Taxpayer successful in 'abuse of rights' VAT challenge

\textit{Pendragon Plc & Ors [2013] EWCA Civ 868}

The Court of Appeal has held that, although a differently constituted First Tier Tribunal might have decided this case differently, neither the Upper Tribunal nor HMRC had shown that it had erred in law in its original decision. Consequently, the Upper Tribunal should not have upheld HMRC's appeal, and the Court of Appeal reinstated the original decision that a demonstrator car financing arrangement was not abusive. The judgment clearly sets out the principles to be applied in this type of case.

The original case concerned arrangements which the Taxpayer had put in place as a means of financing the acquisition of demonstrator cars for its car dealership business. The First Tier Upper Tribunal (FTT) had found that the arrangements, which resulted in VAT being accounted for only on any margin on the sales of the cars after use as demonstrators, were not self-cancelling or uncommercial and had been put in place as a means of obtaining finance, in addition to reducing the amount of VAT. Consequently, the FTT had not considered that the arrangements amounted to an abuse of rights.

The UT accepted HMRC's criticisms of the FTT, in particular on the question of whether the essential aim of the arrangements was to achieve a VAT advantage. The UT considered that the arrangements did involve an abuse of rights and that, in not finding that, the FTT must have misdirected itself on a point of law. The UT had failed to consider the scale of the tax advantage in determining whether it was the essential aim, and had failed to balance the other commercial factors against the VAT advantage. The UT considered that the Taxpayer had not needed to obtain finance, it had facilities available. The UT therefore allowed HMRC's appeal and reinstated HMRC's VAT assessments. The Taxpayer appealed the decision to overturn the FTT's decision to the Court of Appeal (CA).

Before the CA, the Taxpayer argued that the UT had been wrong to disturb the FTT's decision. HMRC sought to argue that the UT had been correct, and that the FTT had erred in law by admitting subjective witness evidence from the Taxpayer when the assessment of what had been the essential aim should have been based on an objective evaluation of the evidence. HMRC also considered that the FTT should have taken account of the correspondence between the Taxpayer and its tax advisers which would reveal the aim of the arrangements.

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Held

The CA began by carrying out an exhaustive review of the case law on the abuse of rights principle. In particular, the CA concluded that:

- if obtaining an illegitimate tax advantage was an essential aim of a transaction, that was sufficient for abuse of rights purposes: it did not have to be the sole aim of the transaction;
- if a transaction had significant commercial aims other than obtaining a tax advantage, and not simply collateral side effects, the abuse of rights principle would not apply; and
- it was the aim of the transaction which was to be objectively assessed, not the subjective aim of the parties to a transaction.

The CA then considered how an appellate court should approach an appeal such as this. The FTT was charged with finding facts and then drawing conclusions from those facts to decide the case. An appellate court should only disturb the FTT's decision if it could point to an error of law in the FTT's reasoning or if it considered that no reasonable Tribunal could have reached that decision. It was possible that two differently constituted Tribunals could reach different decisions based on the same facts, and for both decisions to be correct in law. But that did not mean that the decision of the first Tribunal should be overturned. Consequently, the CA's task in this case was to consider whether the FTT's decision on the abuse of rights issue was correct in law and, if so, even if the UT's decision could also be regarded as correct in law, the FTT's decision must be reinstated.

The CA next considered the HMRC's criticism of the FTT for admitting the Taxpayer's witness evidence which the UT considered to be primarily subjective and not relevant to an objective assessment of the aim of the transactions. The CA acknowledged that much of the witness's evidence had been subjective, however it noted that the FTT had been careful to concentrate on the objective aspects of the evidence and had sought to disregard what appeared subjective. So it found no error of law in how the FTT had dealt with the Taxpayer's witness.

Moving on to the evidence from the Taxpayer's correspondence with its tax advisers, the CA considered that the FTT had been right to examine the evidence but also right to regard the views of the tax advisers on the purpose of the transactions to be subjective rather than objective. The CA found no significant, if any, error in law on the part of the FTT here either.

The CA then turned to the UT's criticism of the FTT for failing to consider the scale of the VAT

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advantage obtained and compare it to the other commercial aspects of the transactions. The UT had considered that the scale of the VAT advantage was "overwhelmingly" the reason that the Taxpayer had entered into the transactions. However, the CA could find no case in which this approach had been adopted. It considered that the scale of the advantage would be significant in any case, otherwise the case would be unlikely ever to come before the courts. The CA agreed with the Appellant that, in an abuse of rights enquiry, the tax advantage should be 'taken as read', and the real enquiry was whether the transactions were commercial or artificial.

This led the CA on to the question of whether the Taxpayer had been motivated by obtaining third party finance. The UT had pointed out that the Taxpayer had had unused finance facilities available at the time, so it did not need to enter into new funding arrangements, and the UT had cited the FTT's failure to recognise this as an error of law. But the CA pointed out that the Taxpayer's witness evidence had been that it was looking for further funding to ensure that it had sufficient 'headroom' facilities available to fund contingencies and further its expansion plans, so it needed to put new arrangements in place. The FTT had accepted that decision and, in the CA's opinion, had been entitled to do so and had not, as the UT had found, erred in law in that respect.

The CA then turned to the aspects of the transactions which HMRC and/or the UT had considered to be artificial, i.e. the use of the captive leasing companies in the lease arrangements, the terms of the leases providing that ownership of the demonstrator cars would pass after the final payment had been made, and the use of the offshore bank rather than its UK parent.

The FTT had considered that the bank would require security over the vehicles in order to lend, and obtaining this by means of the leases and captive leasing companies was not an uncommercial arrangement. The leases gave the bank security but enabled the dealerships to continue to use the cars. The FTT had recognised that the arrangements had been structured in a tax-efficient way, referring back to Halifax as the authority that taxpayers were not required to organise their affairs in the manner which would maximise the tax cost, but had not considered those arrangements abusive. The FTT had not specifically dealt with the use of the offshore bank, but had referred to the use of a German bank in RBS Deutschland Holdings (C-277/09), in which the ECJ had refused to accept that the tax advantage arising from disparate VAT treatment of lease transactions in the UK and Germany gave rise to abuse.

The CA could find no error of law in any of the FTT's findings on these issues, and held that the
FTT had been entitled to reach its conclusions on them. Instead, the CA found that the UT had not been justified in criticising the FTT’s findings, and it found nothing in either the UT’s decision or the arguments put before it by HMRC to justify the reversal of the FTT’s decision, which the CA reinstated.

Comment

The judgement carefully examines both the jurisprudence on abuse of rights and the role of the appellate courts. The CA also went into depth in examining the facts and the essential aim of the transactions in the scheme, seeking to determine the commerciality or artificiality of each. In the Editors’ opinion, the CA carefully sought to put to the back of its mind the tax advantage, acknowledging that it was an essential aim of the parties but that it was the essential aim of each transaction that had to be considered, and in the end found that each transaction, and each party, had a commercial rationale. The CA carefully distinguished the active captive leasing companies involved in this scheme from the company interposed in the Halifax case which, in its view, had no real commercial function.

If you would like to discuss any aspect of this case, please contact 4 Eyes Ltd.