The CJEU recently released its judgment in the case of HMRC v Paul Newey (trading as ‘Ocean Finance’) following a reference from the UK courts. This judgment serves to highlight yet again the principle that the alliance between the contractual position and the commercial and economic reality must be harmonious. The story of ‘substance over form’ has been told many times by the UK and European Courts and it is one that is now entrenched in the VAT arena.

Anbreen Khan is a partner specialising in indirect tax advisory and dispute resolution at Deloitte LLP. Anbreen leads the tax dispute resolution group and has advised on and successfully led a number of landmark VAT cases in the UK and in Europe. Email: akhan@deloitte.co.uk; tel: 020 7007 0688.

Emma Hughes is a tax manager at Deloitte LLP within the tax dispute resolution group. She specialises in indirect tax, managing a number of high profile indirect tax cases before the UK and European Courts, and she has recently been involved in settling disputes with HMRC by means of alternative dispute resolution. Email: emhughes@deloitte.co.uk; tel: 020 7007 2393.

The recent CJEU judgment in the case of HMRC v Paul Newey (trading as ‘Ocean Finance’) (Case C-653/11) followed a reference from the Upper Tribunal. The case concerned Mr Newey, who incorporated a wholly-owned loan broking company, Alabaster (CI) Ltd, in Jersey to mitigate irrecoverable input tax incurred on advertising relating to exempt loans for UK customers. HMRC challenged this structure and argued that it was the taxpayer, Mr Newey, based in the UK, that was receiving the advertising services and providing the loan broking services. Accordingly, in HMRC’s view, the advertising services (which were supplied by a Jersey third party) were subject to the reverse charge in the UK and the input tax was irrecoverable. In the alternative, HMRC challenged the arrangements on the basis of the ‘Halifax’ ‘abuse of law’ principle.

The First-tier Tribunal (FTT) gave its decision in April 2010 in favour of Mr Newey. The FTT held that in considering the evidence before it, the Jersey company, Alabaster, was making the supplies of loan broking services to lenders and that it, and not Mr Newey, was the recipient of the advertising services. It is significant that the tribunal found that the evidence reflected the economic reality. As a result, the supplies of advertising were outside the scope of UK VAT. It was a determining factor that the evidence before the FTT showed that Alabaster was a commercial enterprise carrying on its own economic activities for which it had equipped itself to perform through a service agreement with Mr Newey. Alabaster received the advertising services itself for the purposes of its business and there was only a supply of advertising services to Alabaster and not to Mr Newey. That conclusion, the FTT held, was not

affected by the fact that, indirectly, Mr Newey also benefited from the advertising that was supplied.

In respect of the ‘abuse’ argument, the FTT held that whilst the essential aim of the structure was to obtain a tax advantage, there was no abuse as the structure was not contrary to the purpose of the EU Sixth Directive.

HMRC appealed to the Upper Tribunal, which subsequently referred a number of questions to the CJEU. The questions sought guidance on the weight to be attributed to contracts in determining the VAT supply position and whether the UK, in circumstances such as those in the present case, should depart from the contractual analysis. Further, the CJEU was asked to consider how those arrangements should be recharacterised if the contractual analysis resulted in a tax advantage, which was contrary to the purposes of the Sixth Directive and the Halifax abuse principle.

The CJEU judgment

The CJEU ruled that contractual terms are not decisive for the purposes of identifying the supplier and the recipient of a ‘supply of services’. It is ultimately for the national court, which is best-placed to consider the facts before it, to determine whether the contracts reflect the economic reality which has been set up with the sole aim of obtaining a tax advantage, and therefore whether they should be disregarded.

If the national court finds that the contractual terms do not genuinely reflect the economic reality, then those contractual terms would have to be redefined so as to re-establish the situation that would have prevailed in the absence of the transactions constituting that abusive practice.

Economic and commercial reality

The CJEU recognised that the contractual position normally reflects the economic and commercial reality of the transactions and, in order to satisfy the requirements of legal certainty, the relevant contractual terms constitute a factor to be taken into consideration. We have also seen the Supreme Court of the UK recently emphasise the need to recognise genuine economic activity in the decisions of Loyalty Management UK Ltd [2013] STC 784 and WHA Ltd [2013] STC 943.

The judgment highlights that in circumstances where contracts deviate significantly (i.e. constitute a wholly artificial arrangement) from the commercial and economic reality of a ‘supply of services’, and if those contractual terms were put in place with the sole aim of obtaining a tax advantage, then they can be disregarded. Ultimately, it will require consideration of all the circumstances of the contractual arrangements and whether or not it is believed such arrangements emulate reality.

However, whilst the FTT found that, as a matter of fact, Alabaster both made the supplies of loan broking and received the supplies of the advertising services, the CJEU, taking into account the economic reality of the business relationships
present, suggested that it was ‘conceivable that the effective use and enjoyment of the services at issue in the main proceedings took place in the UK and that Mr Newey profited therefrom’. The CJEU appeared to consider the facts of Mr Newey’s power and involvement in approving the contents of the advertisements and in processing the loan applications in the UK to be relevant in suggesting this possible outcome.

Whilst the CJEU recognised that it is for the referring court, ‘by means of an analysis of all the circumstances of the dispute in the main proceedings, to ascertain whether the contractual terms do not genuinely reflect the economic reality’, the decision of the CJEU at least appears to imply the possibility that the reality of the situation perhaps differs to that of the findings of the FTT. If indeed this is subsequently found to be the case by the UK courts, then the CJEU held that the contracts could be recharacterised to represent the genuine realities of the arrangements and so subject the advertising services to UK VAT.

Abuse of law
The CJEU judgment did not provide any further guidance as to the impact of the abuse of law doctrine. However, it is worth recapping as to where the principle currently stands. For it to be found that an abusive practice exists (following Halifax [2006] STC 919), it is necessary, first, that the transactions concerned result in the accrual of a tax advantage, the grant of which would be contrary to the purpose of the provisions of the Sixth Directive. Second, it must also be apparent from a number of objective factors that the essential aim of the transactions concerned is to obtain a tax advantage. Further guidance from the CJEU has been given in a number of notable cases, including Part Service Srl (C-425/06) and Weald Leasing Ltd (C-103/09).

In Ocean Finance, HMRC’s alternative argument was on the basis that the arrangements fell foul of the abuse test introduced following Halifax. HMRC argued that Alabaster was artificially introduced into the organisational structure, and the fact that the current structure enabled Mr Newey to not suffer as much irrecoverable input tax as it previously had confirmed that the structure was ‘abusive’. The fact that the CJEU determined that contracts are not decisive for the purposes of identifying the commercial and economic reality of a ‘supply of services’ for VAT purposes is significant, given that commercial relationships often are not constrained within the parameters of a contract. The judgment reinforces the common trend that it is for the referring court to ascertain whether the arrangements constitute a wholly artificial arrangement.

As such, the Ocean Finance judgment does not take us any further into the abuse of law arena. The definition of abuse is not expanded on in the judgment but merely reinforces the abuse tests that were borne out of Halifax.

Establishment
Whilst HMRC did not bring a challenge on place of business establishment or fixed establishment in the case of Ocean Finance (possibly to see how far the abuse argument could be run), this battle ground has not been forgotten. In considering the place of business establishment, the starting point is to consider who provides what services to whom and where those services are supplied for VAT purposes. The place of supply of services for VAT purposes, set out in art 44 of the Principal VAT Directive (EC/2006/112), is where the recipient of the supply has established its business. The CJEU has held that if this does not achieve a rational result, then it is appropriate to consider whether the services were supplied to a fixed establishment of the recipient in another location. Key points for a business to consider include the actual place of business, where key decisions are made and where the board meets.

Where contracts deviate significantly from the commercial and economic reality of a ‘supply of services’, and if those contractual terms were put in place with the sole aim of obtaining a tax advantage, then they can be disregarded

Although the proper and rational analysis may be that supplies to the offshore company are outside the scope of UK VAT, it is worth considering whether it is possible that the UK entity had a fixed establishment in the UK to which it might be said that the offshore company services were supplied. Consideration of staff and equipment and commercial rationale are all relevant in establishing whether a fixed establishment exists (such principles are set out in the cases DFDS (C-260/95), Berkholz (C-168/84) and RAL (C-452/03)).

Action point for advisers and businesses
It is essential that taxpayers consider the VAT implications of any new and existing business arrangements involving an offshore structure carefully. It is also important for those trading with businesses located offshore to review their own VAT arrangements and for all taxpayers to ensure that any contracts reflect ‘commercial and economic reality’.

What next?
The matter will now be referred back to the Upper Tribunal to consider the guidance from the CJEU. We anticipate further litigation in this case before the UK courts as each side contends what, in its view, its perception of commercial and economic reality was.