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CUSTOMS & EXCISE COMMISSIONERS v FIRST NATIONAL BANK OF CHICAGO[1]

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VAT is simple. I sell goods subject to VAT and I account for the VAT on the sale. I buy goods subject to VAT and I recover the VAT on that supply. The fact that the supply has been made to me and I have an invoice allows me to recover the VAT on that supply. There is actually no need for me to make payment to recover the VAT as a tax is supply driven. Of course I do make a payment and in doing so hand over my money to the person who supplied me the goods.

Why is this not a supply of the money? Article 13(B)(d)(iv) states that transactions concerning currency, bank notes and coins are exempt supplies so why is this not an exempt supply? If I had paid for the goods by exchanging other goods for them then they would be a barter and VAT would be payable on both elements. If I had paid for them by issuing shares then that issue would also be a supply.[2] So, why, just because I choose to settle the amount with currency is that supply ignored? If this were the case (because it certainly does not appear to be the case in reality) then all traders would be making exempt supplies equal to their costs and taxable supplies equal to their sales so a typical currently fully taxable trader would become a partially exempt trader whose partial exemption method to recover input tax on non-attributable expenses would follow the formula

$$\frac{\text{Sales}}{\text{Sales plus costs}}$$

and no one would be fully taxable. Given the nature of VAT this does seem to be an absurdity. In practice, everyone ignores the fact that cash has been transferred.

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1 Case C-172/96. Judgment of 14th July 1998 STC [1998] 850.

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3 Although this is not the case in all member states.

When we talk about cash we must, of course, mean all the currencies of all the member states; one cannot be parochial about this and whether I pay for my goods in pesatas or lire is not an issue.

But what if what I am buying is pesetas and I pay in lire? What if I only take delivery of the pesetas in 6 months' time?

Some might agree that the passing of money is not in the course or furtherance of the taxpayer's business. But surely paying one's suppliers is? A deposit of money which pays interest is a supply; it may be incidental,[3] but it is still a supply.

It is these type of fundamental issues which the European Court of Justice had to address in the First National Bank of Chicago case.

The Commissioners of Customs & Excise made a decision of 26th September 1994 that these kind of transactions, i.e. buying foreign exchange, were outside the scope of VAT seeing each transaction as merely an exchange of one means of payment for another which did not involve a supply for a consideration. However, this view severely affected the First National Bank of Chicago's partial exemption method by removing foreign exchange transactions with non-EU counterparties from both the top and bottom line of its partial exemption pro-rata calculation. Accordingly, the Bank were worse off following this ruling and, therefore, sought to challenge it.

Background

The decision by Customs & Excise in September 1994 was very sensible, practical and immediately strikes one as the easiest solution in the circumstances. There is no need for the cold towel around the head and all concerned can go back to bed having realised that they all had a close shave with a very difficult decision. Should legal justification be needed for this view they could perhaps have found it in recent European Court of Justice authority which states that where there is a supply and that supply does not result in any consumption in the supply chain, then there is, in fact, no supply at all.[4]

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4 See Sofitam for example, *Sofitam v Ministre Chargé du Budget* [1993] ECR-I-3515.

5 See *Mohr v Finanzamt Bad Segeberg* (Case C-215/94) [1996] STC 328 where a payment made by a Government to a farmer to not produce milk from his dairy farm was held not to be a consideration for a supply. This case was then considered in a similar case relating to potatoes *Landboden Agrardienste Gmbh & Co Kg v Finansamt Calue* (Case C-384/95 [1998] STC 171.)

6 See *Customs and Excise Commissioners v Morrisons Academy Boarding House Association*

Both parties in the case agreed to abide by the British Bankers Association view of what constituted a foreign exchange transaction; namely any transaction between the parties for the purchase by one party of an agreed amount in one currency against the sale by the other of an agreed amount in another currency, both such amounts being deliverable on the same value date and in respect of which transaction the parties have agreed either orally, electronically or, in writing, the currencies involved, the amounts of such currencies to be purchased and sold, which party will purchase which currency and the value date.

The case has been awaited with much interest. So what did the court decide and how did they come to it?

Judgment of the Court

Broadly speaking the United Kingdom's position was that unless a commission charge was made for exchanging one currency for another then there were no supplies. They accepted that the logical consequence of this were that if you were to go to a bureau de change which operated on a commission free basis and instead made their money out of the spread between the buy and sell price then they would not be making any supplies at all for VAT purposes. The European Commission, other governments and the bank contended that whether or not there was a charge by way of commission or a turn taken by way of spread there was still a supply. Two points followed from this. First, there is no requirement that someone does something for a profit for it to be within the scope of VAT.[5] Second, Customs did have different views and indeed practice was different in the underwriting market prior to the implementation of the Eighteenth VAT Directive in that there was a difference in treatment between taking a spread on an underwriting and taking a commission.

Having decided that there is indeed a supply, a number of questions naturally follow. These include:

the value of the supply,

the time of supply, and

the place of supply.

[1978] STC 1.

Regrettably, I can only find an answer to the first of these questions in the European Court's judgment. The answer to the second seems to be rather fudged.

Value of Supply

The Advocate General and the Court readily agreed and accepted that it would be impossible for a bank to note down every single supply that it made and also work out its return on every single foreign exchange transaction. Instead they said that banks could account on the profit they made over a period of time in respect of such transactions and justified this in 2 ways. First, on the authority of the *Glawe*[6] case. This was a case on gaming machines where, of course, the machine would pay out winnings and it was, therefore, impossible to tell how much the machine had actually received; only how much was left in the machine after it had paid out winnings. In that case an analogy was also drawn with a bookmaker who again has to pay out sums and only really has what is left. The second analogy was with a manufacturing business where at the end of the day the amount of VAT accounted for is the VAT on his profit margin (although this ignores that some of his costs do not bear VAT i.e. salaries so that in fact VAT is accounted for on the cost of labour and profit margin).

One thought does occur and that is what those engaging in foreign exchange transactions are being permitted to do is in effect to adopt a simplified system of VAT operating on a margin rather than on a transaction by transaction basis. Whilst there is authority for such simplified schemes in the Sixth Directive, under Article 24 for small undertakings, Article 25 for farmers, Article 26 for travel agents, Article 26(a) for second hand goods etc., and for Article 27 where a specific derogation has been given, for example, to the UK for retail schemes, none of these really cover the case in hand. However, perhaps the rationale for this can be found in the nature of VAT being a tax on value added, for which see below.

Time of Supply

The European Court said these profit margins i.e. the value of the supply have to be taken into account over a period of time i.e. once the bank has managed to calculate what its profit is on any particular transaction. Again how this fits in with the time of supply rules one can only postulate.

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7 *H J Glawe Spielund Unterhaltungsger ä te Aufstellunges Gesellsthaft Mbh & Co Kg v Finanzamt Hamburg Barmbk Uhlenhors* Case C-38/93 [1994] STC 543.

Regrettably, we are no further forward as to practical operation foreign exchange gains and losses in a VAT context than we were before the decision. One may, therefore, be entitled to ask the question why are we in this state?

Value Added Tax is a tax on value added

As the title to this section suggests Value Added Tax is supposed to be a tax on value added. Referring back to the manufacturing analogy, value added would, of course, represent the costs of labour and the profit margin and, therefore, the amount of tax accounted for by the manufacturer is correct. However, measuring value added in the real world is very difficult to do. It also raises issues as to when the value is added and how the tax could be collected. However, it is fundamental to the tax that the tax is a tax on value added and not necessarily a tax on transactions. However, the concept had to be made to fit the real world and the mechanism that was developed to do this was the mechanism we are familiar with, of taxing the full value of a particular transaction and then giving credit for tax borne on the cost components of that transaction. Where this falls apart, as in the case of foreign exchange, however, is where identifying the transaction and the respective cost components cannot be done in practical terms such that an alternative, and one could argue truer, mechanism has to be found. In essence this is the result that we have in the First National Bank of Chicago case. VAT takes account of the value added by the bank, a term described by the Court as the amount which it could actually apply to its own use, determined by looking at the net result of its transactions over a given period of time.

There are, therefore, a lot of points to be addressed going forward and I certainly look forward to the next instalment of the debate.