"BANKS, UNIVERSITIES AND HOSPITALS: THE LIMITS TO TAX AVOIDANCE"

Ben Lask[1]

1. On 21st February 2006, the European Court of Justice ("ECJ") delivered its long awaited judgments in three related VAT cases: *Halifax*, *University of Huddersfield* and *BUPA*.[2] In doing so, it provided much-needed guidance on the application of VAT law to arrangements designed to obtain a tax advantage.

Facts

2. All three cases concerned arrangements designed to confer an enhanced entitlement to deduct input VAT on the taxpayer.

3. Halifax and the University of Huddersfield intended to carry out construction works. Since the majority of their services (financial and educational) were exempt, ordinarily they would only have been able to recover between 5 and 6% of the VAT incurred on the purchase of construction related supplies. However, both the bank and the university introduced schemes involving the insertion of one or more additional companies into the transaction chain between them and the third party supplier of construction services. This was in order to enable them to recover all the input VAT incurred in relation to the works. Whilst the Halifax's scheme led to an overall tax saving, the University's scheme was a cash-flow scheme intended to spread the burden of VAT over a period of years. It would not have led to an absolute tax saving unless the sale and

1 Ben Lask, Monckton Chambers, 1 & 2 Raymond Buildings, Gray's Inn, London WC1R 5NR; Tel 020 7405 7211; Fax 020 7405 2084; DX LDE 257

2 Cases C-255/02, C-223/03 and C-419/02.

lease back involved unravelled before the charge to output tax equalled the input tax recovered.[3]

4. BUPA implemented arrangements providing for the making of prepayments in relation to its purchase of drugs and prostheses. An imminent change in the law meant that its supplies of such products would soon become exempt rather than zero-rated. However, as a result of the prepayment arrangements, the zero-rating (which enabled BUPA to recover the input VAT on its purchases) would effectively have been preserved for between 6 to 7 years in one case, and up to 100 years in another case, after the change in the law.

5. Halifax, Huddersfield and BUPA appealed against the Commissioners' refusal of their claims for input VAT recovery, and questions raising the following issues were referred to the ECJ:

- whether transactions of the kind at issue constituted supplies of goods or services and economic activities within the meaning of Articles 2(1), 4(1) and (2), 5(1) and 6(1) of the Sixth VAT Directive where they were carried out with the sole purpose of obtaining a tax advantage; and

- whether and in what circumstances a taxable person would be denied the right to deduct input VAT on the basis that the transactions giving rise to that right constituted an abusive practice.

The Meaning of "Supply" and "Economic Activities"

6. On the question of what constitutes a supply for VAT purposes, the ECJ followed its recent judgments in the carousel fraud cases,[4] holding that the concepts of "supply" and "economic activities" are objective in nature and apply without regard to the purpose or results of the transactions concerned. Thus transactions (such as those entered into by Halifax and Huddersfield) carried out solely for the purpose of obtaining a tax advantage nonetheless constitute "supplies" and "economic activities" for VAT purposes, provided that goods and services are in fact supplied. Indeed the ECJ made clear that whether a transaction is carried out for the

3 A similar scheme had previously been approved by HMRC: see *Commissioners of Customs and Excise v University of Wales College* [1995] STC 611.

4 Joined Cases C-354/03, C-355/03 and C-484/03 *Optigen and Others*.

sole purpose of obtaining a tax advantage is entirely irrelevant in determining whether it falls within the scope of these key concepts.

7. The ECJ accepted that the objective criteria on which the concepts of "supply" and "economic activity" are based will not be satisfied where tax is evaded by, for example, the issue of untruthful tax returns or improper invoices. Although such a situation might arise where the transactions at issue are a sham (in the English law sense), this was not an issue on the facts of these cases.

Abusive Practice

8. The ECJ referred to its earlier case law on the abuse of rights principle, by which Community legislation does not apply to transactions carried out solely for the purpose of wrongfully obtaining advantages provided for by Community law.[5] It also confirmed that, since the Sixth Directive recognises and encourages the prevention of tax evasion, avoidance and abuse, the principle must apply in the VAT sphere.[6]

9. However, the Community law principle of legal certainty must be observed strictly where, as with VAT, the rules in question entail financial consequences. Moreover, traders are entitled to choose between available transactions, and structure their business, so as to limit their tax liability.

10. With those considerations in mind, the ECJ held that an abusive practice can only be found to exist in the VAT sphere where two conditions are satisfied:

> *"...first, the transactions concerned, notwithstanding formal application of the conditions laid down by the relevant provisions of the Sixth Directive and the national legislation transposing it, result in the accrual of a tax advantage the grant of which would be contrary to the purpose of those provisions.*
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> *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. As the Advocate General observed in point 89 of his Opinion, the prohibition of abuse is not relevant*

5 Case C-110/99 *Emsland-Stärke* [2000] ECR I-11569.

6 Joined Cases C-487/01 and C-7/02 *Gemeente Leusden and Holin Groep* [2004] ECR I-5337.

> *where the economic activity carried out may have some explanation other than the mere attainment of tax advantages."*[7]

11. In relation to the first condition, the ECJ explained that it would be contrary to the principle of fiscal neutrality, and thus the purpose of the Sixth Directive, to allow a taxpayer to deduct all its input VAT where, in the context of its "normal commercial operations", it would not have been able to do so.

12. Explaining the second condition, the ECJ said that the national court's task is to determine the "real substance and significance" of the transactions concerned, where appropriate taking into account their purely artificial nature and any legal, economic or personal links between the operators involved.

13. The ECJ went on to say that, where tax authorities find that the right to deduct has been exercised abusively, they are entitled to recover the amounts deducted retroactively. In calculating the amounts to be recovered, they must reconstruct the situation that would have existed but for the abusive transactions. This would include reimbursing any output tax for which a taxable person was liable under any transactions forming part of an abusive scheme. However, the finding of an abuse must not lead to the imposition of penalties, and the taxpayer who would have benefited from the first non-abusive transaction must still be allowed to deduct.

Prepayments

14. The general rule is that VAT becomes chargeable when goods are delivered: see the first sub-paragraph of Article 10(2). The second sub-paragraph stipulates that, where payments are made on account before goods are delivered, VAT becomes chargeable on receipt of payment (and by virtue of Article 17(1), the right to deduct arises at the same time). The ECJ held that, since the second sub-paragraph constitutes a derogation from the general rule, it must be interpreted strictly. Accordingly, in order for tax to become chargeable in a prepayment situation, all the relevant information, including the precise identification of the goods, must already be known.

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7 *Halifax*, paras.74-75.

15. Under BUPA's arrangements, substantial prepayments were made for goods referred to in general terms in a schedule accompanying the agreement. The buyer could subsequently select which articles it required and could unilaterally withdraw from the agreement at any time, recovering any unused balance of the prepayments should it do so. In those circumstances, the ECJ held, the prepayments did not fall within the second sub-paragraph of Article 10(2).

Comment

16. The ECJ's judgments in these cases clarify the legal tools that can and cannot be used by the tax authorities to prevent input VAT recovery under schemes which they consider to be tax avoidance arrangements.

17. The ECJ has made it plain that transactions do not fall entirely outside the scope of the VAT system simply on the basis that their sole purpose is to obtain a tax advantage. In holding as much, the ECJ was keen not to disturb the wide scope of VAT, or to undermine legal certainty and the objective application of the VAT rules by requiring the tax authorities to inquire into the intentions of taxpayers.

18. On the other hand, it is apparent that arrangements will constitute an "abusive practice" where their result is contrary to the purpose of the Sixth Directive and their "essential aim" is to obtain a tax advantage. In those circumstances the arrangements will be ineffective in obtaining the tax advantage sought.

19. While the application of the abuse principle to VAT had been widely anticipated, this is the first time the ECJ considered the question in depth and set out how the principle should apply. The principle is described by the ECJ as a principle of interpretation. This means that it applies without the need for any legislative implementation. It indicates the way in which the meaning of the Sixth Directive is to be approached and, more particularly, the way in which the provisions conferring fiscal advantages (classically, the provisions dealing with input tax deduction) are to be interpreted. Since domestic law implementing the Sixth Directive is to be interpreted consistently with the Sixth Directive, it follows that the abuse principle "feeds into" the domestic implementing provisions. So far as the concept of an "abusive practice" is concerned, four points may be noted.

20. First, in many cases, it will not be apparent whether a particular tax arrangement is contrary to the purpose of the Sixth Directive. That will no

doubt have to be worked out on a case-by-case basis. However in the case of taxpayers that carry out significant exempt transactions, such as banks and educational establishments, there is obviously a risk that any arrangement that seeks to increase the amount of input tax recovery may be challenged by HMRC. Such a challenge might be mounted on the basis that the arrangement is suspect unless it can be shown to be a "normal commercial operation" (what constitutes a normal commercial operation will, no doubt, be the subject of further litigation).

21. Secondly, in relation to the second limb for identifying an "abusive practice" (which refers to its "essential aim"), the ECJ has opted for a test that relies on "objective factors". Accordingly, there may be some argument as to whether or not subjective factors (primarily the intention of the taxpayer(s) involved) are relevant.

22. Thirdly, the abuse principle does not seem to apply "where the economic activity carried out *may have* some explanation other than the mere attainment of tax advantages" (emphasis added) (a distillation of the AG's Opinion).[8] There will inevitably be some debate as to how high the evidential threshold needs to be in order to reach that conclusion.

23. Fourthly, it is not entirely clear whether, under the second limb, the attainment of a tax advantage must be the *sole* purpose of an arrangement in order for the doctrine of abuse to bite, or whether it need only be the *predominant* aim. Different parts of the judgment point in different directions. Thus, in paragraph 69, the ECJ states that the abuse principle applies where the "sole" purpose is wrongfully to obtain a tax advantage; and, in paragraph 75, the ECJ approves the AG's observation referred to above. On the other hand, in the same paragraph, the ECJ refers to "the essential aim" of the transactions concerned; and, in paragraph 81, refers to the responsibility of national courts to "determine the real substance and significance" of those transactions.

24. It was unnecessary for the ECJ to determine whether the mere existence of an independent commercial purpose other than the attainment of a tax advantage would preclude the application of the abuse doctrine, or whether any such purpose must carry a certain degree of significance. This was because, in *Halifax* and *Huddersfield*, the VAT Tribunal had already found on the facts that obtaining a tax advantage was the sole purpose of the transactions concerned. Consequently it will not be surprising if, before

8 The French version of the judgment could be rendered as meaning "is capable of having" some other explanation.

long, the ECJ is asked to consider the application of the abuse doctrine to a case in which a set of arrangements gives rise, not only to a tax advantage, but to one or more real though ancillary benefits.

25. Finally, in relation to the application of the abuse principle, while it is clear that the national tax authorities must "redefine" situations in which an abusive practice is present, the details are still to be worked out. The reconstructed transaction is that which would have prevailed in the absence of the abuse. But in practice it may not be easy to identify what that transaction – which did not take place – would have been.

26. Further, there are at least two different ways in which the "redefinition" exercise can be understood. On the one hand, it might be said that the exercise involves reconstructing the chain of transactions, thus enabling the tax authorities to charge tax on the transactions that would have prevailed in the absence of the abusive practice, as well as removing the fiscal advantage that it was designed to achieve. On the other hand, the exercise may simply involve identifying the tax position as it would have been in the absence of the abusive practice, in order to define what the taxpayer in question was really entitled to, while leaving the chain of transactions untouched.

Application of the ECJ's Abuse Test

27. The VAT Tribunal considered the *Halifax* judgment in the context of a disclosure application on 10 March 2006. The Commissioners alleged that arrangements put in place by the Appellant constituted an abusive practice and sought disclosure of, *inter alia*, any tax planning advice received by the Appellant. The Appellant refused the request on the grounds that such documents went to the trader's subjective intention which, following *Halifax*, was irrelevant to the question of abuse.

28. The Tribunal rejected the Appellant's arguments and allowed the Commissioners' application. In doing so, it provided useful guidance as to the Tribunal's role in considering the question of abuse and the type of evidence that will be relevant. The President, Mr Oliver QC held:

> *"…The Tribunal has to determine whether the essential aim of the transaction is to obtain a tax advantage. That exercise is directed at the objective purpose of the transaction. The Tribunal's function in this respect is to examine the evidence and assess the purpose of the transaction…On that basis it seems to me that the*

tax advice, if any, given to the management of O2 who decided to adopt the transaction will be relevant to the above issue. Thus the documents (if any) containing recommendations made to O2's decision makers and those advising them will be relevant…The obtaining of tax advice, the circumstances in which it was obtained and the nature of the advice are, in my view, objective factors. They constitute evidence without which the Tribunal cannot properly determine whether the essential aim of the transactions concerned was to obtain a tax advantage…"[9]

9 *MMO2 Plc and O2 Communications v Commissioners for Revenue and Customs*, 10 March 2006, paras.12-14.