

Hire purchase leasing and partial exemption Royal Bank of Scotland Group plc

Summary

HMRC has appealed the original Tribunal decision (see 2007 document archive), which concerned the appropriate partial exemption recovery method for an asset finance business. This case is being followed closely by all businesses which provide asset finance on hire purchase (HP) or similar terms, and it is also likely to have wider significance for partially exempt taxpayers.

Background

This case concerns the appropriate partial exemption method for an HP / asset finance business carried on by Lombard (a subsidiary of RBS and a member of the VAT group of which RBS is the representative member). Lombard's business was included as a sector in the Taxpayer's partial exemption special method and, insofar as the business involved asset finance, the method provided for a 15% flat rate recovery of input tax on overheads (based on a historic agreement between HMRC and the Federation of Leasing Agents as the relevant trade body).

RBS proposed an amended special method which included a "transaction count" basis of recovery for the asset finance business. This sought to treat each deal as entailing two transactions - a taxable supply of goods and an exempt supply of credit - and therefore led to 50% recovery. HMRC refused to approve this method on the basis that it did not secure a "fair and reasonable" recovery of residual input tax. Indeed, HMRC considered that RBS should have nil recovery (i.e., that all the overheads costs were used exclusively by RBS in making the exempt supplies of credit).

RBS appealed, and the Edinburgh VAT Tribunal allowed the appeal. It held (in the absence of a suitable alternative method) that the RBS proposed "transaction count" method was fair and reasonable, and that the 15% flat rate recovery was not of itself either fair or reasonable. It also stated that HMRC's 'nil recovery' policy was one that no "sensible and realistic person" would seek to support.

Following this decision, HMRC published Revenue & Customs Brief 31/07 confirming its 'nil-recovery' policy and stating that it had lodged an appeal against the Tribunal's decision. HMRC explained its view that, applying the "cost components" doctrine arising from ECJ cases such as *Midland Bank (C-98/98)*, input tax was not recoverable unless the costs to which it related were reflected in the selling price of a taxable supply. As in most HP transactions the goods were resold at cost (i.e., without any margin to cover overheads), such overheads could only be cost components of the exempt supply of credit and the input tax thereon was therefore wholly irrecoverable. In HMRC's view, this "cost component" point was not tested before the Tribunal.

Appeal

The basic premise of HMRC's appeal before the Court of Session was that RBS had failed to discharge the burden of showing that its proposed 'transaction count' method secured a fair and reasonable attribution of residual input tax to taxable supplies. HMRC relied on the statement of the courts' jurisdiction in relation to partial exemption methods expounded by Warren J in *St. Helen's School [2006] EWHC 3306 (Ch)*, and in particular the principle that if a proposed method is not demonstrated to be fair and reasonable then the previously agreed method should continue to apply (even if it is less fair and reasonable than the proposal).

HMRC argued that, whilst the Tribunal had cited *St. Helen's School* in its decision, it had paid lip service to the principles set out therein. On a proper analysis of its decision, the Tribunal had accepted the proposed 'transaction count' method because it considered it to be the only method on the table. In doing so, HMRC argued that the Tribunal had made an error of law. HMRC put forward three specific grounds of appeal, which are summarised below:-

- The Tribunal had failed to make sufficiently detailed findings of fact, particularly in relation to the evidence of Mr Meville (the lead HMRC officer).
- The Tribunal had given inadequate reasons for reaching its decision. None of its findings of fact in relation to the nature of the business were later picked up on when arriving at its conclusions, and there was no explanation of the basis on which the Tribunal arrived at its conclusions.
- In its decision, the Tribunal had hinted that it drew support from the decision in *Sovereign Finance (16237)*. However, that case concerned a different point (the construction of an agreed special method) and, to the extent that the Tribunal concluded that the reasoning contained therein provided a basis for the RBS proposed method, it had erred in law.

RBS accepted that the law was as set out in the decision of Warren J in *St. Helen's School*. It considered that it had discharged the burden of demonstrating that its proposed 'transaction count' method was fair and reasonable, and supported it principally on the basis that HP / asset finance involved a single commercial transaction. Whilst it was necessary for it to be split into two transactions (for VAT purposes only), that was an artificial construct and - leaving aside output values - there was no means to allocate costs between the two elements of a single transaction. The proposed transaction count method was a simple, logical and workable solution which one was driven to accept by the artificiality of dividing a single transaction in two.

RBS addressed HMRC's three grounds of appeal as follows:

- The Tribunal had made all the necessary findings of fact, the key ones behind those dealing with the unitary nature of the business. The RBS proposed method was not based on evidence but rather on the artificiality of splitting a single commercial transaction in two, and the absence of any other appropriate method. It was not necessary for the Tribunal to deal with Mr Melville's evidence in detail because it had entirely rejected his approach of splitting the business activities into "processes" and attributing those processes to the taxable and exempt elements of the supplies.
- It was reasonable to infer from the Tribunal's decision that it had considered the proposed method to produce a fair and reasonable result for the reasons advanced by RBS (and it had been correct to do so).
- The Tribunal did not place a great deal of weight on *Sovereign Finance*, but it was correct to conclude that the decision provided some support for the RBS proposed method.

The Court reserved judgment.

Implications

The forthcoming decision of the Court of Session in this case will have a significant impact on VAT recovery in the HP and asset finance sectors. All HP and asset finance businesses should take immediate steps to assess whether their partial exemption special method is producing a fair and reasonable residual input tax recovery rate in the light of this decision. HP and asset finance businesses should also consider whether their VAT recovery position could be enhanced by submitting proposals to HMRC for a new special method and/or serving on HMRC a Special Method Override (SMO) notice.

The decision may also have a wider significance for all partially exempt taxpayers, particularly in the light of the requirement to declare that proposed partial exemption methods are "fair and reasonable".

It is interesting to note that, despite the clear statement in Revenue & Customs Brief 31/07, HMRC did not mount any arguments before the Court of Session based on the "cost components" theory and the relative profitability of the two elements of the business. HMRC's reliance on relative profitability was recently rejected by the London VAT Tribunal in *Camden Motors (Holdings) Ltd (20674)* as "contrary to basic

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principles of VAT'. Whether this is an indication that HMRC has abandoned its controversial 'nil-recovery' policy in this sector remains to be seen. (In the Editor's view this is untenable).

Watch this space!