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Court of Appeal to consider validity of Jersey company used by loan broker to avoid VAT on advertising

HMRC v. Ocean Finance
A3/2015/2717

Article by David Bowden

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Executive speed read summary

Ocean Finance (a UK loan broking company) set up a Jersey company (Alabaster) to provide advertising services to Ocean Finance. There was a service agreement between the 2 companies. The arrangement was set up in 1997 to reduce Ocean Finance's VAT bill. Ocean Finance was exempt from VAT for its loan broking business but did have to pay VAT on external advertising costs. It wanted to avoid VAT leakage by using a Jersey company. The First Tier Tribunal in 2010 determined the facts and ruled that the arrangements with Alabaster were not abusive with the result that Ocean Finance's scheme to reduce its VAT bill worked. On appeal to the Upper Tribunal a number of questions were referred to the Court of Justice of the European Union which handed down its ruling in 2013. The case went back to the Upper Tribunal which still found in Ocean Finance's favour. The CJEU said it was for UK courts to decide if Ocean Finance's contract with Alabaster could be overridden or not. By then in another VAT appeal (which had also gone to the CJEU) the Supreme Court in another VAT avoidance scheme operated by a motor breakdown insurer had ruled in HMRC's favour. Buoyed by this success, HMRC sought to appeal the Upper Tribunal ruling to the Court of Appeal. This appeal will now be heard over 2 days starting on 28 or 29 March 2017. It will have to decide if Ocean Finance's VAT reduction scheme for its advertising costs using Alabaster is 'abusive' or not.

HM Revenue & Customs v. Paul Newey trading as 'Ocean Finance'
A3/2015/2717 *28 – 30 March 2017*
Court of Appeal (Civil division)

What are the facts in this case?

Before 1997, Ocean Finance carried out loan broking from the UK and achieved a significant market share. Whilst its supplies of loan broking services were exempt from VAT but as a result it suffered irrecoverable input VAT on its overheads. In 1997, Ocean Finance decided to put in place alternative arrangements to reduce the amount of irrecoverable input VAT on its advertising costs.

Ocean Finance set up a wholly owned Jersey based company called 'Alabaster'. Alabaster obtained rights to use the name 'Ocean Finance' and obtained permission to carry on a loan broking business in the UK. Alabaster had a small space in the offices occupied by the Ocean Finance's accountants (Moore Stephens). Alabaster had as its main employee a secondee from Moore Stephens. Alabaster's 4 Jersey directors were recruited locally by Moore Stephens and some of them were partners in that firm. None of the directors had direct loan broking experience.

Ocean Finance and Alabaster entered into a services agreement under which Ocean Finance agreed to provide loan processing services to Alabaster. These services covered:

- processing tasks for the loan broking business,
- dealing with enquiries from prospective borrowers,
- referring loan applications to lenders in accordance with Alabaster's instructions, and
- introducing business from 3rd party introducers to Alabaster.

Alabaster entered into advertising agreement with a local advertising agency in Jersey which arranged to advertise Ocean Finance in the UK. Ocean Finance remained involved in the advertising process including discussing content and having a right of veto. All advertising required the approval of an Alabaster director. As a result of these arrangements, no irrecoverable input VAT arose on the considerable advertising expenditure incurred by the Ocean Finance.

What did HMRC say about Ocean Finance's arrangement with Alabaster?

HMRC's case is that these arrangements were not effective for VAT purposes for 2 reasons:

- having regard to the '*essential characteristics of the transactions'* for VAT purposes, the relevant supplies were made and received by Ocean Finance than Alabaster, or
- the arrangements amounted to an abuse and should be recharacterised.

What happened in the First Tier Tribunal?

The FTT accepted that Ocean Finance played no part in the management of Alabaster. In its ruling dated 23 April 2010, Tribunal Judge Roger Berner and Lay Member Mrs Neill rejected both of these submissions advanced by HMRC - **[2010] UKFTT 183.** The FTT concluded that whilst Alabaster lacked the necessary infrastructure to carry out a loan broking business, it equipped itself to conduct such a business by outsourcing the processing functions to Ocean Finance. The FTT ruled that these arrangements did not amount to abuse.

What happened when the case was first before the Upper Tribunal?
On appeal, the Upper Tribunal referred 6 questions to the CJEU. The UT sought guidance on what weight the contractual arrangements should be given in determining the question who makes a supply of services. The UT also sought guidance as to what extent other factors should influence that analysis.

What does the 6th Council VAT Directive say?
These are the material provisions from the 6th Council VAT Directive (**77/388/EEC**) which has now been consolidated in the Principal VAT Directive (**2006/112/EC)**.

- **Article 9.1**: '*The place where a service is supplied shall be deemed to be the place where the supplier has established his business ….*'
- **Article 9.2:** '*However….(e) the place where the following services are supplied when performed for customers established outside the Community … shall be the place where the customer has established his business or has a fixed establishment to which the service is supplied or, in the absence of such a place, the place where he has his permanent address or usually resides…* advertising services',
- **Article 13**: '*Without prejudice to other Community provisions, Member States shall exempt the following under conditions which they shall lay down for the purpose of ensuring the correct and straightforward application of the exemptions and of preventing any possible evasion, avoidance or abuse:…(d) the following transactions: 1.the granting and the negotiation of credit and the management of credit by the person granting it*…'

What questions were referred to the Court of Justice of the EU?
These were the 6 questions referred by the Upper Tribunal to the CJEU:

- What weight should a national court give to contracts in determining the question of which person made a supply of services for the purposes of VAT? Is the contractual position decisive in determining the VAT supply position?
- If the contractual position is not decisive, in what circumstances should a national court depart from the contractual position?
- To what extent is it relevant whether:
  - the person who makes the supply as a matter of contract is under the overall control of another person?
  - the business knowledge, commercial relationship and experience rests with a person other than that which enters into the contract?
  - all or most of the decisive elements in the supply are performed by a person other than that which enters into the contract?
  - the commercial risk of financial and reputational loss arising from the supply rests with someone other than that which enters into the contracts?
  - the person making the supply as a matter of contract, sub-contracts decisive elements necessary for such supply to a person controlling that first person and such sub-contracting arrangements lack certain commercial features?
- Should a national court depart from the contractual analysis?
- If the answer is 'no', is the tax result of arrangements a tax advantage the grant of which would be contrary to the purpose of the 6th Council VAT Directive?
- If the answer is 'yes', how should arrangements be re-characterised?

What ruling did the CJEU give?
The 3rd Chamber of the CJEU (Judges Ilešič, Jarašiūnas, Ó Caoimh, Toader and Fernlund) down its judgement (**C-653/11**) on 20 June 2013. It proceeded directly to judgement without hearing the opinion of its Advocate General Paolo Mengozzi. The CJEU held that:

- formal contractual arrangements are not determinative of the VAT analysis,
- a contract can be overridden where it does not wholly reflect the economic or commercial reality, but
- left the application to the national court to determine if Ocean Finance's contract with Alabaster should be over-ridden or not.

What happened when the case returned to the Upper Tribunal?
The case then returned to the Upper Tribunal. HMRC submitted that in view of the CJEU ruling, the original FTT decision should not stand because properly interpreted the arrangements:

- should be characterised as a matter of economic reality as supplies to and from Ocean Finance, or
- alternatively, that Ocean Finance's arrangement was '*abusive*' and should be re-characterised.

In a complex and detailed 124 page reserved judgement had down on 2 June 2015, Mr Justice Warren sitting in the Upper Tribunal rejected both submissions of HMRC - **[2015] UKUT 300 (TCC)**

Warren J concluded that the CJEU did not in fact perceive any scope for departure from the contractual terms unless the arrangements were '*wholly artificial'* and did not reflect the economic or commercial reality. He rejected HMRC's submission that there was a free-standing concept of '*commercial and economic reality*' which might justify departure from contractual arrangements other than where there are '*wholly artificial arrangements'* which engaged the abuse principle. The judge noted that the CJEU ruling showed that an '*abusive*' practice could be found to exist even where the abusive transactions are not simply inserted into an existing structure but where a completely new structure is adopted.

Warren J concluded that the FTT was entitled to hold that contractually the relevant '*supplies*' were made by and to Alabaster rather than Ocean Finance. There was no scope to conclude that the supplies were made to and from Ocean Finance in the absence of such abuse. On abuse, Warren J held that the FTT had been entitled to conclude that the arrangements were not abusive. Whilst it was clear that the arrangements were entered into solely to obtain a tax advantage, the FTT was entitled to find that the arrangements were not wholly artificial. This was despite Alabaster's lack of knowledge of the credit broking business. The FTT's conclusion that Alabaster was not a brass plate company which was rubber stamping Ocean Finance's decisions were findings of fact which the FTT was entitled to reach.

Warren J said that in applying the abuse principle, the arrangements should be viewed as a whole on their own merits and without being judged by reference to any arrangements they replaced.

What has the Supreme Court previously ruled in *WHA*?
In *WHA Ltd v Customs and Excise Commissioners* **[2013] UKSC 24**, the Supreme Court dismissed a taxpayer's final appeal. It concerned the effectiveness of a scheme which was designed to minimise the liability to VAT of a group of companies involved in providing motor breakdown insurance ('MBI').
The supply of insurance is exempt from VAT - insurers neither charge VAT on premiums nor account to HMRC for VAT in respect of their insurance business. Insurers also bear the VAT element of the costs incurred in the course of their business which are chargeable to VAT, as they may not deduct that VAT element from any VAT that they have received. When an MBI insurer indemnifies an insured against the cost of repairs, the insurer may not deduct the VAT element of the repairing garage's invoice. The MBI insurer sought to prevent VAT leakage by using a Gibraltar based company (Oriel).

Lord Reed in giving the Supreme Court judgment ruled that:

- Decisions about the application of the VAT system are highly fact-sensitive. When determining the relevant supply in which a taxable person engages, regard must be had to all the circumstances in which a transaction takes place. In cases involving a construct of contractual relationships, the matter must be assessed as a whole to determine the economic reality.
- NIG undertook to the insured to meet the cost of repairs to a vehicle and did not undertake responsibility for the repairs themselves. The economic reality is that the payments made by WHA to the garages merely discharged the obligation which NIG undertook to the insured to pay for the repair of a vehicle up to the value permitted by the policy in the event of a breakdown. The interposition of 2 other companies in the chain of contracts linking WHA to NIG did not alter the position that WHA simply acted as the paymaster of the costs'
- Deduction of input tax is meant to relieve the trader in question of the VAT payable or paid in the course of his economic activities. However, WHA's own profit and loss was unaffected by VAT as it paid the garages out of a float provided by another company.

What is the position in the Court of Appeal?
With HMRC having won in the Supreme Court in *WHA*, it remains dissatisfied with the UT decision and has been granted permission to appeal. This appeal has been listed for a 2 day hearing to start on either 28 or 29 March 2017.

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