – defines a '*hire-purchase agreement'* as an '*agreement under which goods are hired in return for periodical payments by the person to whom they are hired, and the property in the goods will pass to that person if the terms of the agreement are complied with and one or more specified events occurs, including the exercise of an option by that person'*,
- **Section 99** - provides that '*at any time before the final payment by the debtor under a regulated hire-purchase agreement falls due, the debtor is entitled to terminate the agreement by giving notice*', and
- **Section 100** – deals with the '*half-rule'* providing that a '*debtor is to be liable, unless the agreement provides for a smaller payment, to pay to the creditor the amount, if any, by which one-half of the "*total price" *exceeds the aggregate of the sums paid and the sums due in respect of the total price immediately before the termination'*.

What happened in the First Tier Tribunal?
On 17 December 2012 Judges Michael Tildesley OBE and Ruth Watts Davies in a reserved judgement in the First Tier Tribunal **[2013] UKFTT 381 (TC)** ruled in favour of HMRC that these Agility hire purchase agreements were for VAT purposes a supply of goods rather than a supply of services.

What ruling was made on 1st appeal by the Upper Tribunal?
On 2 May 2014 a reserved judgement written by Mr Justice Nugee was handed down by the Upper Tribunal – **[2014] UKUT 200 (TCC).** Surprisingly the UT allowed the taxpayer's appeal from the FTT decision ruling that '*the economic purpose of the contract is to be found by identifying the precise way in which performance satisfies the interests of the parties'* with Nugee J ruling that the Agility contract satisfies these interests of the parties '*by affording the customer an opportunity to purchase but without committing him to do so, and by giving MBFS a return on the finance it provides in circumstances where either the vehicle will be purchased or it will be returned at no risk to MBFS*.' Nugee J concluded by saying that he did not think that Agility could be '*characterised as in effect a contract for sale of the vehicle. It is a contract which may well lead to a sale of the vehicle but equally may well not*'. The UT therefore ruled that Agility was not '*a contract under which ownership is to pass in the normal course of events*'.

What happened in the Court of Appeal?
On 26 November 2015 the Court of Appeal handed down its reserved judgment - **[2015] EWCA Civ 1211.** Lord Justice Patten gave the judgment (with which the Chancellor and Lord Justice Christopher Clarke agreed) in which it decided the Upper Tribunal was wrong not to refer certain issues to the CJEU. Patten LJ ruled that '*in the absence of any direct guidance about the interpretation of Article 14(2)(b), we have reached the conclusion that the issue is not acte clair*' noting that '*although Article 14(2)(b) is directed in terms to what the relevant contract of hire provides, there is much less certainty as to whether the qualifying phrase "*in the normal course of events*" requires a tax authority to do no more than to identify the existence of an option which is not exercisable later than upon payment of the final instalment or to go further and determine the economic purpose of the contract*'.

What questions were referred by the Court of Appeal to the CJEU?
The Court of Appeal referred these 4 questions:

- What is the meaning of the words '*a contract...which provides that in the normal course of events ownership is to pass at the latest upon payment of the final instalment'* in Article 14.2(b)1?

- Does the phrase '*in the normal course of events'* require a tax authority to do no more than to identify the existence of an option to purchase which can be exercised no later than upon payment of the final instalment?
- Alternatively, does the phrase '*in the normal course of events'* require a national authority to go further and to determine the economic purpose of the contract?
- If the answer to this is 'yes':
  - should the interpretation of Article 14.2 be influenced by an analysis of whether the customer is likely to exercise such an option?
  - Is the size of the price payable on exercise of the option to purchase relevant for the purposes of determining the economic purpose of the contract?

Disappointingly both the Advocate General and the 1st Chamber lumped all these questions together and provide an answer in the round to the questions as a whole.

What authorities are referred to in the CJEU's judgement?
These 3 prior CJEU authorities are relevant in this case:

Eon Aset Menidjmunt OOD v. Direktor na Direktsia Obzhalvane i upravlenie na izpalnenieto — Varna pri Tsentralno upravlenie na Natsionalnata agentsia za prihodite **C-118/11**
(CJEU, 2nd Chamber, Judges *Cunha Rodrigues, Lõhmus, Ó Caoimh, Arabadjiev and Fernlund. Advocate General Trstenjak)*
Where a leasing agreement provides either that ownership of the subject matter of the leasing agreement is to be transferred to the lessee on the expiry of that agreement or that all the essential powers attaching to ownership of are to be enjoyed by the lessee and substantially all the rewards and risks incidental to legal ownership of are transferred to the lessee and the present value of the amount of the lease payments is practically identical to the market value of the transaction resulting from that agreement must be treated as an acquisition of capital goods.

NLB Leasing d.o.o. v. Republika Slovenija **[2015] EUECJ C-209/14**
(CJEU, 2nd Chamber - Judges Silva de Lapuerta, Bonichot, Arabadjiev, da Cruz Vilaça and Lycourgos. Advocate General: N. Jääskinen)
Articles 2(1), 14 and 24(1) of the Principal VAT Directive must be interpreted as meaning that where a lease agreement relating to immovable property provided either that ownership of that property was to be transferred to the lessee on the expiry of that agreement or that all the essential powers attaching to ownership of that property were to be enjoyed by the lessee and, in particular, substantially all the rewards and risks incidental to legal ownership of that property were transferred to the lessee and the present value of the amount of the lease payments was practically identical to the market value of the property, the transaction resulting from that agreement must be treated as a supply of goods for VAT purposes.

BLP Group plc v Commissioners of Customs & **Excise [1995] EUECJ C-4/94, [1996] 1 WLR 174**
(CJEU, 1st Chamber – Judges Silva de Lapuerta, Bonichot and Arabadjiev. Advocate General Szpunar)
Article 17 of the 6th Council VAT Directive ***77/388*** *is to be interpreted as meaning that (except in cases expressly provided for) where a taxable person supplied services to another taxable person who used them for an exempt transaction, the latter person was not entitled to deduct the input VAT paid, even if the ultimate purpose of the transaction was the carrying out of a taxable transaction. It was true that if BLP had taken out a bank loan to raise cash rather than sell shares, it would have been able to deduct the VAT paid on the advisers' services. However, that was a consequence of the fact that those services, whose costs formed part of BLP's overheads and hence of the cost components of the products, would have been used by BLP for taxable transactions.*

What other decision did the Advocate-General refer to?
Advocate General Szpunar also referred to this decision in his opinion but it is not mentioned in the judgment of the First Chamber.

Auto Lease Holland BV v. Bundesamt für Finanzen **C-185/01**
(CJEU, 5th Chamber, Judges Wathelet, Timmermans, Jann, von Bahr and Rosas. Advocate General Léger)
Where there is a right to use tangible property means there is a possibility of it becoming consumed, this right is similar to ownership in a manner which justifies that right of use being regarded as constituting a supply of goods for VAT purposes.

What did the CJEU rule on classification of hire purchase under the Principal VAT Directive?
The CJEU said that the classification of a contract as a '*finance lease'* was not in itself '*sufficient for the actual handing over of goods pursuant to that contract to be categorised as a transaction subject to VAT'*, but rather '*in order for such a contract to be considered a "*supply of goods*" ' under of the VAT Directive*' it

was '*also necessary to determine whether the contract is a contract for* "hire which provides that in the normal course of events ownership is to pass at the latest upon payment of the final instalment"'.

The CJEU ruled that these 2 conditions had to be satisfied:

- Article 14(b) had to be read as meaning that an agreement under which the goods are handed over contains a clause expressly relating to the transfer of ownership of those goods from the lessor to the lessee. The Principal VAT Directive refers not to the transfer of the power to dispose of property as owner but rather to the '*passing of ownership'* of that property. It also uses the term '*instalments*' common in credit agreements but uncommon in pure lease agreements, and
- It had to be clear from the terms of the contract (objectively assessed at the time when it was signed) that ownership of the vehicle is intended to be acquired automatically by the lessee if performance of the contract proceeds normally over the full term of the contract.

What did the CJEU rule 'in the normal course of events' means?
On this the 1st Chamber said that the '*only inference'* to be drawn from the words '*in the normal course of events ownership is to pass at the latest upon payment of the final instalment'* is that the '*final payment of sums to be paid by the lessee*' under the contract '*results by operation of law in the transfer'* to that customer of ownership of the vehicle. Further this expression also has to be regarded as referring '*simply to the foreseeable performance of an agreement over its full term by the parties*' who are '*acting in good faith'* under the contract.

The 1st Chamber agreed with its Advocate-General that this '*contractually determined outcome — of ownership being transferred — is incompatible with a genuine economic alternative for the lessee'*. The 1st Chamber cautioned that the position would be different '*only if exercising the option to purchase, optional though it is in formal terms, appeared in fact, given the financial terms of the agreement, to be the only economically rational choice the lessee could make'*. The Court said that this may be '*evident*' where the '*aggregate of the contractual instalments will correspond to the market value of the goods'* and that the customer will '*not be required, as a result of exercising the option, to pay a substantial additional sum*'.

Going on the 1st Chamber said that '*any other interpretation would require national tax authorities, presented with contracts which'* were '*not objectively linked to taxable transactions at the outset, to make follow-up inquiries to determine the intentions of the party contracting with the taxable person at the time when the option is exercised and, if necessary, to make adjustments'*. On this the court ruled that '*such a requirement would, however, be contrary to the VAT system's objectives of ensuring legal certainty and facilitating application of the tax by having regard, save in exceptional cases, to the objective character of the transaction in question*'. The 1st Chamber ruled that it was for a national court to determine '*whether the contract pursuant to which a vehicle was handed over to a user satisfies the conditions referred to in the present judgment*'.

What is the conclusion reached?
The conclusion of the 1st Chamber (in agreement with its Advocate-General) is that Article 14(2)(b) of the Principal VAT Directive had to be interpreted as applying to a hire purchase agreements with an option to purchase '*if it can be inferred from the financial terms of the contract that exercising the option appears to be the only economically rational choice that the lessee will be able to make at the appropriate time if the contract is performed for its full term, which it is for the national court to ascertain'*.

What will happen next with this case?
Now that the CJEU has given its judgment the case will now return to the Court of Appeal in London for it to apply the first chamber ruling.

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