

Lower Mill Estates and Weald Leasing

Two significant cases relating to the concept of abuse of rights (relevant only at present to VAT although it might be the template for a GAAR (see earlier briefing notes)) have been reported in the last month or so.

The earlier of these, Weald Leasing, is an ECJ decision. The second is an Upper Tier Tribunal decision, the Lower Mill Estate Limited.

Abuse of rights – what is it?

The broad principle is that community law cannot be relied upon for abusive or fraudulent ends. An abusive practice is a transaction carried out not in the context of **normal commercial operations** (*Halifax*) but solely for the purpose of wrongfully obtaining advantages provided for by community law. It is a two stage test. A court can only find there has been an abusive practice if first, the transactions concerned, notwithstanding the formal application of the conditions laid down by the relevant provisions of the Sixth Directive and of the national legislation transposing it, result in the accrual of a tax advantage the grant of which will be contrary to the purpose of those provisions.

Secondly, it must also be apparent from a number of objective factors that the essential aim of the transactions concerned is to obtain the tax advantage (*Halifax*).

However, it is important to bear in mind that in *Halifax*, the ECJ accepted that a taxpayer who has alternative courses open to him is entitled to choose that which minimises his liability to VAT and, as recognised in Lower Mill Estate, it is sometimes very difficult to separate the two limbs of the test. If a taxpayer has a permissible choice, it is not easy to see how making one choice rather than the other could ever be contrary to the purposes of the Directive.

Lower Mill Estate

In this case a single shareholder owned two companies and each company entered into separate contracts with individuals. At the end of the day, each individual wanted a holiday home. Since there was a planning condition that prevented year round occupation, a sale of a completed home would have been a standard rated supply. So, "instead", one company (Lower Mill Estate ("LME")) sold land on long leases to the individuals. A second company, (Conservation Builders Limited ("CBE")), provided construction services to those individuals. The sale of the land was standard rated but the sale of the construction services was zero rated.

HMRC ran three arguments designed to establish that the total consideration paid by the individuals were subject to the standard rate of VAT. Firstly that there was a single supply of services of a completed holiday home. Secondly that the services of CBE were not supplied to the individual but were supplied to LME. Thirdly that the transaction should be recategorised under the abuse of rights legislation.

In the First Tier Tribunal, the Tribunal ("FTT") was not persuaded that there had been a single supply but was persuaded by the abuse of rights argument.

On appeal, HMRC said that the FTT was wrong on the single supply point; but it was right under the abuse of rights regime. The taxpayer disagreed with the latter.

Single Supply

On the single supply argument, the UTT upheld the FTT, and said that there was no single supply of the completed holiday home. There were separate supplies of land, on the one hand and of construction services on the other, the important authority being *Telewest Communications*. In that case Lady Justice Arden rejected HMRC's case on artificiality.

"In my judgment there is an objection in principle in this field of law to taxing transactions according to their economic reality. The economic reality of a transaction is antithetical to legal certainty. If VAT is payable accordingly to economic reality, the seller will not know what VAT to account for, and the purchaser will not know what VAT to pay".

"The mere fact that the court seeks to find the commercial reality of a transaction does not mean that it would seek to apply the economic reality of the transaction. The economic reality of the transaction may have nothing to do with either the essential features of what the parties agreed or the legal structure of their transaction..... economic purpose is not the same as economic effect.....".

On the basis of this and other cases, the UTT concluded that apart from any abuse or sham it is not possible to combine supplies by two suppliers under two contracts so as to result in one supply for VAT purposes.

Abuse of rights

On the abuse of rights, the court found for the taxpayer. It was highly critical of the judgment given by the FTT. It is also of considerable importance that evidence given by the

shareholder about the reasons why he adopted the model he did (known as the self build model) was unchallenged in the FTT. The UTT said that the FTT had given insufficient weight to this unchallenged evidence (more of this later).

The UTT recognised that the application of the Halifax principle (abuse) will not arise at all unless arrangements were entered into which have the effect that less VAT is payable than might have been the case if other arrangements were entered into.

The different arrangements might have broadly the same results (in this case, the provision of a completed holiday home) but what you need to look at is the actual transaction compared with a different transaction in which to judge whether there has been an abuse.

The FTT had compared the self build model with the provision of a completed holiday home. So the main reason why abuse was suggested was because of the common control of the two companies. This itself is not abusive, and the proper comparator was not between the provision of land and construction services, on the one hand, with a completed holiday home on the other. It was between land and construction services provided separately by connected suppliers, and land and construction services provided separately by unconnected suppliers.

The evidence of the shareholder then became important since his unchallenged evidence was that he was commercially unable to pursue a model which was to provide a completed holiday home because he was insufficiently funded.

He had decided to adopt the self build model before he had taken tax advice; also, commercially he was reluctant to introduce construction risk into the land owning company.

There is clearly a difference, commercially, between buying a completed building on one hand (where the builder takes the construction risk) and buying land and construction services separately (where the buyer takes the construction risk).

On the evidence, there was no contractual obligation for any individual to purchase construction services from the shareholders construction company (although they invariably did). It was also the case that many of these properties were custom built.

The shareholder also said that there were other reasons for not providing the completed home. It is capital intensive since it requires the builder to fund the entire cost of the building; and all the consideration (which repays the developer's costs) is delayed until the house is sold (under the construction contract there were staged payments).

Importantly, the UTT found that:

"The reality of the situation was that the self build model was the only model open to him. HMRC do not accept this, but it was not challenged in cross examination so far as we are aware and yet the Tribunal made no finding about this reason - a critically important reason according to Mr Peacock about why JNP [the shareholder] pursued the self build model".

The UTT then went on to consider these facts against the first limb of the abuse of rights concept. They said that there is clearly nothing contrary to the purposes of the Sixth Directive where a landowner and an unrelated builder provide land and construction services to a customer and where each supply is treated separately for VAT purposes. Why, therefore, is it contrary to the purpose of the Sixth Directive where the landowner is related to the builder. As the UTT said, it would have been possible for the individual to end up with a completed home, even if he had purchased land from one company and the construction services from an unrelated company. The UTT went on to say that it did not understand why HMRC said that the tax consequences of a given set of transactions would be contrary to the purposes of the Directive if entered into between the purchaser on the one hand and connected persons on the other hand, but it would not be contrary to the Directive, if those very self same transactions, are not artificially contrived and are entered into between purchasers and two unconnected persons. The Tribunal summarised its position:

Paragraph 130 of the UTT Judgment:

"130. It is to be accepted (indeed it is common ground) that a supply of land by a landowner and a supply of construction services by an independent trader are separate supplies to be taxed as such. There is not a single supply by either of them of a completed holiday home nor a joint single supply. Further, it cannot be contended that the result is anti-purposive: there is no scope for the application of the Halifax principle. It is also to be accepted, in our view, that JMP had genuine commercial reasons unconnected with tax for adopting the self-build model. If it is not anti-purposive for a purchaser to acquire a completed holiday home from two unconnected traders as a result of separate supplies, we do not consider that it is anti-purposive either for the purchaser to acquire his completed holiday home as a result of separate supplies from LME and CBL in circumstances where there are genuine commercial reasons having nothing to do with tax saving for the supplies to be made available to the purchaser only as separate supplies. We do not need to go so far as to say that it would have been impossible, or even very difficult, for LME to have adopted the development model. It is enough that there are real and genuine commercial reasons. On the other hand, our conclusion should not be taken as entailing that it would always be open to a developer, including a Waites or a Wimpey which would normally adopt the development model, to adopt the self-build model and to seek to have the supply of land and the supply of construction services recognised as separate supplies to which the Halifax principle was not applicable."

On the basis of this it found at 133 and 134:

"133. Two consequences follow from the preceding paragraph:

- a. Transactions normally taking place under the development model cannot form the normal commercial operations against which the comparison required in the present case as a result of Halifax should be judged.*

b. Structuring LME's and CBL's businesses in accordance with the self-build model as a matter of genuine commercial choice was an effective choice for VAT purposes as envisaged in Halifax and WHA.

134. In our view, the correct comparison to make is between transactions taking place under the LME/CBL self-build model and transactions under which LME supplies the land and an unrelated company builds the holiday home.

The first limb of Halifax is not, therefore, satisfied".

Because of this, the UTT did not dwell in detail on the second limb of Halifax, ie. whether the essential aim of the transactions was to obtain the tax advantage. It recognised that the essential aim is a high hurdle and it is for HMRC to prove essential aim, but "given that our rejection of the development model as the appropriate comparator is put primarily on the basis that normal commercial operations of a developer such as LME would not necessarily be the normal transactions under the development model" it felt that it did not need to dwell, in any more detail, on the essential point.

A number of important principles can be distilled from the decision but, most importantly, commercial justification for the arrangements actually put in place by a taxpayer are absolutely crucial. It must be able to show that the arrangements are normal commercial operations.

In order to benefit from the freedom to structure transactions so that you don't pay the maximum amount of VAT, you will need to show that there are justifiable and objective reasons as to why, given two alternative ways of achieving the same commercial end, the route which resulted in lower tax also had a commercial rationale.

Weald Leasing

In Weald Leasing, a group of companies making exempt outputs, were unable to recover VAT on purchases made to it. To divide and spread the payment of the irrecoverable VAT, a couple of companies were set up, one of which (Weald Leasing) purchased the kit and then leased it to a second company. This then subleased it to the end users in the Group. Weald Leasing claimed it was entitled to deduct the input VAT on the cost of the kit since it was attributable to taxable supplies of leasing. HMRC said not, and the structure to enable recovery of VAT was an abuse of rights.

The ECJ, both the court itself and the Advocate General said this was not necessarily the case.

"34 A taxable person cannot be criticised for choosing a leasing transaction which procures him an advantage, as is apparent from the decision making the reference, and spreading the payment of his tax liability, rather than a purchase transaction which does not procure him any such advantage, provided the VAT on that leasing transaction is duly and fully paid".

"38 Furthermore, resort to a leasing transaction in respect of an asset does not automatically mean that the amount of VAT on that transaction would be less than would have been paid if the assets had been purchased".

Importantly, however, the ECJ bounced this back to the national court and said that "that being so, the national court will have to determine, first, whether the contractual terms of the leasing transactions at issue in the main proceedings are contrary to the Sixth Directive and of the national legislation transposing it. That would particularly be the case if the rentals were set at levels which were unusually low or did not reflect any economic reality".

They also said, importantly, that "the fact that an undertaking which resorts to leasing transactions such as those at issue in the main proceedings does not engage in leasing transactions in the context of its normal commercial operations does not affect the foregoing considerations".

It bolsters its view about the rental levels by saying that there is no abusive tax advantage "..... provided that the contractual terms of those transactions, particularly those concerned with setting the level of rentals, correspond to arms length terms"

So the lease and leaseback schemes that were doing the rounds all those years ago are not per se abusive provided the rental levels are objectively justifiable.

Conclusion

So the common theme from both of these cases is that a taxpayer does have freedom to decide how to deliver a service and HMRC (and the Courts) will not automatically tax the transaction on the basis that there is an economically equivalent route to achieve the same end on which the taxpayer would suffer a greater amount of tax.

However, the taxpayer will need to be able to show that there are justifiable objective and commercial reasons for the route taken and the consideration (where there are connected parties) for the transaction is computed on an arms length basis.

For further information please contact:



Nigel Popplewell
Partner

Tel: +44(0)117 902 2782

nigel.popplewell@burgess-salmon.com