[2015] UKFTT 0686 (TC)

TC04803

Appeal number:TC/2012/02909

VALUE ADDED TAX – preliminary issue – supplies of demonstrator cars used by motor dealers – repayment of overpaid output tax where supplies should have been treated as exempt – whether repayment should have been reduced by restriction of input tax credit because trader was partially exempt – Article 19(2) Sixth Directive – whether demonstrators were capital goods – JDL Limited v C&E Commissioners and Nordania Finans A/S v Skatteministeriet considered – whether restriction of input tax credit in breach of principle of fiscal neutrality – demonstrators were not capital goods

FIRST-TIER TRIBUNAL
TAX CHAMBER

CLECKHEATON HOLDINGS LIMITED **Appellant**

- and -

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE & CUSTOMS **Respondents**

TRIBUNAL: JUDGE JONATHAN CANNAN
MR RICHARD CROSSLAND

Sitting in public in Manchester on 18 May 2015

Ms Amanda Brown of KPMG LLP for the Appellant

Mr James Puzey of counsel instructed by the General Counsel and Solicitor of HM Revenue & Customs for the Respondents

DECISION

Introduction

1. This appeal concerns the historic treatment of supplies by a motor dealer of demonstrator cars ("Demonstrators"). On 13 February 2009 the Appellant submitted a claim for repayment of overpaid VAT which it had accounted for on the profit margin on sales of Demonstrators ("the Claim"). This was part of a wider claim, but for present purposes the claim in relation to Demonstrators covered output tax accounted for by the Appellant the period 1 April 1973 to 31 December 1999 ("the Claim Period"). This was a "Fleming Claim" prompted by the decision of the House of Lords in *Michael Fleming t/a Bodycraft) and Conde Nast Publications Ltd v Commissioners of Revenue & Customs [2008] UKHL 2.*

2. In November 2009 the Claim was agreed by HMRC in the sum of £159,334 and that sum was repaid together with statutory interest.

3. In October 2011 HMRC informed the Appellant that they considered that they had overpaid the Appellant in relation to the Claim. The Claim had been repaid on the basis that the Appellant had accounted for output tax when in fact the supplies of Demonstrators over the period were exempt supplies. HMRC contended that in repaying the Claim they had not taken into account restrictions on the input tax that the Appellant was entitled to in the Claim Period as a result of having made those exempt supplies.

4. In the circumstances HMRC notified an assessment to VAT pursuant to section 80(4A) Value Added Tax Act 1994 ("VATA 1994") in the sum of £13,094 plus statutory interest of £25,245. That is the assessment under appeal. The notice of appeal was served on 8 February 2012 and the grounds of appeal may be summarised as follows:

(1) HMRC are wrong as a matter of law in applying an input tax restriction in the Claim Period, alternatively

(2) HMRC have applied the wrong methodology in calculating the input tax restriction.

(3) The assessment was made in breach of the Appellant's legitimate expectations and the EU principle of legal certainty.

5. The Appellant no longer pursues the third ground of appeal. Further, both parties agreed at the hearing that determination of the second ground of appeal, which relates to the quantum of the assessment, should be deferred pending the outcome of the first ground of appeal. We agreed that was a sensible approach. This decision therefore deals only with the first ground of appeal as a preliminary issue.

6. We should also record that there are a large number of other appeals by motor traders which the Tribunal has stayed pending the outcome of this appeal.

Background

7. It is helpful to consider the history of the taxation of Demonstrators, which we base largely on Ms Brown's skeleton argument.

8. When the UK introduced VAT in 1972, HMRC restricted the recovery of input tax in relation to the purchase of motor cars. Article 4 of the Value Added Tax (Cars) Order 1972 (SI 1972 No 1970) provided that:

> " *4(1) Tax on the supply … of a motor car shall not be deducted as input tax … except where –*
>
> …
>
> *(c) the motor car is unused and is supplied … for the purpose of being sold.*"

9. It was common ground that Article 4(1) and subsequent statutory instruments in the same terms, culminating in Article 7(1) and (2) of the Value Added Tax (Input Tax) Order 1992 SI 1992 No 3222 had the effect of preventing a motor dealer from obtaining input tax credit on the supply by a manufacturer of a Demonstrator. This is known as an input tax "block" and it applied to Demonstrators because they were not supplied for the purpose of being sold.

10. Where a trader supplied a motor car on which input tax had been blocked, provision was made for output tax to be charged as if the supply were for a consideration equal to the profit margin, if any - see Article 7(1) of the 1972 Cars Order. This gave motor dealers a form of relief against the input tax block.

11. The validity of the input tax block for motor cars was confirmed by the ECJ in *Royscot Leasing & Others v Customs & Excise Commissioners [1999] STC 998*. One of the traders in that case was a franchised motor dealer, TC Harrison Group Limited, which used Demonstrators in its business. Article 11(4) of the Second Directive permitted Member States to exclude from the deduction system goods capable of being used partly for the private purposes of a taxable person or his staff. It was argued that this did not apply where the goods were essential tools of the business such as Demonstrators.

12. The Advocate General expressed the view at [75] of his opinion that such restrictions "severely disrupt the functioning and neutrality of the VAT system" but that the problem called for a legislative solution. The ECJ held that Article 11(4) expressly authorised Member States to exclude such expenditure from the right of deduction. At [25] it stated:

> " *However, in excluding from the right of deduction certain goods such as motor cars, the United Kingdom has not impaired the general system of the right of deduction, but has made use of an authorisation deriving from Article 11(4) of the Second Directive. This is a fortiori the case inasmuch as cars are goods which, by their nature, are capable of being used exclusively or partially for the private needs of the taxable person or of his staff.*"

13. In June 1997 the Court of Justice released its judgment in *EC Commission v Italian Republic [1997] STC 1062* ("Commission v Italy"). Italian law provided that supplies of goods where the right to input tax credit had been blocked were deemed not to be subject to VAT, in other words they were outside the scope of VAT. The ECJ held that the Sixth Directive required Member States to treat such supplies as exempt, rather than outside the scope of VAT. Treating a supply as exempt where input tax had been blocked gave traders the same relief for the blocked input tax.

14. In the light of Commission v Italy, HMCE as they then were issued Business Brief 23/97. Amongst other supplies the Business Brief set out Customs & Excise's view as to the implications of the judgment for the sale of business cars. They considered that the judgment required the supply of a motor car where input tax had been blocked to be treated as an exempt supply, rather than a taxable supply where output tax would be accounted for only on the profit margin. Traders were given the option of continuing to use the margin scheme or to treat the supply as exempt whilst HMCE considered the full implications of the judgment.

15. The Business Brief stated that repayments would be made to traders who had accounted for output tax on the margin, but that claims should take into account the partial exemption implications of treating the sale of such cars as exempt.

16. In response to Commission v Italy the requirement for output tax to be accounted for by reference to the profit margin was removed by Article 6(c) of the Value Added Tax (Input Tax) (Amendment) Order 1999 SI 1999 No 2930. Further, by Article 6(b) the input tax block on motor cars forming "part of the stock in trade of a motor manufacturer or a motor dealer" was removed. For this purpose "stock in trade" was defined by reference to cars which were intended to be sold within 12 months of purchase. From 2000 onwards therefore, Demonstrators could be regarded as stock in trade of a motor dealer so that full input tax recovery was allowed and output tax was charged when a Demonstrator was sold.

17. During the Claim Period the Appellant accounted for output tax on supplies of Demonstrators in accordance with the domestic statutory provisions referred to above. However, on the basis of Commission v Italy it ought to have been treating the supply of Demonstrators as exempt. The House of Lords decision in Fleming opened up the opportunity to reclaim the output tax which it should not have paid.

18. The Claim was made pursuant to section 80(1) VATA 1994 which provides as follows:

> "*(1) Where a person –*
>
> *(a) has accounted to the Commissioners for VAT for a prescribed accounting period (whenever ended), and*
>
> *(b) in doing so has brought into account as output tax an amount that was not output tax due,*
>
> *the Commissioners shall be liable to credit the person with that amount.*"

19. In October 2011, having repaid the output tax, HMRC sought to effectively claw back part of the repayment. They made the assessment pursuant to section 80(4A) VATA 1994 which provides as follows:

"*(4A) Where –*

> *(a) An amount has been credited under subsection (1) or (1A) above to any person at any time on or after 26 May 2005, and*
>
> *(b) The amount so credited exceeded the amount which the Commissioners were liable at that time to credit to that person,,*

the Commissioners may, to the best of their judgement, assess the excess credited to that person and notify it to him."

20. HMRC stated in a letter dated 14 October 2011 notifying the Appellant of the assessment that when they paid the Claim they did so on the basis that there could be no input tax adjustment because Demonstrators were "capital goods". That conclusion was said to have been reached on the basis of a High Court decision in *Customs & Excise Commissioners v JDL Limited [2001] EWHC 2200*. Subsequently and in the light of a decision of the ECJ in *Nordania Finans A/S v Skatteministeriet [2008] STC 3314* HMRC had formed the view that JDL was wrongly decided.

21. We deal with the issues in JDL and Nordania in detail when we come to consider the authorities. Those issues concern the interpretation of Articles 17 and 19 of the Sixth Directive.

22. Article 17 defined the origin and scope of the right to deduct input tax. In particular Article 17(2) and (5) provide as follows:

"*2. In so far as the goods and services are used for the purposes of his taxable transactions, the taxable person shall be entitled to deduct from the tax which he is liable to pay:*

> *(a) the value added tax due or paid within the territory of the country in respect of goods or services supplied or to be supplied to him by another taxable person; ...*"

" *5. As regards goods and services to be used by a taxable person both for transactions covered by paragraphs 2 and 3, in respect of which value added tax is deductible, and for transactions in respect of which value added tax is not deductible, only such proportion of the value added tax shall be deductible as is attributable to the former transactions.*

This proportion shall be determined, in accordance with Article 19, for all the transactions carried out by the taxable person.

However, Member States may:

…

(c) authorise or compel the taxable person to make the deduction on the basis of the use of all or part of the goods and services;"

23. Article 17(5) deals with the right to deduct input tax where goods or services are used to make both taxable and exempt supplies, so called "mixed use" supplies and overheads. Article 19 sets out the deductible proportion as follows:

" *1. The proportion deductible under the first subparagraph of Article 17(5) shall be made up of a fraction having:*

- *as numerator, the total amount, exclusive of value added tax, of turnover per year attributable to transactions in respect of which value added tax is deductible under Article 17(2) and (3),*

- *as denominator, the total amount, exclusive of value added tax, of turnover per year attributable to transactions included in the numerator and to transactions in respect of which value added tax is not deductible. The Member States may also include in the denominator the amount of subsidies, other than those specified in Article 11A(1)(a).*

The proportion shall be determined on an annual basis, fixed as a percentage and rounded up to a figure not exceeding the next unit.

2. By way of derogation from the provisions of paragraph 1, ***there shall be excluded from the calculation of the deductible proportion amounts of turnover attributable to the supplies of capital goods used by the taxable person for the purposes of his business.*** *Amounts of turnover attributable to transactions specified in Article 13B(d), in so far as these are* ***incidental transactions****, and to* ***incidental real estate and financial transactions shall also be excluded****. Where Member States exercise the option provided under Article 20(5) not to require adjustment in respect of capital goods, they may include disposals of capital goods in the calculation of the deductible proportion.*"

(emphasis added)

24. Article 19(1) provides the basis for what is known as the "standard method" of apportioning input tax to taxable supplies based on turnover. Article 17(5)(c) provides the basis to use "special methods" based on other proxies for use. In the UK provision is made for special methods in regulation 102 VAT Regulations 1995 which also exclude capital goods from the calculations.

25. In so far as relevant for present purposes, the result of Articles 17 and 19 is that in identifying the deductible proportion of input tax relating to taxable and exempt transactions, the calculation excludes turnover attributable to capital goods used by the trader for the purposes of his business. It also excludes certain incidental transactions which is relevant only for consideration of some of the authorities below.

26. In JDL, Lawrence Collins J held that the VAT Tribunal in that case had been entitled to come to the conclusion that Demonstrators sold by the trader were capital goods for the purposes of Article 19(2). As such they were to be excluded from total turnover in the denominator of the partial exemption calculation.

27. In Nordania the ECJ was concerned with a trader supplying vehicles by way of hire purchase where the vehicle could be purchased at the end of the agreement by the customer making a final additional payment. The judgment gave guidance as to how Article 19(2) and the term "capital goods" was to be interpreted.

28. Both parties presented their arguments on this appeal principally by reference to Articles 17 and 19 rather than the UK domestic provisions and we shall take the same approach in this decision.

29. The issues which arise in relation to the first ground of the present appeal may be summarised as follows:

(1) Are the Demonstrators "capital goods" for the purposes of Article 19(2)? The assessment was made on the basis that the Demonstrators are not capital goods and so turnover attributable to exempt supplies of Demonstrators should be taken into account in a partial exemption calculation. The Appellant contends that the Demonstrators are capital goods and so turnover attributable to supplies of Demonstrators is to be left out of account.

(2) In answering that question, are we bound by the judgment in JDL? HMRC contend that the approach to identifying capital goods in JDL should no longer be regarded as good law in the light of the decision of the ECJ in Nordania. The Appellant contends that JDL remains good law.

(3) In any event, HMRC contend that the Demonstrators in the present case are materially different from those considered in JDL. The Appellant contends that the facts are indistinguishable.

30. It is common ground that even if there is to be an adjustment to the input tax recoverable during the Claim Period, that adjustment only applies to the period 1 April 1973 to 31 March 1987. For the period 1 April 1987 onwards there is no adjustment because de minimis limits provided for in the domestic legislation are engaged. Thus in practical terms the assessment covers the period 1 April 1973 to 31 March 1987.

Findings of Fact

31. The Appellant's evidence comprised a witness statement from Mr Richard Smith who is a director and Chief Executive Officer of the Appellant. He is a

chartered accountant who joined the Appellant as company secretary in January 1987, attaining his current position in July 1993. His witness statement was not challenged. It stood as his evidence in chief and we did not hear any oral evidence. On the basis of Mr Smith's evidence we make the following findings of fact. Save where expressly identified these findings relate to the whole of the Claim Period.

32. The Appellant is a retail motor trader selling new and used vehicles. It also has a servicing business and at one stage operated a small self drive hire business using Ford vehicles. The Appellant currently sells new vehicles under four franchises for Ford, Fiat, Jeep and Abarth. It has had a Ford franchise since 1973. Over the years the other franchises have changed and at various stages included Vauxhall and Rover.

33. Franchise agreements between motor traders and motor manufacturers generally include terms relating to the standards expected of traders in relation to premises, staff levels, tools and servicing facilities. Targets are set for the number of vehicles expected to be sold in any period. During the Claim Period strict terms and targets were also set for the number of Demonstrators and courtesy cars that a trader is expected to operate. Traders such as the Appellant were contractually required to purchase Demonstrators to be made available to give potential customers an opportunity to test drive particular models. The contractual obligations carried with them certain financial incentives in the form of bonus payments.

34. Different franchise agreements involved different terms. Generally the terms in relation to Demonstrators purchased by the Appellant in the Claim Period would involve:

(1) The number and model of Demonstrators to be purchased each year. Traders would be required to have at least one Demonstrator for each current model of each manufacturer.

(2) Maintaining Demonstrators in good condition.

(3) A minimum and maximum period or maximum mileage for which a Demonstrator could be used as such. Most manufacturers required Demonstrators to be retained for a minimum of three months and a maximum of six months. Less popular models might be retained for up to nine months. Within these periods traders could choose when to change Demonstrators.

(4) The level of bonus payments payable by a manufacturer in relation to each Demonstrator would depend on satisfying these terms.

35. Demonstrators of popular models may be test driven several times a day, with less popular models being test driven two or three times a week. Test drives would usually follow specific routes of up to 15 miles and the potential customer would be accompanied by a sales person.

36. Demonstrators were also available for the personal use of staff, but the Appellant would aim to keep the mileage as low as possible so as to maintain the value of the Demonstrator. During the Claim Period the Appellant aimed to keep the mileage of Demonstrators below 1,000 miles.

37. Vehicles purchased by the Appellant from manufacturers were acquired as "consignment stock". When the vehicles were received by the Appellant it would take a decision as to which vehicles it would select as Demonstrators and which would be for sale as new to customers. When a vehicle was selected as a Demonstrator the manufacturer would invoice the Appellant for the sale and the vehicle would be registered and licensed at DVLA in the name of the Appellant. Payment by the Appellant to the manufacturer for a Demonstrator would sometimes be deferred in whole or in part pursuant to the franchise agreement.

38. Demonstrators would not be held out for sale whilst they were being used as Demonstrators. If a Demonstrator was sold before the minimum period of use the Appellant would lose the associated demonstrator bonus. The Appellant would therefore only sell a Demonstrator after the minimum period of use and either at or before the end of the maximum period.

39. Customers know that Demonstrators are sold at the end of their use as such. They know that a Demonstrator will usually be in good condition with a very low mileage and will be available without the production time associated with a new vehicle. Customers therefore often approached the Appellant with a view to reserving a Demonstrator for purchase at the end of its period of use. Approximately 70% of Demonstrators are reserved by customers for purchase before the end of the required period of use. Approximately 30% require active marketing after the period of use as a Demonstrator.

40. Demonstrators are such a valuable marketing tool that the Appellant would operate them even if it wasn't required to do so under the terms of a franchise agreement. A significant proportion of prospective customers who take a test drive went on to purchase that make and model of vehicle. During the Claim Period customers were often loyal to particular brands and local dealers.

41. Mr Smith gave detailed evidence as to the way in which costs and overheads were consumed in the business during the Claim Period. That evidence is principally relevant to the second ground of appeal on quantum which we are not addressing in this decision. For present purposes the following findings of fact are relevant.

42. Input tax incurred by the Appellant on overheads falls into two broad categories. Property occupancy expenses and operational expenses.

43. There was relatively little cost associated with property occupancy prior to 1990 because light and heat were not subject to VAT at that time. The main items would be repairs to buildings and legal fees. Approximately 31% of floor space was devoted to new and used car sales and 69% to servicing, parts and repairs. Approximately 50% of outside space was devoted to used car sales. New cars would be kept inside the showroom. Demonstrators would be kept outside on the forecourt.

44. Operational overheads included telephone and stationery costs, IT and professional fees. Servicing, parts and repairs would account for some 96% of individual transactions compared to 4% for car sales.

45. Mr Smith's evidence was that if it was necessary to allocate overheads by reference to use by Demonstrators, then for most of the period for which Demonstrators were held they did not use overheads because they were themselves overheads. In any event 70% of Demonstrators were sold to pre-identified customers and therefore did not use overheads because they were not held in the business pending sale. Further, as high value items, the turnover from Demonstrators did not reflect the extent to which they used overheads.

46. Ms Brown submitted that Mr Smith's evidence established a complete disconnect between the turnover generated by the sale of Demonstrators and the input tax on mixed use goods consumed in generating that turnover. We deal with this submission and Mr Smith's evidence regarding use of overheads in our discussion below.

Discussion

47. We start our discussion by considering JDL. That was a case which also concerned vehicles purchased by a motor dealer from a manufacturer as consignment stock and then identified as Demonstrators and registered in the name of JDL. The principal facts found by the VAT Tribunal were recorded at [9] – [11] of the judgment of Lawrence Collins J. In particular:

> (1) The manufacturers required JDL to purchase Demonstrators and to use them as such. After a period of up to 6 or 12 months and sometimes well over 12 months the cars were no longer to be used as Demonstrators. On ceasing to be used as a Demonstrators JDL could use the vehicles as it wished, for example as courtesy cars or as company cars for directors and employees. When JDL had no further use for the cars they would be sold for whatever they could fetch either by JDL as a used car or at auction. A Demonstrator could remain with JDL for several years after it ceased to be used as a Demonstrator.
>
> (2) The sooner a Demonstrator was sold, the higher the price it was likely to fetch. On average JDL would break even on the sale of Demonstrators or show a slight loss.
>
> (3) Demonstrators and ex-Demonstrators were depreciated monthly in JDL's management accounts in contrast to new and used cars intended for resale which were treated as stock in trade and not depreciated.

48. The appeal in JDL concerned the VAT treatment of Demonstrators from November 1994 to October 1997. During that period the effect of the domestic legislation was that input tax was blocked unless the vehicle was supplied unused for the purpose of being sold. JDL had accounted for output tax on sales of Demonstrators on the profit margin. As in the present appeal, it was common ground that JDL was not entitled to input tax credit on purchase of the Demonstrators because they were not acquired for the purpose of being sold. It was also common ground that JDL was entitled to rely on Commission v Italy and that it had overpaid output tax.

49. The issue in JDL was identical to the issue in the present appeal. Namely, whether supplies of Demonstrators were supplies of "capital goods used by the

taxable person for the purposes of his business". Lawrence Collins J considered previous ECJ authorities, in particular *Verbond van Nederlandsee Onderneimingen v. Inspecteur der Invoerrechten en Accijnzen [1977] ECR 113* and *Régie Dauphinoise-Cabinet A Forest Sarl v. Ministre du Budget [1996] STC 1176.*

50. In Verbond the trader was a trade association which had incurred expenditure on a printer and certain office supplies. The issue was whether they were capital goods for the purposes of the Second Directive. The ECJ said at [12]:

"*12. The ordinary meaning of the expression and its function in the context of the provisions of the Second Directive indicate that it covers goods used for the purposes of some business activity and distinguishable by their durable nature and their value and such that the acquisition costs are not normally treated as current expenditure but written off over several years.*"

51. In Régie Dauphinoise the trader operated a property management business. In the course of that business it received advances from owners and lessees which it was entitled to invest and retain the interest. The tax authority regarded the interest as exempt income that should be included in the denominator for the partial exemption calculation. The trader maintained that the sums should be excluded under Article 19(2) as "incidental transactions".

52. The ECJ held that the interest was not an incidental transaction and therefore not to be excluded from the calculation of deductible input tax. At [21] and [22] it stated:

" *21. The purpose of excluding incidental financial transactions from the denominator of the fraction used to calculate the deductible proportion in accordance with Article 19 of the Sixth Directive is to comply with the objective of complete neutrality guaranteed by the common system of VAT. As the Advocate General has observed at point 39 of his Opinion, if all receipts from a taxable person' s financial transactions linked to a taxable activity were to be included in that denominator, even where the creation of such receipts did not entail the use of goods or services subject to VAT or, at least, entailed only their very limited use, calculation of the deduction would be distorted.*

22. However, placements by property management companies are the consequence of advances to them by co-owners and lessees for whom they manage their properties. With the consent of their clients, those companies are able to place these monies for their own account with financial institutions. That is why, as the Court has pointed out at paragraph 18 of this judgment, the receipt of interest from those placements constitutes the ***direct, permanent and necessary extension of the taxable activity*** *of property management companies. Such placements cannot therefore be characterized as incidental financial transactions within the meaning of Article 19(2) of the Sixth Directive. To take them into account in order to calculate the deductible proportion would not be such as to affect the neutrality of the system of value added tax.*"

(emphasis added)

53. HMCE submitted in JDL that capital goods could not include goods which were the same or similar to other goods supplied by a trader. That submission was rejected. A similar submission that capital goods must be distinguishable by their durable nature and value from the trader's trading stock was also rejected. Those submissions were plainly too wide and they are not repeated in those terms by Mr Puzey.

54. In the light of the authorities Lawrence Collins J held that Verbond was not to be treated as laying down an all-embracing test for the meaning of the term "capital goods". He concluded at [41]:

> " *41. Whether or not a particular item is a capital good for a trader is essentially a question for the Tribunal to decide on the facts of the particular case. The essential facts on which the Tribunal relied in coming to its conclusion that the ex-demonstrators were capital goods were these: the demonstrators were not acquired for the purpose of being sold, but for the purpose of being used by JDL for the purpose of carrying on its taxable activities and at the end of their life as demonstrators or courtesy cars were sold off; they were of substantial durability and value compared with other articles used in the management and day to day running of the business, and were depreciated in the management accounts. In my judgment the Tribunal asked itself the right questions and was entitled to come to its conclusion on the evidence before it.*"

55. We now turn to a number of decisions of the Court of Justice since JDL. *EDM v Fazenda Pública [2005] STC 66* concerned the exclusion of incidental financial transactions. EDM was a holding company and its main activity was the business of mineral prospecting and exploitation. It also carried out financial transactions involving loans to subsidiaries, indeed the income from those transactions was greater than that generated by the main activity. At [75] the Court recognised that the purpose of excluding such transactions from the calculation under Article 19 was "to avoid such transactions distorting that calculation and to thus meet the objective of neutrality guaranteed by the common system of VAT". At [76] and [80] it stated:

> " *76. As the Court held at paragraph 21 of the judgment in Régie Dauphinoise, if all receipts from a taxable person's financial transactions linked to a taxable activity were to be included in that denominator, even where the creation of such receipts did not entail the use of goods or services subject to VAT, or at least entailed only their very limited use, calculation of the deduction would be distorted.*
>
> …
>
> *80. … in calculating the deductible proportion referred to in Articles 17 and 19 of the Sixth Directive, those transactions are to be regarded as incidental transactions within the meaning of the second sentence of Article 19(2) thereof in so far as they involve only very limited use of assets or services subject to*

VAT; although the scale of the income generated by financial transactions within the scope of the Sixth Directive may be an indication that those transactions should not be regarded as incidental within the meaning of that provision, the fact that income greater than that produced by the activity stated by the undertaking concerned to be its main activity is generated by such transactions does not suffice to preclude their classification as 'incidental transactions'"

56. There are two decisions of the ECJ which Mr Puzey submits put the judgment in JDL in a new light. These are *Nordania Finans A/S v Skatteministeriet [2008] STC 3314* and *NCC Construction Danmark A/S v Skatteministeriet [2010] STC 532.*

57. Nordania operated a business involving sales of cars on hire purchase which were subject to VAT. It also had a business involving the provision of financial services which was exempt from VAT. When Nordania entered into a hire purchase agreement with a customer the agreements would typically be for 36 months. Monthly payments would be made, together with a final payment on sale of the vehicle at the end of the agreement. The sale value at the end of the agreement was taken into account when setting the monthly rental payments. In 1998 Nordania leased 4,500 vehicles and it seems that during the course of that year 600 vehicles reached the end of lease agreements and were sold, either to the lessee or to a third party.

58. For the purposes of its partial exemption calculation Nordania took into account turnover from the taxable sale of vehicles at the end of the hire agreements. The Danish tax authorities considered that the vehicles were capital goods for the purposes of Article 19(2) and should be excluded from the calculation.

59. The Court of Justice made reference to the Explanatory Memorandum to the Sixth Directive and to Régie Dauphinoise as follows:

" *22. The objective of Article 19(2) is apparent from the Explanatory Memorandum to the proposal for the Sixth Directive, which was submitted by the Commission of the European Communities to the Council of the European Communities on 29 June 1973 (see Bulletin of the European Communities, supplement 11/73, p. 19), according to which '[t]he factors mentioned in this paragraph must be excluded from the calculation of the proportion lest, being unrepresentative of the taxable person's business activity, they should deprive the amount of any real significance. Such is the case with sales of capital items and real estate and financial transactions which are only ancillary operations, that is to say are only of secondary importance in relation to the total turnover of the business. These factors are only excluded if they are not* ***part of the usual business activity of the taxable person****'.*

23. In that regard, the Court has already held that the purpose of excluding incidental financial transactions from the denominator of the fraction used to calculate the deductible proportion in accordance with Article 19 of the Sixth Directive is to comply with the objective of complete neutrality guaranteed by the common system of VAT. If all receipts from a taxable person's financial *transactions linked to a taxable activity were to be included in that denominator, even where the creation of such receipts did not entail the use of goods or services subject to VAT or, at least, entailed only their very limited use, calculation of the deduction would be distorted (Case C-306/94 Régie Dauphinoise [[1996] ECR I-3695](), paragraph 21).*

*24. By adopting the provisions of Article 19(2) of the Sixth Directive, the Community legislature thus intended to exclude from the calculation of the proportion the turnover attributable to a sale of goods **where that sale is of an unusual nature in relation to the normal activities of the taxable person concerned and does not therefore require the use of goods or services for mixed use in a way that is proportionate to the turnover which it generates**. As the Advocate General stated in point 68 of his Opinion, the inclusion of that turnover in the calculation of the deductible proportion would distort the resultant figure in the sense that it would no longer reflect the division of use of goods or services for mixed use as between taxable and exempt activities respectively.*"

(emphasis added)

60. Importantly, both the Advocate General and the Court referred to Verbond. Both found that the interpretation of the term capital goods in Verbond did not give an answer to the issue in Nordania.

61. At [61] and [62] the Advocate General stated:

" *61. …although under the criteria set out by the court in [Verbond], vehicles purchased by an undertaking in order to carry on its economic activities may be capital goods within the meaning of art 19 of the Sixth Directive, it cannot be inferred from those criteria that such vehicles are to be so categorised if the sale thereof at the end of the leasing contracts forms **an integral part of the taxable person's regular activity**.*

That is why I take the view that the interpretation of the concept of capital goods given by the court in the [Verbond] judgment does not enable an answer to be given to the question referred … "

62. The Court found that the interpretation of capital goods in Verbond was not relevant for the purpose of answering the question referred. At [29] it stated:

" *29. To exclude generally from the calculation of the deductible proportion goods which are used for the purposes of a business activity and are indeed distinguishable by their durable nature and their value, such that the acquisition costs are not normally treated as current expenditure but are written off over several years, without taking account of the fact that the sale of those goods, at the end of the leasing contracts, **is an integral part of the normal activity of the taxable person**, would run directly counter to the objective of neutrality of the common system of VAT.*

…

31. The interpretation given by the Court in [Verbond] is not therefore relevant for the purpose of answering the question referred for a preliminary ruling in the present case."

(emphasis added)

63. Mr Puzey also relied on the decision of the Court of Justice in NCC. The trader carried on a building and contracting business. Its principal business was construction projects on behalf of other parties but it also constructed some buildings on its own account which it would then sell. Sales on its own account were approximately 5% of total turnover. Under Danish law supplies as a contractor to third parties were taxable and supplies of real estate were exempt. A trader was also required to account for VAT on work done constructing buildings for sale on its own behalf as if it the work done was being undertaken for a third party (described as a "self supply").

64. The first and second questions for the ECJ were (1) whether for the purposes of Article 19(2) the sale of buildings constructed by NCC for sale on its own account were "incidental real estate transactions" and (2) whether it was appropriate to assess the extent to which that activity, viewed separately, entailed use of goods and services on which VAT was payable.

65. In answering the first question the Court again referred to the Explanatory Memorandum to the Sixth Directive and followed Régie Dauphinoise and EDM. At 31 it stated:

" *31. In that regard, as is apparent from the case-law of the Court in which it took that objective as its basis, an economic activity cannot be classified as 'incidental' for the purposes of Article 19(2) of the Sixth Directive if it constitutes the direct, permanent and necessary extension of the business (Case C-306/94 Régie Dauphinoise [1996] ECR I-3695, paragraph 22), or if it entails a significant use of goods and services subject to VAT (Case C-77/01 EDM [2004] ECR I-4295, paragraph 76).*"

66. The Advocate General had pointed out at [82] of his opinion that on the facts the exempt activity and the taxable activity derived from the same transaction and it would be artificial to exclude turnover from the exempt activity. At [35] the Court answered the first question as follows:

" *35. …the sale, in the case of a building business, of buildings constructed on its own account cannot be classified as an 'incidental real estate transaction' within the meaning of that provision, where that activity constitutes the direct, permanent and necessary extension of its business. In those circumstances, it is not necessary, in this case, to assess to what extent that sales activity, viewed separately, entails a use of goods and services on which VAT is payable.*"

67. The third question in NCC was whether it was consistent with the principle of fiscal neutrality for a building business, which is required to pay VAT on self supplies, not to be able to fully deduct the VAT relating to the general costs incurred thereby because the turnover from the sale of such buildings was exempt from VAT.

68. The Court held that the result was consistent with fiscal neutrality. At [44] it stated that the principle of fiscal neutrality required "*that different types of economic operators in comparable situations be treated in the same way in order to avoid any distortion of competition within the internal market…*". The Danish legislature wished to put building businesses like NCC on the same footing as building developers who could not deduct VAT on supplies from third party traders because the eventual supply of real estate was exempt.

69. Ms Brown submitted that the focus in cases such as Régie Dauphinoise and EDM in identifying income as "incidental" for these purposes was to look at the use they made of mixed use inputs. If that use was not commensurate with the income then the income should be excluded from the calculation because otherwise it would distort the calculation. She submitted that we must consider how Demonstrators were used in the business and sold and that we should recognise that they do not consume input tax in a way proportionate to the turnover generated. As such they should be treated as capital goods.

70. Nordania was directly concerned with the meaning of capital goods, and Ms Brown submitted that it too established that capital goods were excluded from the computation because they do not use input tax on mixed use goods in a way proportionate to turnover. The facts of Nordania are very different from JDL and the present appeal. However she submitted that the principles applied were the same as had been applied in cases prior to JDL. In Nordania there was a single transaction which was the disposal of a car and it would have been irrational to distinguish for the purposes of Article 19(2) between the monthly payments and the final payment. It was clear that Nordania was not using the cars in their business as such, they were selling them.

71. It is right that the facts of Nordania are very different to the present appeal, but we are concerned with the principles which emerge from the Court's judgment. It seems clear to us that Nordania, as a matter of principle, established that Verbond does not define capital goods for the purposes of Article 19(2). The test as to what are capital goods involves consideration of whether the turnover in question is an integral part of the normal activity of the taxable person and whether the turnover is of an unusual nature when compared to the normal activities of the taxable person. We accept that to some extent this will involve consideration of how the supply uses mixed use inputs and also the factors identified in Verbond.

72. In JDL Lawrence Collins J expressly acknowledged that Verbond did not lay down an all-embracing test as to the meaning of the term capital goods. However it is clear that the characteristics he considered to be relevant did not include whether the transactions were an integral part of the trader's normal activity. At [38] he stated:

“ *38. There is no general definition of "capital goods" for the purposes of the Sixth Directive or the United Kingdom VAT legislation. The Verbond ruling was not concerned with the meaning of capital goods in the present context, and the Tribunal, correctly, did not treat the Verbond ruling as laying down an all-embracing test for the meaning of the expression "capital goods" irrespective of the context in which the expression was used. I accept that the purpose of Art. 19(2) of the Sixth Directive, and of Reg. 101(3) of the 1995 Regulation, is to prevent distortion, but that does not mean that the expression "capital goods" is used in a special and unusual sense. In my judgment the Tribunal was right to derive from the Verbond ruling that relevant characteristics of capital goods were their value and purpose relative to other goods used in the management and day to day running of the business, and their accounting treatment.*”

73. We agree that there is no reason to consider that the expression “capital goods” is used in a special or unusual sense. It seems to us that it represents a broad approach to identifying supplies that should be excluded from the partial exemption calculation in Article 17(5). Having said that in our view the law has moved on, or at least been clarified by the ECJ, since JDL was decided. In particular in identifying capital goods it is important to consider the extent to which a transaction is an integral part of the normal activity of the trader and the extent to which the transaction is unusual in the sense that it does not use inputs in a way which is proportionate to the turnover generated.

74. On the facts of Nordania, the ECJ considered that the vehicles were not capital goods. The trader was selling cars, and that was all it was doing. Ms Brown acknowledges that the Court in Nordania had said that Verbond was not the relevant test. However she submitted that did not mean that the High Court in JDL had got it wrong. She submitted that even in the light of Nordania the result would have been the same in JDL. The focus had correctly been on whether there was a distortion between turnover on the sale of Demonstrators and use of mixed use inputs in achieving those sales.

75. We must deal with the facts of the present case. We are not concerned with what might have happened if HMRC’s appeal in JDL had been allowed on the basis that the VAT Tribunal had applied the wrong test. We must consider whether the Demonstrators are capital goods for the purposes of Article 19(2). The relevant test is not simply whether inclusion of the turnover would give rise to distortion because sales of Demonstrators do not use inputs in the same way as taxable sales. It remains necessary for us to take some meaning from the term “capital goods” just as the ECJ did in Nordania. Our focus must be on what is meant by capital goods in the context of Article 19(2) and in that regard we must follow the judgments of the ECJ.

76. Ms Brown relied upon the principle of fiscal neutrality, indeed it lay at the heart of her submissions. She submitted that fiscal neutrality has two aspects:

(1) Ensuring that the deduction mechanism operates to relieve a trader entirely of the burden of VAT paid in the course of his economic activities making taxable supplies, and

(2) Ensuring that supplies of goods or services which are similar and therefore in competition with each other are not treated differently for VAT purposes.

77. It is clear and we accept that fiscal neutrality operates in these two distinct senses – See NCC at [27] and [39] to [44] and also for example *Finanzamt Steglitz v Ines Zimmermann C-147/11* at [46] to [49].

78. The deduction system is the means by which a trader is relieved of the burden of VAT in relation to his taxable transactions. We accept that fiscal neutrality requires a fair and reasonable apportionment of inputs to taxable outputs. Article 19(2) and the standard method during the relevant part of the Claim Period adopt turnover as a proxy for use.

79. Ms Brown submitted that the effect of the input tax block was to put businesses which were subject to the input tax block into the position of a final consumer. Sales of Demonstrators were treated as exempt from VAT so as to avoid a double charge to tax. That was the reasoning in Commission v Italy. We would add that the reasoning in Commission v Italy also involved treating the supplies as exempt rather than outside the scope of VAT so as to engage the restrictions on input tax credit in Articles 17 and 19.

80. In written submissions following the hearing Ms Brown summarised the issue before us in the following terms: "… the starting point for determining the question of whether demonstrator cars are capital goods is to identify whether they are goods the use and sale of which consumes input tax in the same way as the Appellant's stock of new and used cars. At the heart of this question will be to determine whether for the whole of the period of ownership the demonstrator cars were to be resold (that being the nature of the normal activities of the Appellant's business) or whether they were for use within the business and by the business by way of its own consumption (even when after use as a demonstrator they are then sold)".

81. For the reasons given above we do not consider that the issue is simply whether or not the asset in question uses inputs in a way not proportionate to its eventual sales value. That is not the starting point. It seems to us that the starting point is identifying whether the Demonstrators are capital goods having regard to the meaning given to that term in the authorities in the context in which it is used, namely Article 19(2).

82. Ms Brown submitted that the Sixth Directive provided two mechanisms to ensure the neutrality of the deduction system where turnover does not represent an appropriate proxy for the use of mixed use inputs. Firstly Article 19(2) expressly removes from the calculation two types of turnover where the assumed proxy does not hold true in the form of capital goods and certain incidental transactions. Secondly where a turnover calculation does not result in an appropriate proxy for use, Member States can adopt an alternative solution based on use. In our view those methods are only alternatives in the sense that in the end only one method will be used. More broadly, they are both part of the same mechanism which is designed to fairly apportion mixed use input tax between taxable supplies and exempt supplies.

83. We accept Mr Puzey's submission that the starting point is that a turnover based calculation will be employed and turnover in relation to capital goods will be excluded. At that stage consideration must be given to whether the Demonstrators are capital goods. If they are not, but the turnover based calculation does not produce a fair and reasonable apportionment then a special method may be employed. Detailed comparative analysis of use is reserved to the next stage which in this appeal is the issue of quantum.

84. The UK domestic legislation in what is now regulation 102 makes provision for special methods of input tax apportionment to be used. Regulation 102 excludes from any special method "the value of a supply" of capital goods. It is easy to see that including capital goods in a turnover based calculation would tend to distort input tax recovery and therefore fiscal neutrality. It is less easy to see why capital goods should not be included in a use based special method where they do use mixed use inputs. It is notable that regulation 102 refers to excluding the "value" attributable to capital goods from the calculation. Whether anything turns on that was not the subject of submissions. In any event the point remains that if the Demonstrators do not use inputs in the same way as new cars purchased for sale then if they are not capital goods a special method can be used to apportion input tax to them. The appropriate proxy for use of inputs by the Demonstrators if they are not capital goods would be a matter to be considered in determining quantum pursuant to the second ground of appeal.

85. We turn now to consider whether the Demonstrators were capital goods for the purposes of Article 19(2) on the facts as found.

86. The Demonstrators were purchased for use in the business with a view to selling them as used cars. The point was not specifically covered in Mr Smith's evidence but we infer that the reasons for seeking to keep the mileage of Demonstrators as low as possible include ensuring that the Demonstrator has the appearance and feel of a new vehicle as well as maximising the value of the vehicle on resale. The Demonstrators were actually used for relatively short periods of time prior to sale.

87. The Appellant was in business selling both new and used vehicles. As such, the Demonstrators were goods of the same type and value as those sold in the ordinary course of the Appellant's trading activities.

88. There is no evidence as to how the Demonstrators were treated for accounting purposes, in particular whether they were treated as fixed assets and depreciated in the management accounts. We accept that the economic circumstances in the period 1973 to 1987 involved periods of generally high inflation and the need to depreciate in the management accounts may not have existed. We therefore attach no significance to the absence of such evidence.

89. We do not accept on the facts that there is a complete disconnect between use of mixed use overheads and turnover from the sale of Demonstrators. The Demonstrators occupied space on the premises and sales transactions would require processing in

exactly the same way as a new or used car being sold by the Appellant. We are not satisfied that mixed use inputs are not used at all in making sales of Demonstrators. .

90. The fact that 70% of Demonstrators were sold without marketing would reduce the extent to which sales of Demonstrators used inputs. However in our view that is not a very significant factor in determining whether they are capital goods.

91. The regularity with which Demonstrators were bought and sold at two to six month intervals is an indicator that such sales are part of the Appellant's normal trading activity.

92. Ms Brown submitted that the very reason input tax had been blocked on the purchase of Demonstrators was because they were not purchased for the purpose of being sold. As such Demonstrators clearly had a different character to cars purchased for resale as new. The cost of running the Demonstrators was a cost component of the taxable supplies made by the Appellant.

93. We accept that Demonstrators were different in character to new car purchased for sale, but only to the extent that they were used in the business for a short period of time prior to sale. We do not consider that the existence of the input tax block means that the Demonstrators were sold otherwise than as an integral part of the Appellant's normal activities or that the transactions are otherwise unusual.

94. In the light of all the evidence we are satisfied that the purchase and sale of a Demonstrator is just as much a part of the trading activity of the Appellant as the purchase and sale of new and used cars. Sales of Demonstrators are integral to that activity. It would be distortive to exclude such turnover from the partial exemption calculation, although we accept that a special method might be required to properly reflect the use those sales make of inputs. In our view fiscal neutrality is maintained because it will still be necessary to identify the extent to which sales of the Demonstrators use the mixed use inputs.

95. Mr Puzey invited us to find that the sale of Demonstrators was a direct, permanent and necessary extension of the taxable activity of selling new cars. We do so, but recognising that this formulation is relevant in the context of incidental transactions and it does not appear to be relevant in the context of capital goods.

96. In relation to the second aspect of fiscal neutrality, Ms Brown submitted that all taxpayers subject to the input tax block should be treated equally. HMRC's assessment in the present case had the effect that motor traders were treated differently to other businesses subject to the input tax block. In her words they were subject to "an additional restriction on their recovery of input tax over and above non motor traders purely because of the nature of their business". It was submitted that this difference in treatment was not justified.

97. Ms Brown used as a comparator the findings of the F-tT in *General Motors UK Limited v Commissioners for Revenue & Customs [2013] UKFTT 443 (TC)*. That case concerned the treatment of self supplies by a car manufacturer. The principles involved are not relevant for present purposes. However Ms Brown relied on evidence

accepted by the F-tT which described fleet purchasers purchasing in excess of 5,000 cars for use in their businesses. She submitted that an eventual sale by such fleet purchasers would be exempt because input tax would have been blocked on the purchase but there would be no doubt that the cars were capital goods and therefore excluded from the partial exemption calculation. In those circumstances Ms Brown submitted that the Appellant was suffering unequal treatment if Demonstrators were not also treated as capital goods.

98. We have no evidence as to the use of fleet cars by businesses but we take notice of the fact that large businesses do operate fleets of vehicles where cars are necessary for employees in the performance of their duties and also as “perk” cars. We do not accept Ms Brown’s submission that the different treatment for partial exemption purposes amounts to unequal treatment and a breach of fiscal neutrality. The Appellant and motor traders generally make use of Demonstrators in their businesses for short periods of time. The Demonstrators will be sold when they are no longer required for that use. Those sales simply form part of the normal trading activity of a motor dealer which buys and sells new and used cars. Fleet purchasers in our view are not comparable to motor traders in this regard. There is no evidence as to how long fleet purchasers might use vehicles, but in any event they are not in the business of selling cars. In the circumstances we are not satisfied that there is any breach of the principle of fiscal neutrality.

99. We have concluded above that JDL must now be considered in the light of subsequent decisions of the Court of Justice. Even if we are wrong and JDL is binding upon us we would find that the facts of the present appeal are materially different to those in JDL. In JDL it was significant that the Demonstrators were depreciated in the accounts. In the present case for the reasons we have given the accounting treatment is neutral.

100. Further, in JDL some Demonstrators could be held for more than a year whereas in the present appeal they are held for between 2 and 6 months. Ms Brown submitted that those vehicles in JDL would not have been the subject of the output tax repayment claim because there would have been no profit margin on such sales. We do not consider that fact was irrelevant in JDL. The output tax reclaim in JDL would have related to cars on which there was a profit margin, but the input tax restriction would presumably have been calculated by reference to turnover on the sale of all Demonstrators. There is no suggestion that the court or the VAT Tribunal in JDL was only considering the capital goods argument by reference to those vehicles on which a profit was made.

101. In our view therefore JDL can be distinguished on its facts and for the reasons given above we are entitled to find that the Demonstrators were not capital goods.

Conclusion

102. In all the circumstances we find that the Demonstrators were not capital goods for the purposes of Article 19(2). The preliminary issue is therefore answered in favour of the Respondents. The result is that we must dismiss the first ground of

appeal. The parties should now seek to agree directions for the future conduct of the appeal and inform the Tribunal of the position within 60 days from the date of this decision.

104. This document contains full findings of fact and reasons for the preliminary decision. Any party dissatisfied with this preliminary decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to “Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)” which accompanies and forms part of this decision notice.

JONATHAN CANNAN

TRIBUNAL JUDGE

RELEASE DATE: 22 DECEMBER 2015