[2016] UKFTT 158 (TC)

TC04944

Appeal number: TC/2013/06458

VAT – whether supplies of Nesquik fruit powders are zero-rated as food of a kind used for human consumption within Group 1 of schedule 8 VATA - scope of exception from zero-rating for powders for the preparation of beverages – consideration of the application of social policy and fiscal neutrality principles - appeal dismissed

FIRST-TIER TRIBUNAL
TAX CHAMBER

NESTLE UK LIMITED **Appellant**

- and -

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

TRIBUNAL: JUDGE HARRIET MORGAN
MEMBER GILL HUNTER

Sitting in public at the Royal Courts of Justice, Strand, London on 30 June to 2 July 2015

Mr Roderick Cordara QC, instructed by PricewaterhouseCoopers, as Counsel for the Appellant

Ms Eleni Metrophanous, instructed by the General Counsel and Solicitor to HM Revenue and Customs, as Counsel for the Respondents ("HMRC")

DECISION

1. The appellant appealed against HMRC's decision to refuse a claim for the repayment of £4,004,000 of output tax the appellant considered it had over declared on sales of Nesquik strawberry and banana flavoured powders ("**Strawberry Nesquik**" and "**Banana Nesquik**" and together the "**Product**") in the periods 09/08 to 06/12. HMRC made their decision on 15 October 2012 and upheld it on review on 10 July 2013.

2. The appellant made the repayment claim on the basis that supplies of the Product are zero-rated under sub-s 30(2) of the Value Added Tax Act ("**VATA**") as supplies of "food of a kind used for human consumption" within Group 1 of Part II of Schedule 8 VATA ("**Group 1**"). Group 1 provides that:

> (1) zero-rating applies to a supply of anything comprised in the general items set out in Group 1, one of which is "food of a kind used for human consumption",
>
> (2) except a supply of anything comprised in any of the excepted items listed in Group 1,
>
> (3) unless it is also comprised in any of the items overriding the exceptions listed in Group 1 which relates to that excepted item.

3. The Product is a flavoured powder with added nutrients for adding to milk. There was no dispute that it is "food of a kind used for human consumption". The issue was whether or not the Product falls within the excepted items in Group 1 as a "powder for the preparation of beverages" ("**excepted item 4**").

4. The appellant argued that supplies of the Product are zero-rated as the Product is not within excepted item 4, in outline, on two bases:

> (1) "Beverages" is to be construed as excluding "milk and preparations and extracts thereof" being an overriding item which relates to excepted item 4 ("**overriding item 6**"). The Product is for adding to milk to be consumed as a milk drink which is excluded from being such a "beverage".
>
> (2) The Product is not in any event "*for the preparation of* beverages" as adding the Product to milk does not create a "beverage" but merely flavours the milk.

5. In summary HMRC's view was that, on the plain meaning of the provisions, the Product falls within excepted item 4:

> (1) The term "beverages" is not to be read as subject to overriding item 6. The overriding items do not operate as interpretative provisions in that way. Rather, if the Product falls within excepted item 4, as HMRC consider it does, supplies of the Product would be excluded from excepted item 4 only if the Product itself falls within overriding item 6. The Product is not within overriding item 6 as it is does not contain any milk.

(2) The addition of the Product to milk creates a distinct beverage which suffices for it to be regarded as "*for the preparation of* beverages".

Facts

6. The appellant is a UK subsidiary of Nestlé SA ("**Nestlé**"), a Swiss multinational consumer goods company. Nestlé is engaged in the manufacture and sale of food and drink products including the Product.

7. Historically, the Product has been treated as standard-rated for VAT purposes. The appellant also makes supplies of a chocolate flavoured Nesquik powder ("**Chocolate Nesquik**") which are treated as zero-rated. The Product and Chocolate Nesquik are collectively referred to as ("**Nesquik**").

8. We heard evidence from Ms Elizabeth Read and Ms Egle Augustinaviciute. Ms Read has been employed by the appellant as a corporate nutritionist since September 2008. Ms Augustinaviciute has been employed by the appellant for 12 years. For the last 7 years (until recently) she was the senior brand manager for "coffee mixes and other beverages", which includes Nesquik. Both witnesses were very knowledgeable regarding the Nesquik product and the facts set out below are taken from their evidence.

History of the Nesquik product

9. A Nesquik product was first developed in 1948 in the US as a chocolate powdered flavouring for milk. Chocolate Nesquik was launched across Europe including the UK in the late 1950s and shortly after the fruit flavoured powders were introduced. At that time Nesquik was marketed as a product to make milk more delicious and the focus was on the flavour.

10. Over the years the key focus in the product development and marketing became the nutritional aspects of Nesquik with the aim of complementing the existing nutrients in milk, in particular, to help growth and development in children and adolescents. The benefits of Nesquik, including the vitamins and the minerals it contains, were more widely communicated in promotional materials used by the appellant in packaging, in-store communications and television advertisements. In accordance with this focus, in 2010 Nestlé removed all artificial flavours from Nesquik and new packaging and labels were introduced to highlight this. In 2013 the products were reformulated by improving further the vitamin and mineral contents with the aim of better complementing milk and helping children's development.

11. Nestlé continues to reformulate vitamins and minerals within the Nesquik range. Changes are implemented across all three flavours with the aim of ensuring that a typical serving broadly has the same levels of nutrition whichever product is used.

Nutritional focus and content

12. Ms Read explained in her witness statement that the nutritional focus of Nesquik accords with Nestlé's wider global commitment to lead the industry in

nutrition and health research through internal programmes and external collaboration with top institutions, to provide nutritionally sound products designed for children, to help reduce the risk of under-nutrition through micro-nutrient fortification, to reduce sugars in its products and to deliver nutritional information and advice in its labels and provide portion guidance. Ms Read liaises with relevant individuals at the Nestlé Research Centre, which is the biggest in the world for these areas, to apply the relevant information to Nesquik products and communications in the UK.

13. In line with this, at the relevant time (and currently) Nestlé produces Nesquik as an intended complement to milk. The intention is for the Product to be used by consumers to flavour milk with a view to encouraging children to consume milk, in particular, where they might otherwise not do so. Nestlé is of the view, based on its own research and that of independent health associations and bodies (see below), that milk consumption brings nutritional benefits due to the nutrients in the milk itself. These benefits are potentially enhanced or complemented by the addition of the Product as it contains nutrients of the same type as those in milk as well as nutrients which are not in milk (or in milk in small amounts) such as Vitamin D. Nesquik could be used with water but it is intended for and is marketed for use with milk. Ms Read believes it to be most commonly used with milk.

14. In using Nesquik, Nestlé recommend (as stated on the packaging) that, for each serving, around 15 grammes of Nesquik powder (being 3 to 4 teaspoons) is mixed with 200 mls of semi-skimmed milk. Nestlé recommends that the powders are consumed with semi-skimmed milk on the basis of nutritional and government guidelines and studies showing that 65% of the milk purchased in the UK is semi-skimmed milk.

15. A typical serving of a Nesquik drink made with Strawberry or Banana Nesquik contains 7 grammes of protein, which represents 29% of the guideline daily amount for children aged 5 to 10 ("**GDA**"), and 247 milligrammes of calcium, which represents 31% of the recommended daily allowance for children ("**RDA**") (in each case as those guidelines applied at the time). The protein and calcium derives entirely from the milk in the typical serving.

16. As regards a typical serving of a Chocolate Nesquik drink, there is a slightly higher protein and calcium content as the cocoa in this powder contains these nutrients. A typical serving contains 7.7 grammes of protein, which represents 32% of the GDA for children and 252 milligrammes of calcium, which represents 31% of the RDA (in each case as those guidelines applied at the time).

17. In the relevant period Strawberry and Banana Nesquik had the same nutritional content when looking at the nutritional value of the powder alone. The content of a typical serving of the powder alone is (in grammes and where indicated milligrams): carbohydrate, 14.6g (of which sugars comprise 12.3g); vitamin D, 1.1g; vitamin C, 10.1g; thiamine, 0.2g; niacin, 3.8g; vitamin B6, 0.3g; folic acid, 30mg; pantothetic acid, 0.3g; magnesium, 34.5mg; phosphorous, 2g; iron, 2.2g. The Product does not contain protein fat, fibre, sodium, salt equivalent or calcium.

18. The composition of Chocolate Nesquik was at the relevant time similar but not the same as that of the Product with the following differences as regards a typical serving of the powder alone: protein, 0.7g; carbohydrate, 11.9g (of which sugars, 11.5g); fat, 0.5g (of which saturates, 0.2g); fibre, 0.9g; sodium, 0.02g; salt equivalent, 0.05g; calcium, 4.1g; phosphorous, 21.3mg.

19. The differences in Chocolate Nesquik and the Product are largely due to the natural composition and nutritional content of cocoa which comprised around 19 to 21% of Chocolate Nesquik at the time. Less sugar is added to Chocolate Nesquik than to the Product. The cocoa gives it a stronger flavour compared with the natural flavours in the Product which requires more sugar to enhance the flavour. No precise figure was put on the difference but Ms Read thought it would be small.

20. In the relevant period Chocolate Nesquik was identical in composition to the hot chocolate powder produced by Nestlé.

21. A large part of Ms Read's evidence related to the nutritional benefits of drinking milk and of drinking milk with Nesquik added.

Nutritional benefits of milk

22. As noted above, milk contains protein and calcium as well as water (which is needed for hydration). Evidence was produced that the nutritional qualities found in milk are accepted by some recognised health and medical bodies, such as the UK Department of Health and NHS Choices, as being important in the development and maintenance of children's health, in particular, in terms of bone growth and development. For example, the NHS acknowledges on its website that "because they're good sources of protein and calcium, milk and dairy products form part of a healthy diet. Our bodies need protein to work properly and to grow or repair themselves. Calcium helps to keep our bones strong. The calcium in dairy foods is particularly good for us because our bodies absorb it easily."

23. We were also referred to the National Diet and Nutrition Survey for 4 to 18 year-old children in the UK, which showed that, where there was evidence of a low intake of micro-nutrients in children, milk and milk products provided contributions to the overall diet.

Benefits of flavoured milks

24. Nesquik contains some of the same micro-nutrients as milk, including potassium and magnesium. By adding Nesquik to milk, the potential benefits of these micro-nutrients in the milk are increased so improving the RDA percentage of each micro-nutrient in a typical serving (compared with plain milk).

25. Adding the Product to milk also provides micro-nutrients that are not present or present in trace amounts in milk in the UK, such as vitamin D, iron and vitamin C, which are also thought to be necessary for growth and development. A typical serving of a Nesquik drink has 22%, 16% and 12% of the RDA for vitamin D, iron

and vitamin C respectively. Vitamin D assists the absorption of calcium which is present in the milk.

26. There are reports from reputable bodies that many people living in the UK, including children, are deficient in vitamin D. The reports produced to substantiate this include statements from the NHS Choices website, a report from the Royal College of Paediatrics and Child Health from December 2012 and the National Diet and Nutrition Survey results for the years 2008-2009 to 2011-2012. The deficiency is thought to be as a result of a lack of exposure to sunshine and low dietary vitamin D levels as less than 10% of intake comes from natural vitamin D in the diet. There is very little vitamin D in milk (only trace amounts). Consumption of a Nesquik beverage can assist in meeting the need for adequate vitamin D intake.

Role of flavoured milk as an alternative to milk

27. Some studies and reports produced by health associations and similar bodies recognise the consumption of nutritious beverages, including flavoured milk, as an alternative to milk on the basis that they help contribute to the daily nutrient needs of children. Studies referred to and produced included leaflets produced by the British Dietetics Association, research in the US (based on clinical evidence and trials) as reported by the American Academy of Paediatrics and research of the US Dairy Council. The report from the American Academy of Paediatrics contained evidence that children who consumed flavoured milks in the study had a higher intake of milk overall compared to people who drink plain milk (and obviously those who do not drink milk at all).

28. Ms Read was questioned on whether the relatively high sugar content of Nesquik may have a negative impact on children's health. Ms Read produced studies which show that there is no adverse nutritional effect on children who consume flavoured milk compared with those who do not. The report by the American Academy of Paediatrics shows that the children studied, who consumed flavoured milk, had higher calcium intakes but a similar percentage of energy from total fat and added sugars, compared with children who are non-consumers of flavoured milk. It was concluded that this was because those children are likely to drink less beverages containing sugar such as soft drinks. This accords with work that Nestlé have done in Australia, looking at Milo, which is a chocolate-flavoured powder for adding to milk. This study concluded that there was no nutritional difference for children who consumed just milk on its own compared with children who consumed milk with Milo added.

29. Ms Read noted that in a typical serving of a Nesquik drink around half of the sugar is naturally occurring in the milk. The amount of sugar in a serving is comparable to the amount in that amount of milk with a banana added. Sugar is metabolised in the same way whether it comes from a banana or whether it comes from confectionery or from Nesquik. The difference is that in the banana you would get the addition of other micro-nutrients.

30. Ms Read asserted that "Nesquik powder adds a unique and great-tasting flavour to milk which children enjoy. It therefore plays a valuable role in encouraging children to drink milk and get the important nutrients they need. The intended benefit of a typical serving of Nesquik, which is itself designed to complement milk, contributes towards a child's daily intake of protein, calcium and other essential micro-nutrients necessary for growth and development."

Sales and marketing

31. In the period 2010 to 2013, in the UK market, sales of the Product and Chocolate Nesquik respectively accounted for around 64% and 36% of total Nesquik sales. Looking at each powder individually, Strawberry, Chocolate and Banana Nesquik accounted for around 47.4%, 36.2% and 16.5% of total sales respectively.

32. Nesquik is packaged in single yellow mould plastic boxes/tubs in three sizes: 300g, 500g and 1kg. For the last five years Nesquik has been mostly available in 300g and 500g sizes. All three flavours are sold in 300g size and sales of this size represent 69% of total sales. Only Strawberry and Chocolate Nesquik are sold in the 500g size and this size is only available in larger stores. The 1kg size was launched in 2013 for Chocolate Nesquik and is exclusive to one particular supermarket.

33. In 2010-2013 sales of the 300g size represented approximately 70-75% of all sales of Nesquik, sales of the 500g size represented around 25-30% of all sales with sales of the 1kg size representing around 1% of all sales.

34. Nesquik is predominantly sold in supermarkets but also in wholesale, convenience and discount stores. Whilst all three flavours are sold through the same channels, the slower selling flavour, Banana Nesquik, is not as widely available in discount stores as these generally only list "best sellers".

35. Nestlé recommends to retailers that Nesquik is positioned in stores with fresh milk, as it is intended to be consumed with fresh milk. However, Nestlé recognises that retailers are in fact unlikely to place the Product with fresh milk due to the expense of storage in the fridge section (given the product does not need to be refrigerated). Therefore, the secondary recommendation is for Nesquik to be positioned with long life or UHT milk. In the period in question retailers were most likely to position the product with UHT milk and similar products but over time this has changed as retailers have reviewed their shelf space and locations. Many supermarkets now locate Nesquik with hot chocolate powders and similar products. Nestlé make the recommendation but it is the retailers choice where to locate the product. In some supermarkets Nesquik appears in the same section as some ready-made milk drinks.

36. Nesquik has been advertised through a variety of media throughout its history, including posters and newspaper and television adverts. In the last few years the majority of consumer communications have been done through TV advertisements as Nestlé has found TV provides the best medium to achieve maximum reach in terms of

new and existing customers. In addition, TV advertising has consistently performed well and has been well received.

37. Nesquik communications are entirely focused on busy working mothers who are looking to strike a balance between health and happiness for their children as Nesquik offers them a solution as to how to get their children to drink more milk. Nestlé advertises Nesquik without specifically distinguishing between the different flavours in terms of the advertising message. It is clear to the consumer which flavour of Nesquik forms part of the advert due to the different colour of the product on the box label. For example, Strawberry Nesquik is represented by a picture of pink milk. Strawberry and Chocolate flavours are used in those adverts as the bestsellers.

Use and preparation

38. Nesquik is a powder designed to be stirred into milk to provide flavour and additional interest to drinking milk. Once Nesquik powder is added to milk, no additional ingredients are intended to be added. Ms Augustinaviciute asserted that the viscosity of the milk is not affected. The powder only changes the milk so as to alter its flavour and colour, mimicking that of the powder concerned. She confirmed that she was not using the term "viscosity" in any scientific sense but was forming this view as regards perception and "mouth feel".

39. We were invited to taste samples of a Nesquik drink compared with plain milk, Yazoo strawberry flavour milk, Sainsbury's banana flavoured milk, Frijj strawberry milkshake and a McDonald's milkshake. We agreed that there is no discernible change in the viscosity of the milk with Nesquik powder added.

40. The recommended way of preparing a Nesquik drink, as stated in the instructions provided with the product, is to mix the recommended amount of powder (3 to 4 teaspoons) with a small amount of milk to make a paste and then to add the rest of the milk. This is to avoid any lumps. Ms Augustinaviciute noted that avoiding lumps was potentially more of a problem with Chocolate Nesquik but that all three Nesquik products have the same preparation instructions.

41. The UK website for Nestlé had referred in 2012 to the term "milkshakes" and stated: "Enjoy a glass of tasty goodness. Nesquik turns milk into an incredibly delicious drink." Some other supermarket websites at that time and currently use similar wording. Ms Augustinaviciute explained that Nestlé's preferred wording is to to refer to "flavoured milk" or "milk with Nesquik added". It was a constant struggle to get retailers to use the recommended wording. She noted that in any event in advertising the aim was always to strike a balance between making the product attractive to children whilst appealing to mothers on the basis that their children would be consuming a healthy drink. She doubted that it would make much difference to consumers whether the drink was referred to as a milkshake, flavoured milk or milk with Nesquik added.

42. Ms Augustinaviciute's experience is that some consumers buy multiple flavours as on some days children may want one flavour and on another day they may want a

different one. However, there are a lot of customers who are loyal to a particular flavour as in the case of Banana Nesquik. She agreed that it can be said that some consumers choose the particular product on the basis of flavour.

43. Taking VAT into account, each Nesquik powder is priced the same when sold by the appellant and the recommended resale price for retailers is also the same. The in-store promotional activities are the same for all three Nesquik powders.

44. Nesquik has a 12 month shelf life (whether the pack is open or not). It is usually consumed at breakfast or during the day. In terms of a comparison with ready-made drinks, Ms Augustinaviciute thought they would generally have a shorter life requiring consumption within a few days only.

45. As regards the products produced to the tribunal for comparison with the Product, Ms Augustinaviciute confirmed that the retail price of the Frijj drink is around £1.50 and she estimated it contained only one serving and that it was designed to be drunk "on the go". Nesquik costs £2.19 for 300 grammes and provides around 20 servings. She thought that as a Frijj drink is likely to be consumed "on the go" it would be hard to see it as interchangeable with the Product.

46. However, the Yazoo and Sainsbury's flavoured milk drinks produced were the family-size product which Ms Augustinaviciute would expect to be consumed as a breakfast family drink or at other times at home during the day in the same way as a Nesquik drink. These sorts of products are, in her view, interchangeable. At breakfast time you would pour a pre-prepared milk drink or you would make it yourself.

47. Ms Augustinaviciute said that she thought the most natural way of referring to a Nesquik drink would be as "a glass of milk with Nesquik" or "Nesquik with a glass of milk" or "flavoured milk". She would not think it appropriate to describe it as "a glass of Nesquik".

Legislation

48. Article 110 of Council Directive 2006/112/EC ("**Article 110**") permits member states that, at 1 January 1991, were "granting exemptions with deductibility of the VAT paid at the preceding stage [providing for zero-rating]" to continue to do so. Such exemptions must be "in accordance with Community law and must have been adopted for clearly defined social reasons and for the benefit of the final consumer".

49. Pursuant to sub-s 30(2) VATA:

> "a supply of goods or services is zero-rated by virtue of this subsection if the goods or services are of a description for the time being specified in Schedule 8 or the supply is of a description for the time being so specified."

50. The relevant parts of Group 1 in schedule 8 VATA provide as follows (and the full text of Group 1 is set out in the Annex):

"GROUP 1 - FOOD

The supply of anything comprised in the general items set out below, except –

(a) a supply in the course of catering; and

(b) a supply of anything comprised in any of the excepted items set out below, unless it is also comprised in any of the items overriding the exceptions set out below which relates to that excepted item.

General items

Item No

1 Food of a kind used for human consumption.

Excepted items

Item No

4 Other beverages (including fruit juices and bottled waters) and syrups, concentrates, essences, powders, crystals or other products for the preparation of beverages.

Items overriding the exceptions

Item No

6 Milk and preparations and extracts thereof.

NOTES:

(1) "Food" includes drink.

(6) Items 4 to 6 of the items overriding the exceptions relate to item 4 of the excepted items."

Submissions for the appellant

Meaning of "beverages" in excepted item 4

51. On a purposive construction of the legislation, the term "beverages" in excepted item 4 is to be read subject to overriding item 6 as not including "milk and preparations and extracts thereof". On the assumption that milk is a zero-rated

beverage, the Product is for the preparation of an item which falls outside excepted item 4.

52. On a purposive construction it is necessary to consider the Product in its full factual and legal context. The factual context is that the Product is a form of nutritionally enhanced powder which is intended for use and marketed for use only with milk with the intention of encouraging children to drink milk. Its only function is as an ingredient in a milk drink. No further ingredients are intended to be added to the milk once flavoured by the Product and it is not designed to be used to flavour any other beverage. Once added, the Product does not alter the consistency of milk and, aside from a slight change in colour to mimic the flavour, does not alter the appearance of milk. As set out in the witness evidence, many leading health organisations recognise the valuable role that milk, including flavoured milk, plays in meeting children's daily nutrient needs. The Product has been designed to encourage children to drink and enjoy milk in the form of flavoured milk and research performed by Nestlé confirms this objective is being met.

53. From a legal perspective, although the legislation is couched in a number of steps, it is necessary to look at the provisions holistically to form a view as to the intent of Parliament. It is clear from overriding item 6 that Parliament intends that milk and flavoured milk drinks (being preparations of milk) are not subject to tax. When looking at the provisions in their totality, it cannot really have been the intention of Parliament to tax this type of product when its only function is, when added to zero-rated pure milk, to make a flavoured milk drink.

54. The wording of the provisions supports this construction:

(1) It cannot have been intended that the word "beverages" should be interpreted differently in the two places it appears in excepted item 4.

(2) The several references in the introductory wording to Group 1 to "comprised in" and the use there and in Note 6 of the words "relates" and "relate" signals the intended overlapping nature of and interaction between the excepted items and the overriding items and that the provisions are to be construed holistically.

(3) The term "overriding" is a rather unusual one but is to be given its natural meaning which is to displace and to remove ultimately entirely from the relevant area the effects of the excepted item to which the overriding item "relates".

55. HMRC criticises the appellant for not referring to any case law authorities but that is because there is no authority in which this particular point, as to the interaction between the excepted items and the overriding items, has been considered. The authorities cited by HMRC are largely irrelevant. Most of them relate to whether an item of food falls within an excepted item essentially as a factual question with no argument as to any interaction with the overriding items. This applies to *Customs and Excise Commissioners v Ferrero UK Ltd* [1997] STC 881, *Procter & Gamble UK v Revenue and Customs Commissioners* [2009] EWCA Civ 407, *Kalron Foods Ltd v*

Revenue and Customs Commissioners [2007] STC 1100 and *Innocent Ltd v Revenue and Customs Commissioners* [2010] UKFTT 516 (TC).

56. HMRC argue that the meaning of the term "beverages" is relevant as set out in cases such as *Kalron*, *Innocent Ltd*, *Chi Drinks Limited* [2013] UKFTT 094 (TC) and *GlaxoSmithKline Services Unlimited v Revenue and Customs Commissioners* [2011] UKUT 432 (TCC). However, those cases relate to whether the product in question is as a factual matter a "beverage" on the normal meaning of that term. The only debate in this case is as to whether as matter of statutory construction "beverages" has the meaning the appellant argues for, such that it excludes "milk and preparations and extracts thereof". Otherwise there is no debate as to normal meaning of "beverages". For the purposes of the appellant's second argument the tribunal is asked to assume that milk is a "beverage" (without the need to decide that point).

57. In the case of *R Twining and Company Ltd (LON/2006/305)*, on which HMRC place much reliance, the way in which the tribunal formed their view supports the appellant's position. The tribunal held that the product, a flavoured powder for adding to milk, was within excepted item 4 as a "powder for the preparation of beverages" but was zero-rated as a "preparation" or "extract of milk" within overriding item 6. At [54] to [56] the tribunal acknowledged that this was a difficult decision and noted and put weight on (a) the witness evidence that the product contains milk and milk ingredients and that the witness would consider it to be a preparation or extract of milk and (b) the published view of HMRC that a beverage falls in this category if "it is substantially based on milk" or "it is a mixed drink that has the texture and nature of a milky drink".

58. At [55] the tribunal continued that a clear indicator that the product fell within overriding item 6 was that the taste and feel of the product when added to water was that of a milky drink:

> "The taste and feel of the Product when mixed with both milk (as instructed on the packet) and water (as tested by the tribunal) is that of a milky drink. That element of the analysis clearly points to the powder being a preparation or extract of milk."

59. At [56] the tribunal concluded by asking: "Does the evidence satisfy the tribunal that the product is within override 6 as being a preparation or extract of milk, *that when mixed with milk or water, forms a beverage*?" (emphasis added). Although acknowledging again that this was a difficult decision, the tribunal concluded that it does. It is clear from these passages that it was an essential element of the tribunal reaching their decision that the product was mixed with milk (or water) to produce a milky drink. That is exactly the same situation here.

Meaning of "powder or other product for the preparation of a beverage"

60. The Product is not in any event within excepted item 4 as it is not "*for the preparation of* beverages". The intention of Parliament is to catch products for the preparation of new taxable beverages. Parliament did not intend to alter the tax

position simply because of matters such as flavour or colour where they do not make any difference to the tax status of the final product.

61. Whilst the Product is used in conjunction with a "beverage", it does not constitute or, play a part in creating, a new "beverage". There is already a "beverage", the milk, which endures, albeit with enhanced flavour. A "beverage" that is flavoured by the addition of the Product is itself still a milk drink not some third kind of or new drink.

62. In contrast, when water comes out of a tap, it could be put to many uses. If it is boiled and added to coffee granules, it is common ground that a new "beverage" is created. Arguably if you add one "beverage" to another "beverage", you might create a third "beverage". For example, this could be the case if hot milk and espresso shots are mixed to create a cappuccino. That is not so where the Product is added to a glass of milk. Just as the addition of sugar to tea or coffee would not be regarded as creating a new "beverage", so the addition of the Product to milk also does not do so. The Product is (quite literally) absorbed into and ancillary to the milk drink. It flavours the milk, but does not otherwise materially change it from being a milk drink into something else.

63. The purpose of the Product is to encourage children to drink milk. The appellant's advertising stance is that the Product helps parents help children to drink milk. It is crucial to the premise of the Product, as advertised, that even once it is added, what remains is milk. It is formulated such that it does not alter the consistency, texture or density of milk but merely flavours the milk to make the taste more enticing to children.

64. HMRC accept in their internal guidance note, VFOOD7740, that items which merely flavour a beverage are not caught within excepted item 4. (The full text of this is set out in the Annex.) In this HMRC accept that a syrup used to flavour coffee is not a "syrup for the preparation of beverages". The reference in this guidance to "syrups (and similar)" is clearly intended to cover the other products which are listed in excepted item 4, and so includes powders such as the Product. Both where the Product is added to milk and where vanilla syrup is added to coffee, the final product remains the same (as milk and coffee respectively). The addition of vitamins, sugar and some natural flavourings in the Product is no different to the added sugars found in syrups used to flavour coffee and alcoholic drinks.

65. There is nothing in the legislation that would result in milk flavourings being treated differently to the examples set out in HMRC's guidance. This interpretation supports the view that the provision is not intended as a trap of taxation for anyone producing a food ingredient that might be added to a zero-rated beverage such as, for example, a supplier of Worcester sauce for adding to tomato juice

66. The Product does not, when added to milk, create a milkshake, as that term is commonly used. In common parlance a milkshake is a thicker, much more substantial mixture than sweetened and flavoured milk. The Product has on some websites been described as a milkshake or as "turning milk into a delicious drink". The test as to

whether a new "beverage" is created is an objective one and nothing should turn on the use of these terms.

67. The case of *Snapple Beverage Corporation* [LON/94/1991A] to which HMRC refer is not relevant. It was about tea and whether it had lost its characteristics as tea to such a degree that the ultimate product could not be regarded as tea. The comments in 57 to 59 on the *Twinings* case and in 56 on other cases cited by HMRC are also relevant here.

Approach to construction

68. HMRC contend that the provisions should be given a narrow construction. On the basis of the comments of Chadwick LJ (at [17]) in *Expert Witness Institute v Customs and Excise Commissioners* [2002] STC 42 applying a "strict" construction would be necessary only if the tribunal is left in doubt as to the application of the provision on a "fair interpretation". A court is not required to reject a claim which comes within a fair interpretation of the words of an exemption because there is another more restricted meaning of the words which would exclude the supplies in question. The appellant's interpretation is within a fair interpretation. Also, in the case of *Roger Skinner Limited v The Commissioners for Her Majesty's Revenue & Customs* [2012] UKFTT 525 (TC) Judge Mosedale (at [132]) noted that there is no rule of national law that says zero-rating provisions are to be narrowly construed and, on the contrary, the ruling is, as stated in the *Procter & Gamble* case, that the words should be given their ordinary meaning.

69. In making this argument the appellant is not seeking to extend the categories of zero-rate in an impermissible way as HMRC argue. The question is simply the correct construction of the statutory words which, in effect, must always have applied (albeit that the point has not been considered and decided upon until now).

70. The appellant also submitted that its interpretation of the provisions is clearly supported by social policy objectives and fiscal neutrality considerations as set out below.

Social policy

71. Under Article 110, when interpreting the UK provisions on zero-rating, it is necessary to have regard to the social reasons behind the provisions and whether the zero-rating of the supply in question is for the benefit of the final consumer. The social policy behind specific supplies of milk (and "preparations and extracts thereof") being zero-rated can only be the encouragement of milk drinking, whether pure or flavoured milk, in view of the health benefits that it brings, in particular, for children. Ms Read had given very clear evidence that the Product is one which contributes overall to the health of children but it is not necessary to rely on that given this very clear mainstream policy that favours milk. The Product is intended for use solely with milk as a milk drink. It has no other function than to be consumed in milk and it clearly helps to deliver the social benefit of milk drinking.

72. The requirement in Article 110 that the supply must be for the benefit of the final consumer means that only supplies in the chain sufficiently linked to the final consumer can be zero-rated. In the Court of Appeal case of *Jubilee Hall v Commissioners* [1999] STC 381 Sir John Vinelott described the final consumer (at page 384 j) as "the person who does not use exempted goods or services in the course of an economic activity." He noted that the final consumer according to this description can be regarded as benefitting not only from immediate supplies made to him but also from "the provision of goods and services at a stage higher in the production or distribution chain which is nevertheless sufficiently close to the consumer to be of advantage to him".

73. In this case the final consumer is the person who drinks the milk flavoured with the Product. The appellant's supplies of the Product to the supermarket (or other outlet) which sells it to the final consumer are sufficiently close to the consumer to be of advantage to him. The Product clearly functions to help deliver that benefit.

74. In the *EC Commission* case it was accepted that the European Commission may not challenge measures taken in pursuance of a member state's social policy unless it can be shown that the social policy is not sufficiently clearly defined or that the measures in question either are not justified by or are disproportionate to the social reasons advanced. The Attorney General took a similar view in that case where he noted that when looking at issues of social policy "the court should declare measures contrary to Community law only when their objective is clearly unrelated to the satisfaction of the fundamental needs, be they individual or collective, of the population of the member state."

75. In this case the social policy and political choice made by the UK is clear and there is no distortion of the kind referred to in the *EC Commission* case. HMRC have not explained why Parliament would not have regarded the Product as related to the satisfaction of the fundamental need of the consumption of milk.

Fiscal neutrality

76. The requirement in Article 110, that the zero-rating of supplies must be in accordance with Community law, means that the principle of fiscal neutrality is also relevant in construing this legislation. In *Marks & Spencer plc v Revenue and Customs Commissioners (case C-309/06)* [2008] STC 1408 the Court of Justice of the European Union (as it is now named) ("**CJEU**") confirmed that the effect of the relevant directive article (being that preceding the current Article 110) is that the maintenance of exemptions or reduced rates of VAT is permissible only if compliant with fiscal neutrality. In the Court of Appeal decision in *Sub One Ltd (t/a Subway) v Revenue and Customs Commissioners* [2014] STC 2508 it was clearly accepted (at [60]) that fiscal neutrality can, if necessary, trump socio-political judgment of a member state as to which food to zero-rate.

77. To apply the standard-rate to the Product potentially creates unjustifiable distortion in two markets: first, the market for flavoured products for adding to milk where it is accepted that the appellant's own Chocolate Nesquik is zero-rated and,

secondly, the market in which the Product competes with prepared or ready-made milk drinks which HMRC also accept qualify for zero-rating.

78. In assessing the potential for unjustifiable distortion, if goods are the same or similar, competition and distortion of the relevant market can be presumed. This was the conclusion of the CJEU in *Rank Group plc v Revenue and Customs Commissioners* (Joined cases C-259/10 and C-260/10) [2012] STC 23 where it was held that a difference in treatment for the purposes of VAT of two supplies of services, which are identical or similar from the point of view of the consumer and meet the same needs of the consumer, is sufficient to establish an infringement of the fiscal neutrality principle.

79. Looking at the Product compared with those in the two markets identified, they are the same or similar and meet the same needs of the consumer. In each case there is only one common ultimate need that Nesquik and the ready-made milk drinks satisfy, being the consumption of flavoured milk. There is, therefore, a distortion in the market inherent in HMRC's view of the interpretation of these provisions.

80. HMRC submit that the difference in flavour in the Product and Chocolate Nesquik alone justifies a difference in VAT treatment. It is not in accordance with the *Rank* test to have regard to such minor differentials. In the *Sub One* case the Court of Appeal accepted (at [72]) that supplies of "sub" toasted sandwiches were identical or similar (in the sense used in *Rank*) to supplies of a number of other products which had been zero-rated such as bagels, baguettes, paninis, ciabatta melts and toasties. It is clear from this comparison that the level of generality of the market to be taken into account in fiscal neutrality cases is certainly not at the sort of microscopic levels that HMRC suggest. Moreover HMRC themselves appear to accept this in that they acknowledge in the notice referred to at 64 above that variations in flavour by adding syrup to coffee does not change a "beverage" into another "beverage". The correct category to look at is simply "flavoured milk" products.

81. Nor can it be said, as HMRC argue, that ready-made drinks are not a comparator. It is because the Product is used as an ingredient to create something which is identical to a ready-made drink that this case has arisen. In this regard differences in storage or in the manner of use and preparation are irrelevant. The test looks to consumption by the final consumer and, hence, inherently requires reference to what is in the glass when drunk by the consumer. Whether the consumer had to make efforts to produce that end result, how often he had to go to the supermarket to buy the product and where the product is stored (the larder or the fridge) has no impact on this test. That is not the act of consumption. Moreover the argument that the Product is a powder whereas the ready-made products are drinks is also not relevant. The Product is an ingredient in a "beverage" and therefore should be taxed in the same way as that "beverage".

82. Finally Mr Cordara referred to HMRC guidance in VFOOD7660 which states that "substitutes for dairy milk, such as plain soya or rice milk, are also accepted as zero-rated products since they are used as a replacement for milk by those who are allergic to dairy products". He asserted that this statement must have been made in

acknowledgement that, having regard to fiscal neutrality, soya and rice milk should be zero-rated on the basis that they fulfil the same fundamental need as milk.

HMRC's submissions

Views counter to the appellant's first argument

83. The provisions of Group 1 are clear in their structure and meaning. For a supply to be zero-rated it must be of an item within the general items and, if the item falls within the excepted items, it must also fall within an overriding item which relates to the excepted item in question (as identified in the Notes to Group 1).

84. Accordingly, the Product is not zero-rated because it falls within excepted item 4 (as set out in 93 to 100) but does not itself fall within overriding item 6 which relates to that excepted item. The Product contains no milk and, therefore, is not a "preparation" or "extract of milk" within overriding item 6.

85. The appellant's interpretation, as regards its first argument, is wholly out of kilter with this plain meaning:

(1) On the natural meaning there is no indication that the overriding items are to be viewed as anything other than a list of particular items which are zero-rated. If the intention was for overriding item 6 to define the term "beverages" the provisions could simply have stated that "beverages" shall not include milk, coffee or tea etc. The category "milk and preparations and extracts thereof" includes items which are not "beverages" at all.

(2) The overriding items can be contrasted with the Notes to Group 1 which do have an interpretive role in defining or partly defining particular terms. There is nothing in the Notes which indicates that "beverages" is to be limited by the overriding items in this way.

(3) The appellant has cited no case law in favour if its interpretation. The cases of *Chi Drinks, Glaxo* and *Twinings* are examples of where the tribunal has approached the question of whether the product in issue was zero-rated or not under Group 1 in exactly the same way as HMRC approach this case. In those cases the relevant product was simply tested against the relevant category. Moreover it is clear from the case law that the correct approach is to give the terms of the provision, including the term "beverages", their ordinary meaning.

86. HMRC cited a number of further cases many of which relate to whether supplies of a product, which it was accepted was "food of a kind used for human consumption", were excluded from being zero-rated under an excepted item. The cases illustrate that the approach of the courts is to look to the ordinary meaning of the terms in these provisions. Essentially the courts ask what view the ordinary reasonable man in the street would take (as in the Court of Appeal decision in *Ferrero* in relation to whether the product was a "biscuit") or what is the reasonable view on the basis of all the facts (as in *Procter & Gamble* in relation to whether regular Pringles fell within "potato crisps, potato sticks, potato puff and similar products made from the potato").

87. In the *Procter & Gamble* case, the court cautioned over the use of over elaborate tests. Jacobs LJ said "This sort of question, a matter of classification, is not one calling for or justifying over-elaborate almost mind-numbing legal analysis. It is a short practical question calling for a short practical answer". In response to the argument that, because the Pringles were only made of 42% potato, they lacked sufficient "potatoness" to be said to be "made from" potato, Mummery LJ took a similar approach at [79]:

> "I cannot think Parliament intended to invoke such an elusive test. It is an Aristotelian question: does the product have an essence of potato?.....But the real objection is that it is just too elaborate. The statute is simply posing a kind of jury question: is it similar to a potato crisp and made of potato? The question is not capable of elaboration or complex analysis.
>
> The response to these points is that it is vital to recall why the tribunal was required in the first place to answer the question whether the goods in question are made from the potato. It was not in answer to a scientific or technical question about the composition of Regular Pringles or in response to a request for a recipe. It was for the purpose of deciding whether the goods are entitled to zero-rating.
>
> On this point, the VAT legislation uses everyday English words which ought to be interpreted in the sensible way according to their ordinary and natural meaning."

88. HMRC also cited a number of cases on the meaning of the term "beverages" in excepted item 4. In the *Kalron Foods* case Warren J in the High Court decided that the tribunal had not erred in finding that a smoothie made from liquefied fresh fruit and vegetables was a "beverage". He followed the same approach as in the cases cited above, that the test was whether the product "is a beverage or not, applying the ordinary meaning of that word as a matter of the English language unless the context of the VAT legislation required a special meaning to be attributed to it." In rejecting the argument that the term must be given a special meaning, he cautioned (at [68]) that the distinction is not really between "drinks" and "beverages" but rather between "drinks/beverages" on the one hand and "drinkable liquids" (such as soups or food supplements) on the other.

89. In *Innocent Ltd* the tribunal followed the approach in *Kalron* in concluding that fruit smoothies made up of 50% fruit juice and 50% liquidised fruit were "beverages". The tribunal took the view that "beverages" is to be given "its ordinary and natural meaning" and looked at the distinction between "drinkable liquids" and "drinks/beverages".

90. In *Glaxo* the tribunal rejected the argument that the product fell to be zero-rated because of its nutritional values. The tribunal pointed to the fact that there was no discernible policy that such items should be zero-rated given that the excepted

(standard-rated) items contain a number of products which could be expected to contain nutrition, such as fruit juice, whereas some of the overriding (zero-rated) items could be held to be junk food (as had also been noted in *Kalron* and *Innocent Ltd*).

91. HMRC considered the case of *R Twining and Company Ltd* to be particularly relevant as it concerned a similar product to that in issue here (see 57 regarding the circumstances). Again the tribunal applied the test in the same way as HMRC seek to do in this case by first looking to whether the product is within the excepted items and then whether it comes within the overriding items. The tribunal rejected the appellant's argument that the product was not "a powder or other product for the preparation of beverages" but decided the case in favour of the appellant on the basis that it fell within overriding item 6 as, unlike here, it contained milk.

92. The appellant seems to suggest that an item can fall outside excepted item 4 merely because it is associated with an item in overriding item 6. This is also wholly out of kilter with the plain meaning of the provisions. For example, frozen yoghurt is in excepted item 1 but yoghurt that is unsuitable for immediate consumption when frozen is in overriding item 1 which relates to that excepted item. So frozen yoghurt that is not designed to be consumed when frozen is zero-rated because it is specifically identified as an overriding item relating to that particular category and not because it may count as a preparation of milk. Ice cream is associated with milk but it is standard-rated as it is in excepted item 1 but not in the overriding items relating to that item.

Views counter to appellant's second argument

93. The appellant's claim that when the Product is added to milk, the drink that remains is milk, is not supported by the Product itself or its marketing.

(1) The Product produces a drink that is very different from milk. In particular, it more than doubles the sugar content of the milk, resulting in a single drink of the Product accounting for 26% of a child's GDA of sugars. The Product is also enhanced with, in particular, magnesium, iron, folic acid, vitamin C and vitamin D.

(2) The idea that it helps encourage children to drink milk does not assume that the drink is similar to milk but that it contrasts milk. The assumption is that it stops milk tasting or looking like milk.

(3) The Product is described both on the appellant's website and on supermarket websites as turning milk into a delicious drink. It is not called "flavoured milk" in the appellant's marketing but "Nesquik", branded as a drink in its own right. The Product has also been marketed as being for the preparation of milkshakes.

94. There is no evidence from the appellant as to its claim that there is no change to the consistency, texture or density of the milk. In any event, such a change is not necessary for a product to be "for the preparation of beverages". Water added to

coffee granules creates a "beverage"; milk added to cocoa creates a "beverage". Neither is dependent on a change in consistency, texture or density.

95. The case law does not support the appellant's approach. In the *Snapple Beverage Corporation* case, fruit flavoured iced tea was found to be a "beverage" that did not come within overriding item 4 "tea" because in terms of taste and smell the fruit flavouring predominated over the tea. Similarly, the Nesquik drink is not milk but a distinct "beverage" prepared using the Product and milk. In the *Procter & Gamble* case, as noted above, the Court of Appeal made clear that overly elaborate tests were to be avoided.

96. There is no claim that the drink that results from adding milk to the Product is not a "beverage". Any such claim would be bound to fail given the interpretation of that term in *Kalron Foods.*

97. Clearly, the Nesquik drink is not identical to milk; even on the appellant's case, the Product adds a different flavour. The zero-rate is an exemption and should be construed narrowly as accepted by the tribunal in *R Twining and Company Ltd* and as has been adopted as common ground in two Upper Tribunal decisions without adverse comment from the Upper Tribunal (*Revenue and Customs Commissioners v The British Disabled Flying Association* [2013] UKUT 0162 and *Revenue and Customs Commissioners v Astral Construction Limited* [2015] UKUT 21 (TCC). It was however rejected in one tribunal case (the *Skinner* case referred to at 68 above).

98. That HMRC accept that there are flavoured syrups that can flavour coffee but which cannot be said to be "for the preparation of beverages", provides no assistance to the appellant. The tribunal has to decide the issue itself. In any event, because the "beverage" coffee has already undergone a process of preparation, adding a flavour to it is not itself sufficient to qualify as "the preparation of" a "beverage". The same would apply if adding a flavour to hot chocolate. By contrast, a bottle of water or a glass of milk are treated as "beverages" under the legislation but have not already undergone any preparation. When syrups, powders or other products are combined with these, distinct "beverages" are prepared.

99. This is reflected in language and the ordinary meaning of "the preparation of beverages". It would be very natural for someone using the Product to say on being asked what they were doing, "I am making a strawberry milkshake" or "I am making a banana drink". Similarly, someone making hot chocolate using cocoa powder and milk would naturally describe this as preparing a hot chocolate. When on the other hand someone adds flavours to coffee or hot chocolate the natural response would be "I am adding vanilla/hazelnut flavouring to my coffee/hot chocolate".

100. The *Twinings* case referred to above also supports the appellant's position here. That case provides clear support for the view that this type of powder is a "powder for the preparation of beverages". The fact that the tribunal decided the product fell within overriding item 6 because it contained milk does not detract from this.

Social policy

101. The tribunal is not able to look to social policy in construing an exception from zero-rating. Judge Mosedale noted in *Innocent Ltd* that the tribunal was bound by the comments made by Warren J in the High Court in the *Procter & Gamble* case ([2008] EWHC 1558at [46]) that social policy is not relevant to the exceptions. Although the High Court decision was appealed it was not appealed on this point. The Court of Appeal commented that it was by then common ground between the parties that Article 110 permitted but did not require zero-rating and provided no aid to construction in that case.

102. Judge Mosedale went on to say in the *Innocent Ltd* case that, in any event, if the tribunal did have to find a social policy that justified the exceptions, the tribunal was not able to find any such clear policy. In particular (as endorsed by the decision in *Kalron*) it cannot be said that there is an anti-junk food or drinks policy. For example, fruit juice and bottled water are standard-rated items but they would not be regarded as junk drinks. She also did not agree with Mr Cordara's submission in that case that there is a social policy to zero-rate only nutritional drinks. She noted that sugar is a nutrient but plenty of drinks which contain sugar, such as soft drinks and fruit juice, are standard-rated. On the other hand tea is zero-rated although it would not normally be regarded as nutritional unless it has milk or sugar added.

103. Even if it were justified to have regard to social policy in construing this provision, on the same basis as set out by Judge Mosedale, there is no clear social policy of the kind which would support the appellant's position.

Fiscal neutrality

104. The appellant refers to the doctrine of fiscal neutrality, both in relation to ready-made milk drinks and Chocolate Nesquik. The fiscal neutrality argument as regards ready-made drinks was not mentioned in the appellant's grounds of appeal and should not be considered by the tribunal on the authority of *Bagel Nash Ltd* [2015] UKFTT 72 (TC) at [9] to [15].

105. Article 110 does not permit the extension of the zero-rate category merely the retention of pre-existing zero-rating (as it applied in 1991) subject to the provision being in accordance with Community law (and justified by social policy). This means that the categories of zero-rate can be narrowed if there is an issue of fiscal neutrality but they cannot be extended. The effect of the appellant's argument would be to extend the category of zero-rated products beyond milk and milk products (as provided for in overriding item 6) and cocoa and cocoa products (as provided for in overriding item 5). The cases of *Marks & Spencer* and *Sub One* do not form authority for the proposition that the zero-rating provisions can be extended in this way applying fiscal neutrality principles. Further details of HMRC's submission on these cases are set out in the discussion.

106. The appellant accepts that member states have discretion and what is zero-rated is a political choice as set out in the *EC Commission* case to which Mr Cordara refers.

The appellant has queried why Parliament would zero-rate chocolate flavoured powders of the type the appellant produces and not such fruit flavoured powders. The answer is that there is no discerned intention of Parliament that products which do not contain milk or cocoa should be zero-rated.

107. In any event, there is no problem of fiscal neutrality in this case following the approach in *Rank*. In the *Rank* case, as regard comparing slot machine games, it was held that regard must be had to the relevant or significant evidence liable to have a considerable influence on the consumer's decision to play one game or the other. As the attraction of games of chance lies chiefly in winning, factors likely to have a considerable influence on the decision of the average consumer were "differences relating to the minimum and maximum stakes and prizes, the chances of winning, the formats available and the possibility of interaction between the player and the slot machine".

108. Applying the same approach as in *Rank*, in comparing the relevant products, it is critical that the attraction for the average consumer lies in the flavour, the taste, the appearance, the ingredients and the use. The principle of fiscal neutrality is not breached by the UK limiting the zero-rate to certain forms being, in this case, as regards certain kinds of "beverages" and certain kinds of powders. The UK's discretion as regards zero-rating would be empty if the difference in treatment of the different products cannot, in the case of "beverages", depend at least on flavour.

109. As regards the comparison of the Product with Chocolate Nesquik:

(1) Consistently over a four year period, the appellant's total sales of each flavour of Nesquik were proportionately the same. The Nesquik products are priced the same way for sale to the supermarkets and the recommended retail price and the promotions are the same. It is obvious from this that, for the consumers, it is the flavour which makes a difference in deciding which product to buy. The three products are not interchangeable. Flavour in this case is equivalent to the prize/winnings that, as regards slot machine games, were held in the *Rank* case to make a considerable difference.

(2) In general terms, the average consumer would not regard a fruit drink as interchangeable with a chocolate one. The perception of any food to do with fruit is that it is a healthy option and the perception of chocolate is that it is an indulgent comfort food. A consumer would not, for example, regard a fruit bar as interchangeable with a chocolate bar.

(3) Other differences are:

(a) Chocolate Nesquik is identical to hot chocolate powder and can be consumed hot or cold, but Banana and Strawberry Nesquik typically are consumed cold only.

(b) Chocolate Nesquik is made as to around 20% of its composition with cocoa (with the added fibre, protein and fat that ingredient contains). Less sugar needs to be added to Chocolate Nesquik (although Ms Read was not able to put a precise figure on it).

(c) Chocolate Nesquik is advertised separately on TV from Strawberry Nesquik.

110. As regards the comparison of the Product with ready-made drinks:

(1) Whilst ready-made drinks are drinks, the Products are powders. The appellant argues that the two meet the same consumer need: to consume milk or flavoured milk. However, the Product cannot meet that need at all; it cannot be consumed as flavoured milk or milk as it is a form of powder.

(2) Ready-made drinks are designed for immediate consumption whereas the Product is not. To use the Product a person needs a mug, a spoon and milk. If UHT milk is used, a fridge is not needed to use the Product, whereas the ready-made drinks once opened need refrigerating.

(3) To use the Product the consumer has to prepare the drink by adding milk unlike the ready-made drinks. The consumer needs to be bothered to prepare the Nesquik beverage.

(4) The Product has a 12 month shelf life whether the packaging is open or closed. The ready-made drinks typically have to be consumed within a number of days. The ready-made drinks are not for long-term intermittent use as the appellant's powders are, but they are used either "on the go" or within a few days.

(5) The fact that the consumer needs to be bothered to prepare the Nesquik drink is reflected in the pricing in that the Product is typically more expensive than the ready-made drinks but provides many more servings than those drinks.

(6) As a matter of common sense and experience, for the average consumer, products which require preparation, even in cases where elaborate preparation is not required, are not interchangeable with ready-made ones.

Discussion – preliminary issue

111. The preliminary issues were that:

(1) HMRC argued that the appellant should not be able to raise the issue of fiscal neutrality as regards the comparison of the Product with ready-made drinks as it was not raised in the appellant's grounds of appeal.

(2) HMRC also objected to the appellant's application to produce in evidence a Yazoo strawberry flavour milk, Sainsbury's banana flavour milk, Frijj strawberry milkshake, McDonald's strawberry milkshake and a type of Monin syrup. The appellant wished to produce these in support of the fiscal neutrality position and of its second line of argument that the Product does not create a new "beverage" when added to milk. HMRC objected to them being produced for either reason. However, HMRC said they were happy for the appellant to produce certain photos relating to these products and to refer to them in the abstract as regards the second issue.

(3) In outline, HMRC's objection was that they would be prejudiced by the lateness of the applications, by HMRC being required to comment on products on which they had not made a ruling on the VAT treatment and that simply producing the products was not satisfactory evidence to support either of these arguments.

112. HMRC referred to the case of *Bagel Nash* which concerns the correct VAT treatment of sales of bagels and other cold takeaway food items sold in the food court area in a shopping outlet. The tribunal decided not to hear a fiscal neutrality argument which was raised only at the stage of the parties producing skeleton arguments. The tribunal referred to the comments of Judge Berner at [6] in *Oasis Technologies (UK) Limited v HMRC* [2010] UKFTT 292 that:

> "We decided that fiscal neutrality had to be regarded not simply as an argument, but as a fundamental, and distinct, ground of appeal that ought properly to have been pleaded at an earlier stage of the proceedings. In our view it could not at this stage fairly be considered in the absence of advance notice to HMRC."

113. The tribunal concluded that in any event there was no evidence presented which would enable the tribunal to undertake the fact finding exercise of deciding whether or not supplies are objectively similar. It seemed highly unlikely that, even if an argument on fiscal neutrality were to be advanced, there would be any evidential basis on which to establish appropriate comparators.

114. The question of whether to hear an argument and to admit evidence produced at a late stage is one to be determined according to the circumstances of each particular case having regard to the rules governing the tribunal (The Tribunal (First-tier) (Tax Chamber) Rules 2009) and, in particular, the overriding objective in rule 2 of dealing with matters fairly and justly.

115. Our view was that the production of the items was relevant to the appellant's argument that no new "beverage" is created and potentially of assistance to the tribunal in considering that. We could not see there would be any prejudice to HMRC in allowing these products to be produced to the tribunal as regards that argument. The current VAT treatment of these products appears to be clear and HMRC had also confirmed that they were prepared for Mr Cordara to raise these arguments in the abstract. It could be helpful to the tribunal actually to see these products rather than have them argued about in the abstract.

116. The appellant did not raise its second argument on the fiscal neutrality point until relatively late in the day. The issue of fiscal neutrality was raised as regards the comparison with Chocolate Nesquik in the grounds of appeal and then expanded in the appellant's skeleton argument of 15 June 2015 to include the comparison with ready-made drinks. HMRC has been aware of this argument, therefore, for around two weeks before the hearing. The fact that the appellant intended to produce the products in part in support of this fiscal neutrality argument was only clear in correspondence dating from just before the hearing.

117. Clearly, if the appellant is able to argue this fiscal neutrality point, a comparison as to the similarity of the Product with ready-made drinks is an essential part of the argument although it remained to be seen precisely what weight can be put upon the information provided. In these circumstances we did not think it would be in accordance with justice and fairness to bar the appellant from raising this argument at all or from producing the relevant products in support of this. This was not in our view a case where, as in *Bagel Nash*, it is apparent at the outset that a fiscal neutrality argument cannot succeed.

118. However, we appreciated that HMRC had had a relatively short time to consider this, in particular, in the light of the lateness of the clarification that the products were to be used in support of the fiscal neutrality position. We invited HMRC to apply to make written submissions following the hearing or for an adjournment of that part of the proceedings should they feel they were not able to deal with this issue satisfactorily. HMRC confirmed that they were content for proceedings to go ahead on all bases but would reserve their position as to whether they would need to make any further written submissions. HMRC later confirmed that they did not wish to make any further submissions following the close of the hearing.

Discussion – main issue

119. The issue is whether supplies of the Product fall to be zero-rated or standard-rated under the provisions in Group 1. To recap, under Group 1 zero-rating applies to:

> "The supply of anything comprised in the general items set out below, except –……..
>
> (b) A supply of anything comprised in any of the excepted items set out below, unless it is also comprised in any of the items overriding the exceptions set out below which relates to that excepted item."

120. There is no dispute that the Product falls within the relevant general item as "food of a kind used for human consumption". The issue is whether or not supplies of the Product fall within excepted item 4 as a powder "for the preparation of beverages".

121. The appellant has two lines of argument on the interpretation of excepted item 4:

> (1) "Beverages" is to be read subject to overriding item 6 as not including "milk and preparations and extracts thereof" and so as excluding a Nesquik milk drink. The Product is not therefore for the preparation of "beverages" within that definition.
>
> (2) If that is not accepted, the Product is not in any event "*for the preparation of* beverages", in outline, as the addition of the Product to milk does not create a new "beverage" but merely flavours the milk.

Construction of excepted item 4 – appellant's first argument

122. On the plain meaning of the provisions, whether a supply is zero-rated or not falls to be considered in a series of 3 steps according to:

(1) whether *the item*, which is the subject of the supply, is comprised in the general items, the relevant one being "food of a kind used for human consumption" (in which case the supply is potentially zero-rated), and

(2) if so, whether *that item* is comprised in any of the excepted items (in which case the supply is potentially standard-rated), and

(3) if so, whether *it* is also comprised in any of the items overriding the exceptions which relates to that excepted item (in which case the supply is brought back to being zero-rated).

123. This is clear from the wording that zero-rating applies to a supply of "*anything* comprised in" the general items except "a supply of *anything* comprised in" any of the excepted items unless "*it* is also comprised in" any of the overriding items which "relates to that item". The wording makes it clear that the provision traces the item, which is the subject of the relevant supply, through each of these 3 steps in determining whether zero-rating or standard-rating applies to the supply of that item.

124. On that basis, assuming for the time being that the Product is otherwise within excepted item 4 (so leaving aside the second issue on what being "*for the preparation of* beverages" requires), the question is whether the Product itself falls within any of the overriding items which relates to that excepted item. Note (6) to Group 1 tells us that overriding item 6, being "milk and preparations and extracts thereof" relates to excepted item 4. The Product does not fall within this as it contains no milk (and it is accepted it does not fall within any other relevant overriding item). On that basis the Product is within excepted item 4 as a "powder for the preparation of beverages".

125. We can see no basis for the appellant's view that, in determining the VAT status of supplies of the Product, the term "beverages" in excepted item 4 must be interpreted as subject to overriding item 6 to mean "beverages other than milk and preparations and extracts thereof". There is no indication that, when assessing whether the supply of a particular product falls within an excepted item or not, an overriding item which relates to that excepted item is to be taken as applicable to anything other than determining the status of the supply of that product.

126. We note that the appellant takes support for its view from the use of the word "comprised in" in the introductory wording to Group 1 and the use there and in Note (6) of the words "relates" and "relate". The appellant asserts that this signals the overlapping nature of the provisions and that they are to be interpreted holistically. The appellant also notes that the term "overriding" indicates the complete exclusion of the specified items. However, these terms have to be looked at according to their use in the relevant context:

(1) The term "comprised in" is, in each case, tied to the relevant supply of "anything" which has to be assessed at each of the 3 steps.

(2) The term "relates" or "relate" is confined to expressing what overriding items are relevant at step 3. At step 3, a supply of anything which is comprised in an excepted item, in effect is taken back out of that category, if it is also comprised in an overriding item which "relates to that excepted item". In other words "relates" is used to indentify in which overriding item the product in question must fall for it to be excluded from the relevant excepted item. Note (6) then provides the necessary link by stating which overriding items relate to excepted item 4 and these include overriding item 6.

(3) In this context, the use of the term "overriding" indicates no more than that, if a supply of an item which falls in an excepted item also falls in an overriding item which relates to that excepted item, the standard-rated treatment of supplies of that item is overridden.

127. Overall, looking at the plain meaning of the wording used in the scheme and context of the provisions, we cannot see that the use of these terms is an expression of a broad principle that overriding item 6 applies in some more general interpretive way to other items listed in excepted item 4, which are not the subject of the supply in question. The overriding items do not function as general interpretive provisions.

128. Looking at the factual context we accept that the Product is intended solely for use with milk to provide a flavoured milk drink with added nutrients and that, for the consumer, the addition of the Product makes little discernible difference to the milk otherwise than as regards flavour and colour. We also accept that the appellant's focus, as regards the development and marketing of the Product, is on the encouragement of milk drinking, especially by children, in view of its health benefits as enhanced or complemented by the Product. Some evidence was produced that the drinking of milk is recommended by reputable health bodies on the basis it has health benefits and that some such bodies have indicated that drinking flavoured milk may also have some benefits. We also agree that it is clear from overriding item 6 that Parliament intended to zero-rate supplies of milk and milk products.

129. However, we cannot see that it follows from this that, on a purposive approach to construction of the provisions, Parliament must have intended also to zero-rate a powder for adding to milk, which does not itself contain any milk. We cannot see any discernible intent that supplies of a product are to be zero-rated solely because the product is for use with a zero-rated item such as milk. For all the reasons set out above, the natural meaning of the provisions is clear. It is only if the relevant supply is of something which itself falls within a relevant overriding item that it is excluded from the related excepted item. In that context, the fact that overriding item 6 is confined to milk and "preparations" and "extracts" of milk indicates that zero-rating is intended to be confined to items actually comprising or containing milk. Had the intention been to the contrary we would expect the provisions of Group 1 to have been quite differently structured and worded.

Construction of excepted item 4 – appellant's second argument

130. The appellant's second argument is that the Product is not a "powder *for the preparation of* beverages" on the basis that it does not create a new beverage but

merely flavours an existing beverage. It is submitted that it does not change the consistency, texture or density of the milk; what remains is milk with flavouring (and nutrients) added.

131. HMRC submit that for a powder to be "for the preparation of beverages" does not require that there is any such change. What results from the addition of the Product to milk is a distinct "beverage" which contrasts milk as is emphasised by the ingredients and the marketing. Even on the appellant's argument what remains is not just milk. In HMRC's view this is not the same as where a flavouring is added to coffee where there is a "beverage" which has already undergone preparation.

132. We were presented by HMRC with a number of cases on what constitutes a "beverage" for the purposes of excepted item 4. From these cases we think it clear that milk, with the Product added, is a "beverage". We have not set out the position in any detail as there was no dispute that the "Nesquik drink" is a "beverage" (leaving aside the appellant's first argument on the legal meaning of the term). The appellant asked the tribunal to assume also that pure milk is a "beverage" for the purposes of making this decision. There have been conflicting decisions as to whether milk is a "beverage" or not but we do not feel it necessary to decide this point in these circumstances. There is no dispute that the Product is a powder.

133. In looking at the meaning of the term "powder for the preparation of beverages", on the basis of the approach taken in previous cases on the construction of the legislation in this area (as cited extensively by HMRC), our view is that we must simply apply the natural meaning of the provision. As set out in the *Procter & Gamble* case, it is not appropriate, in applying the ordinary meaning, to seek to draw fine distinctions or apply over elaborate tests. This is not a scientific question but rather one of whether the ordinary man in the street (as the embodiment of a reasonable person) would regard the Product as a "powder for the preparation of beverages".

134. On its natural meaning, we interpret the word "for" used in the context of "the preparation of beverages" in the plural, as requiring an assessment of the use or function of the product in question. It indicates that the legislature is trying to identify those powders (or syrups, concentrates, essences, crystals or other products) which have the required use, namely, "the preparation of beverages", and no other use. It is only products which are "for" that use which are caught. We see this as an objective test to be determined according to available evidence on the characteristics of the product, the market for the relevant product and how it is commonly used.

135. The question then is what being "for" (in the sense of being solely used for) "the preparation of beverages" entails. The ordinary meaning of "the preparation of" is that of an action or process to make or get something ready. This indicates that what is envisaged is the making of a "beverage" from two or more ingredients of which the product is one and, by virtue of the nature of a "beverage", a liquid is one. It seems to us, therefore, that to fall within this provision a product must have, as its sole use, the playing of some part in the action or process of the making of "beverages". Our view is that this entails that the product must at least add something different to the liquid

(with or without other ingredients) and that there is some element of activity involved in the use of the product in the making of the "beverage".

136. The parties have to some extent focussed in their arguments on the precise level of difference the product makes to the liquid to which it is added, the nature of the liquid and the extent of the role the product plays as to whether it can be said to create the "beverage" (or a new "beverage"). In our view, to seek to make distinctions between products according to matters such as the precise effect the product has on thickness, texture, viscosity or flavour or the level of activity the use of the product requires (a brief stir, a long stir, blending into an initial paste or whisking) would lead to the drawing of what would inevitably be fine and difficult distinctions which Parliament cannot have intended. As in the *Procter & Gamble* case as regards whether a regular Pringle is similar to a potato crisp and is made of potato, we do not see that the test of whether something is "for the preparation of beverages" requires complex and elaborate analyses of the type required to distinguish products on such bases. All that is required is that the product (being one solely for that use) plays some part in the process of the making of "beverages" as described. We cannot see that there is otherwise any particular requirement as to the scope or scale of the part the product plays in the process or by reference to precisely when in the process the product is added to the liquid.

137. On this interpretation it is clear that products which can be used with drinks but which are also used in other ways are not products "for the preparation of beverages". To take an example put forward by the appellant, whilst Worcestershire and Tobasco sauces can be and are added to drinks (such as to tomato juice or a "Bloody Mary"), we would think they are used more commonly in conjunction with other foods (such as in cooking or for adding to food as condiments). Similarly, whilst sugar can be added to tea or coffee, it can also be used in many other ways such as in baking or on cereals or to add sweetness to fruits. It is for that reason that we would not expect these products to be regarded as being "*for* the preparation of beverages". It is not because they could be said merely to flavour the relevant drink or because they are added to what may be termed an already prepared "beverage". They simply are not for sole use in making "beverages".

138. It follows from what we have said that we would not regard products which are added to what might be termed pre-prepared "beverages", such as coffee or hot chocolate, as necessarily falling outside of excepted item 4. In our view, for a product to be "for the preparation of beverages" does not depend on it being the only or main ingredient in the "beverage" (other than the relevant liquid) or at what stage it is added to the "beverage". We cannot see that there is any particular relevance in whether a product is added to something which may already constitute a "beverage" and whether the "beverage" has already undergone any preparation or not. In other words we see the reference to "beverages" as being to "beverages" as actually consumed. The provisions potentially capture any relevant product which is for use for addition at any stage in the process of getting the "beverage" ready for consumption.

139. In many (if not most) cases, the type of product envisaged by these provisions will be added to what would commonly be viewed as a drink or "beverage" which could be consumed with no further additions. A glass of water or a glass of milk could be drunk as it is with no additions in the same way as a cup of coffee or hot chocolate. We cannot see that Parliament can be taken to have meant a difference in treatment solely according to whether the relevant product is intended to be used with a glass of cold water or cold milk or a cup of coffee or hot chocolate.

140. Applying this test to the Product, our conclusion is that the Product is a "powder for the preparation of beverages":

(1) From the evidence given as to the formulation, marketing and use of the Product, it is clearly solely for use by the consumer with a liquid, typically milk, in order to be consumed as a Nesquik drink which is a "beverage" on the ordinary meaning of that term.

(2) The use of the Product with milk requires some active preparation (albeit a relatively small amount) such that the use of the Product is part of the activity involved in making the Nesquik drink.

(3) When we sampled a Nesquik drink along with plain milk and ready-made milk drinks we found that the Nesquik drink was the most similar to plain milk in terms of texture, density and viscosity (or mouth feel). We thought that, from a consumer's perspective, the only real perceptible difference in the Nesquik drink compared with milk is as regards flavour and colour. However, our view is that the fact that the Product makes a difference in flavour alone suffices for it to play a part in the formation of the "beverage" which is consumed.

(4) A glass of milk to which the Product is added may well constitute a "beverage" but we do not need to decide that as, on our view, it is not material whether a liquid to which a product is added is a "beverage" before the product is added or becomes one only after the product is added.

141. We note that it could be argued that it may suffice for a product to fall within this provision if it is mainly used in "the preparation of beverages". We feel we are not called upon to decide that as it is clear in this case that the Product is solely for such a use.

Conclusion on interpretation of excepted item 4

142. For all the reasons set out above, our view is that the Product is a "powder for the preparation of beverages" within the meaning of excepted item 4. We have not based this on any need to give a strict or narrow construction to zero-rating provisions but rather on the natural and ordinary meaning of the words used. We do not consider that the appellant's interpretation comes within a fair interpretation.

143. The appellant also argued that its interpretation of the provisions is supported by the social policy behind the provisions and fiscal neutrality considerations. We have considered this as set out below and decided that neither of these principles affects our conclusion.

Social policy

144. It is acknowledged in case law that regard must be had to the social objectives behind VAT exemptions when construing them. In the *Marks & Spencer* case to which we were referred, the CJEU noted at [23] and [24] that the effect of the relevant provision, which preceded that in the current Article 110, is as follows:

> "….exemptions which were in force on 31 December 1975 "may be maintained", which means that it is for the member state concerned alone to decide whether or not to retain a particular piece of legislation which satisfied, inter alia, the conditions [set out in the relevant Council Directive]… which provided that exemptions with refund of tax paid could only be established for clearly defined social reasons and for the benefit of the final consumer.
>
> "Article 28(2)(a) of the Sixth Directive [the predecessor to Article 110] can therefore be compared to a "stand-still" clause intended to prevent social hardship likely to follow from the abolition of exemptions provided for by the national legislature but not included in the Sixth Directive….. That optional maintenance of the previous status quo is therefore merely framed by the Sixth Directive. Consequently it is pursuant to national legislation which does not constitute a measure for the implementation of the Sixth Directive …, but the maintenance of an exemption which is permitted by that directive, regard being had to the social objectives pursued by the legislation of the United Kingdom in not making the final consumer pay VAT on everyday items of food, that Mark & Spencer may claim the exemption with refund of the tax paid at the preceding stage".

145. It is not disputed that this principle can apply to inform the construction of a provision which provides for zero-rating. However, HMRC submit that social policy principles cannot be used to inform the interpretation of an exception from the zero-rating provisions such as excepted item 4. This is based on the views expressed by Warren J in the High Court decision in the *Procter & Gamble* case (as referred to in this tribunal's decision in *Innocent Ltd*).

146. In that case Warren J said (at [46]) that he found policy in the context of deciding whether regular Pringles fell within the relevant excepted item to be of no help:

> "I do not dissent from Mr Cordara's proposition, established by case law, that the value added tax ("VAT") legislation has to be construed against a clear understanding of the policy, but that can only mean such policy as can be established. The starting point is EU legislation which allows, on grounds of social policy, for the zero-rating of supplies. It is on that basis that the UK legislation has an exemption for food. There is, however, no requirement that any exclusion from exemption for certain types of food be justified by any social policy. It does not seem to me, therefore, that

any policy in relation to the exception of items from zero-rating is to be found in the EU legislation".

147. HMRC are taking the view that this statement means that, where there is an issue as to whether an item is correctly to be regarded as falling within the excepted items or not, social policy is not relevant to determining if the item falls outside the excepted items. We have difficulty with that as a proposition and we do not think that Warren J's comments were intended to have that meaning.

148. We note that earlier in his judgement at [6] Warren J, in describing the relevant legislation, comments on Article 110 as follows:

> "It might be noted that the measure which may only be taken for clearly defined purposes is the zero-rating of the supply; it is not the exception from zero-rating which needs to be so justified. Thus there is no need to discover a clearly defined social purpose to except potato crisps and the other items in para 5 (or indeed the items in the other paragraphs) of [schedule 8] from the zero-rating which would otherwise apply to them as items of food."

149. Looking at the above statement together with that cited in 146, it seems to us that Warren J was simply saying that there is no social policy requirement as regards whether an item is standard-rated or not. In other words it is not necessary to look for a justification as to why potato crisps and similar products are standard-rated (such as for example perhaps on the basis that potato crisps are what some would describe as "junk food"). We do not think that this means that it necessarily follows from this that social policy is not relevant in looking at the other side of the coin – at the justification for deciding if the supply of an item falls outside the excepted items so that it is zero-rated.

150. In our view this accords with the meaning of Article 110 as interpreted in *Marks & Spencer*. It is clear that social policy is relevant as regards the maintenance of zero-rating for supplies for which zero-rating was provided in 1991 (and prior to that in 1975). The UK legislation as regards the zero-rating of food has not changed materially since that time. Therefore the question is whether supplies of the Product are within the ambit of the relevant zero-rating provisions having regard to the social policy behind that. In deciding what falls within the ambit of the permitted zero-rating, the UK legislation is framed in such a way that it is necessary to work through 3 steps namely: is the supply of an item in the general items, in this case as food (in which case zero-rating potentially applies), if so, is it in the excepted items, in this case, as a "powder for the preparation of beverages" (in which case the supply is potentially standard-rated) and if so, is it within any of the overriding items which relates to that excepted item (in which case the supply is brought back into being zero-rated). We cannot see why social policy is any less relevant to deciding whether the supply is of an item which falls outside the excepted items (whether on the basis it is not properly included or that it falls in the overriding items), such that it falls to be zero-rated as "food", than to deciding whether the supply of an item is "food" within that general item in the first place.

151. We have, therefore, considered if there is a discernible social policy which would support the appellant's position as it argues for here. Mr Cordara's submission is that there is a clear social policy indicator here in that milk and milk drinks are zero-rated to encourage the drinking of milk, whether flavoured or pure milk, in view of its health benefits. He notes the evidence given by Ms Read as to the health benefits of milk but submits that it is not necessary to rely on that evidence given this very clear recognised policy. He submits that the Product has no other function than to be consumed in milk and it clearly helps to deliver the social benefit of milk drinking. The supply of the Product to a supermarket or other outlet is sufficiently closely linked to the supply of the Product to the consumer to be of benefit to the consumer (within the meaning of test set out in the *Jubilee Hall* case (see 72 above)).

152. The drinking of a certain amount of milk may well have certain nutritional qualities with potential health benefits for both children and adults and some evidence was presented that is the case. However, we can discern no particular intent that that is why milk was included in the zero-rating provisions. In looking at the wider picture of the whole of Group 1, the assumption would then be that there is a policy that food or drinks which contain nutrients which bring certain health benefits are to be zero-rated. Yet it is very difficult to see that there could be any such policy when on the one hand a number of items, which many would regard as healthy, are within the exceptions (and so are standard-rated) whereas others, which many would regard as unhealthy or lacking in nutritional value, are not (and so are zero-rated). For example, fruit juices and bottled water which fall within excepted item 4 as "beverages" and are therefore standard-rated, would be perceived by many to be healthy as the juice contains vitamins and water is essential for hydration. On the other hand drinks containing cocoa and cakes and biscuits (other than chocolate covered ones) are zero-rated but many would regard these as unhealthy as they generally contain relatively high levels of sugar which we are generally warned to eat less of.

153. In the *Marks & Spencer* case, the CJEU referred to the social objectives pursued by the UK's legislation in zero-rating food as being in "not making the final consumer pay VAT on everyday items of food". This justification to us makes more sense, in terms of the food and drink items covered by zero-rating, than a policy based on health benefits (albeit that some of the items classed as everyday food for this purpose may happen to have particular health benefits whereas some do not).

154. Our conclusion is that we cannot see that milk and milk drinks are zero-rated due to a social policy objective of the encouragement of milk drinking due its health benefits. We have not, therefore, considered this further.

Fiscal neutrality

155. It is established in case law that, as a general matter, the principle of fiscal neutrality under Community law precludes member states treating similar goods and supplies of services, which are thus in competition with each other, differently for VAT purposes due to the potential for distortion in the market. In general terms, a

trader can challenge a member state's law or the application of that law on the basis that it infringes this principle.

Applicability of fiscal neutrality to zero-rating provisions

156. The parties both looked to the CJEU decision in *Rank* as determining how fiscal neutrality principles apply, if fiscal neutrality is in point. The parties disagreed, however, on to what extent fiscal neutrality applies in the first place in a zero-rating context.

157. To recap Article 110 allows member states which at 1 January 1991 were providing for zero-rating to continue to do so subject to such provisions being in accordance with Community law and to them having been adopted for social policy reasons and for the benefit of the final consumer. As fiscal neutrality is a principle of Community law on the face of it this means that, for the UK's zero-rating provisions to be permissible, they must not infringe this principle.

158. The appellant argued that it is clearly accepted in the cases that the principle of fiscal neutrality can apply to determine the correct boundary between standard-rated and zero-rated supplies. The appellant cites in support the generality of the comments made by the CJEU in *Marks & Spencer* (see 161) and that, in the appellant's view, the Court of Appeal in *Sub One* accepts that fiscal neutrality can trump socio-political judgement of the UK as regards zero-rating (see 168). For the tribunal to find now that supplies which had previously been standard-rated should be zero-rated would not be an impermissible extension of the boundaries of zero-rating; it would simply be a case of deciding now what the correct boundary should always have been. On that basis the only question is whether the supplies of the Product are sufficiently similar, under the test set out by the CJEU in *Rank*, to other supplies which are zero-rated, such that the same VAT treatment should apply. In the appellant's view, supplies of the Product are sufficiently similar to supplies of Chocolate Nesquik and/or ready-made milk drinks, both of which are accepted to be zero-rated.

159. HMRC argued that the effect of Article 110 is that the outer limits or boundaries of the zero-rating categories are fixed by reference to those in place in 1991. In their view this means that, if there is a fiscal neutrality issue, it can only be resolved by narrowing the relevant category of zero-rating. For the appellant's fiscal neutrality argument to succeed, would involve an impermissible extension beyond the zero-rated categories applicable to milk products and cocoa products (as the Product contains neither). Such an approach is not supported by the cases of *Marks & Spencer* and *Sub One*. On that basis it is not necessary to consider fiscal neutrality further but, if it were necessary, there is not in any event a fiscal neutrality issue under the test in *Rank*.

160. We agree with the appellant that to find now that supplies which have previously been treated as standard-rated should correctly be zero-rated would not necessarily be an impermissible extension to the zero-rating provisions. Nor do we see, either from Article 110 or the cases, that there is a principle as such that the categories of zero-rating can only be narrowed if there is a fiscal neutrality issue.

Following the approach in *Rank*, however, we can see that there is an issue as to what extent the boundaries of the zero-rating categories can be flexed without that being held to deprive the UK of its discretion in fixing the zero-rating boundaries. This is considered further below following an analysis of the cases cited.

Case law – Marks & Spencer

161. In *Marks & Spencer* the CJEU held that, whilst the effect of the relevant article (the predecessor to Article 110) is not to give a trader a directly effective enforceable Community right to have supplies taxed at a zero-rate, the maintenance of such zero-rating (or exemptions) is permissible only if compliant with fiscal neutrality:

> "It must be noted at the outset that the actual wording of [the predecessor to Article 110]……states that the national legislation which may be maintained must be "in accordance with Community law" and satisfy the conditions stated in the last indent of art 17 [being those as to social policy and for the benefit of the final consumer]. Although the addition relating to being "in accordance with Community law" was made only in 1992, such a requirement, which forms an integral part of the proper functioning and the uniform interpretation of the common system of VAT, applies to the whole of the period of erroneous taxation at issue in the main proceedings. As the court has had occasion to point out, the maintenance of exemptions or reduced rates of VAT lower than the minimum rate laid down by the Sixth Directive is permissible only insofar as it complies with inter alia the principle of fiscal neutrality inherent in that system.
>
> It follows that the principles governing the common system of VAT, including that of fiscal neutrality, apply even to the circumstances provided for in article 28(2) of the Sixth Directive and may, if necessary, be relied on by a taxable person against a national provision or the application thereof which fails to have regard to those principles."

162. The question was whether the principle of fiscal neutrality (and other European Community law rights) gave Marks & Spencer the right to claim a refund of VAT which HMRC accepted had been incorrectly charged on supplies of tea cakes which should have been zero-rated as other traders' supplies of tea cakes had been. The CJEU held (at [35]) that the right to a refund of charges levied in breach of rules of Community law also applies to charges levied in breach of national legislation permitted under [Article 110]. Therefore, (at [36]):

> "Where … a member state has maintained in its national legislation an exemption with refund of input tax in respect of certain specified supplies but has misinterpreted its national legislation, with the result that certain supplies which should have benefitted from exemption with refund of input tax under its national legislation have been subject to tax at the standard-rate, the general principle of Community law, including that of

fiscal neutrality, apply so as to give a trader who has made such supplies a right to recover the sums mistakenly charged in respect of them".

163. Ms Mitrophanous argued that this case does not support the appellant's view that fiscal neutrality can apply, as HMRC argue is the effect of the appellant's position, to extend the categories of zero-rating. She noted that, unlike in the present case, there was no dispute in *Marks & Spencer* as to the correct categorisation of the supplies in question. It was accepted that the supplies of tea cakes made by Marks & Spencer were exactly the same as supplies of tea cakes made by other traders. The UK had, as it accepted, wrongly applied standard-rating to Marks & Spencer's supplies whilst correctly zero-rating the identical supplies made by others.

164. As Ms Mitrophanous noted the CJEU was not actually called upon, in these circumstances, to make an assessment as to the correct border line between standard-rated and zero-rated supplies under fiscal neutrality principles. But the statement of the general principle is clear, as set out in full in 161, that the maintenance of zero-rating provisions is permissible only insofar as it complies with the principle of fiscal neutrality. We can see no reason for applying a restricted view of what this means, in the absence of any clear statement to that effect, merely because of the limited circumstances of the actual application of fiscal neutrality in this case.

Sub One

165. The *Sub One* case concerned whether supplies of certain toasted sandwiches (known as subs and meatball marinaras) were zero-rated under Group 1 as "food of a kind used for human consumption" or standard-rated as supplies of catering (under the exception in (a) in the introduction to Group 1) on the basis that they were supplies of "hot food for consumption off the premises".

166. The Court of Appeal held that the correct test for deciding if the supplies were of "hot food for consumption off the premises" was an objective one. The previous decision of the Court of Appeal in *John Pimblett & Sons Ltd v Customs & Excise Commissioners* [1988] STC 358, which applied a subjective test, was wrong. On the correct objective test supplies of both subs and marinaras were correctly standard-rated.

167. The taxpayer argued (amongst other things) that the UK had previously failed to implement EU law correctly, by the courts following the *Pimblett* decision, which had resulted in a breach of fiscal neutrality. Supplies of take-away food of the taxpayer's competitors, which when viewed objectively were similar to the taxpayer's products, had been treated as zero-rated applying the incorrect subjective test. As a result the appellant had been unable to compete fairly. On that basis the appellant should be entitled to a refund of VAT.

168. Lord Justice McCombe noted (at [57]) that HMRC argued that the principle of fiscal neutrality cannot have the effect of overriding the UK's socio-political decision to exclude certain hot take-away food from the zero-rate exemption. HMRC argued that a decision taken by the UK could only be supervised at an EU level in so far as

the measures taken fell outside the scope of a concept of a clearly defined social reason. Lord Justice McCombe said (at [60]) that he thought the earlier decision of Mr Justice Arnold rejecting this argument was correct and he quoted from that judgement as follows:

> "[79] Counsel for HMRC pointed out that zero-rated supplies falling within art 110 were not harmonized. She submitted that it was for the UK to determine the boundary between zero-rated supplies and standard-rated supplies in accordance with its own social policy, and that the principle of fiscal neutrality could not be relied upon to challenge the UK's decision as to where to draw the line. She further submitted that this proposition was supported by the judgments of the CJEU in a series of cases….
>
> [80] I accept counsel for HMRC's submission to the extent that the starting point is that it is for the UK to determine the boundary between zero-rated supplies and standard-rated supplies. I also accept that the CJEU's judgment in *Rank* and *Isle of Wight* demonstrate the principle of fiscal neutrality cannot be relied upon as depriving the UK of its discretion in this respect. It does not follow that the UK can draw the line in such a way as to discriminate between objectively similarly supplies. On the contrary, art 110 is explicit that exemptions must be in accordance with Community law. In my judgment, the *European Commission v France* and *Marks & Spencer II* make it clear that the exemption is only permissible insofar as it complies with the principle of fiscal neutrality. As in *Ideal Tourisme v European Commission*, the UK can distinguish between supplies which are different from the point of view of the consumer; but, as in *Rank*, it cannot distinguish between supplies which are the same from the point of view of the consumer."

169. Lord Justice McCombe rejected HMRC's submission that a recent decision of the CJEU in *Finanzamt Frankfurt am Main V-Hochst v Deutsche Bank AG* (Case C-44/11) [2012] STC 1951 affected this fiscal neutrality analysis (as set out in 166 above). In that case, the CJEU decided (at [45]) that:

> "the principle [of fiscal neutrality] cannot extend the scope of an exemption [being that in the directive for the management of security holdings] in the absence of clear wording to that effect. That principle is not a rule of primary law which can condition the validity of an exemption, but a principle of interpretation, to be applied concurrently with the principle of strict interpretation of exemptions".

170. At [64] McCombe LJ accepted the taxpayer's submission that the current situation was different from the consideration of the strict boundaries of an exemption provided for in the directive itself as in the *Finanzamt* case. In *Sub One* the question was the provision of similar goods, within the same national exemption category, which should be applied consistently with fiscal neutrality:

> "the case [*Finanzamt*] was concerned with "a black letter line", setting the boundaries of an exemption to be found in the Directive itself. The exemption had to be construed strictly and fiscal neutrality principles could not flex those boundaries. Here we are not concerned with such boundaries. We are concerned with a differentiation in treatment between traders supplying similar goods within the same national exemption category. The Appellant submits that if an exemption is in principle permitted in national law by the VAT Directive it must be applied consistently with the principle of fiscal neutrality. I think that Miss Whipple's [counsel for the appellant] submission in this respect is supported by the authorities…."

171. At [65] McCombe LJ noted that the taxpayer's submissions on the fiscal neutrality point also accords with his understanding of the general principle of the fiscal neutrality rules as found in more general cases, such as *Marks & Spencer* and *Rank*. Having set out those decisions, he asks the question whether there was any breach of fiscal neutrality in this case and at [72] answers this as follows:

> "I did not detect in the submissions for the Respondents any contention that the toasted sandwich "Subs" supplied by the Appellant could be significantly distinguished in character for present purposes, from the products that were the subject of the "zero-rate" findings of the tribunals in the cases identified in section A of the appendix. The two types of supplier were, it seems to me, "two supplies of services which are identical or similar from the point of the view of the consumer and meet the same needs of the consumer"… In that sense, there appears to have been a breach of fiscal neutrality. However, that I think could not be said of the Appellant's meatball marinara….."

172. At [73] McCombe LJ goes on to note that, looking at the position apart from any question of fiscal neutrality and simply applying the proper VAT test, the correct treatment was that supplies of both subs and marinaras should be standard-rated. He noted that the fact that competitors of the appellant have been held to be entitled to the zero-rate was a significant misfortune for the appellant. At [74] he continued that the legislation when construed objectively did not fail properly to implement EU law but there had been a failure in practice to implement and/or apply EU law over a number of years. Further, in spite of the developing case law, there was no attempt by government or legislature to clarify the legislation until perhaps 2012, although the possibility (or even the probability) of non-compliance must have been readily apparent.

173. He concluded at [89] that these were not sufficient failings by the UK to entitle the taxpayer to a refund of the VAT charged and in any event (at [90]) there is no EU law right which would entitle the taxpayer to a refund in these circumstances:

> "there is no EU law right in a taxpayer, at least none that I observe in the case law, to be treated in the same way as other taxpayers who have

secured an historic windfall due to a misapplication of the law. As the CJEU put it in the Rank judgement:

> "64 …the principle of fiscal neutrality must be interpreted as meaning that a taxable person cannot claim reimbursement of the VAT paid on certain supplies of services in reliance on a breach of that principle, where the tax authorities of the member state concerned have, in practice, treated similar services as exempt supplies, although they were not exempt from VAT under the relevant national legislation."

This seems to me to be the reverse of the situation that arose in *M&S 2* where the taxpayer had been wrongly taxed under domestic law whereas others had not."

174. Ms Mitrophanous noted that again there was no dispute that the supplies in question fell in the same category. The UK had wrongly applied zero-rating to other supplies which it was accepted were the same as the supplies made by the appellant. It was decided that the appellant did not have any right, whether under fiscal neutrality principles or otherwise, to a refund of the VAT which it had (correctly) paid. She noted that, in response to the point that fiscal neutrality cannot extend categories of exemption (in considering the *Finanzamt* case), the Court of Appeal said it was not a case of extending them but the different treatment of similar goods which came within the same national exemption category.

175. Again, however, our view is that this does not imply a constraint on the applicability of fiscal neutrality principles in the way HMRC argue. The Court accepted (see 168) that the starting point is that it is for the UK to determine the correct border line between standard-rated and zero-rated supplies according to social policy reasons and that, on the basis of the cases including *Rank*, the principle of fiscal neutrality cannot be relied upon as depriving the UK of its discretion in this respect. However, the Court also endorsed the view that it does not follow that the UK can draw the line in such a way as to discriminate between objectively similar supplies and, as in *Rank*, it cannot distinguish between supplies which are the same from the point of view of the consumer. The Court of Appeal regarded this view on the applicability of fiscal neutrality as in accordance with *Marks & Spencer* and not affected by the *Finanzamt* decision. In the circumstances of the case, the Court of Appeal was not called upon to determine where such a line should be drawn, as it was clear that the supplies in question fell within the same category. It seems to us that this simply leaves open the question as to where the correct line is to be drawn in particular cases.

Fiscal neutrality principles as applied in Rank

176. We have further considered the issue of fiscal neutrality, therefore, by reference to the decision of the CJEU in the *Rank* case. In that case the issue was whether the UK had infringed the principle of fiscal neutrality in its application in UK law of the provision in the Sixth Council Directive (77/388/EEC) that "betting, lotteries and

other forms of gambling are exempt from VAT, subject to conditions and limitations laid down by each Member State". The issue concerned certain games of chance including certain slot machine games. A number of questions were referred by the UK courts to the CJEU for a ruling.

177. At [31] the CJEU noted that the first question was:

> "whether the principle of fiscal neutrality must be interpreted as meaning that a difference in treatment for VAT purposes of two supplies of services which are identical or similar from the point of view of the consumer and which meet the same needs of the consumer is sufficient to establish an infringement of that principle or whether such an infringement requires in addition that the actual existence of competition between the services in question or distortion of competition because of the difference in treatment be established."

178. The CJEU noted at [33] that according to settled case-law, the principle of fiscal neutrality precludes treating similar goods and supplies of services, which are thus in competition with each other, differently for VAT purposes (and they referred to a number of cases including *Marks & Spencer*).

179. The CJEU decided (at [31] to [36]) that the principle of fiscal neutrality is not to be interpreted as meaning there is an infringement only if it can be established that there is actual competition or distortion of the market. Rather a difference in treatment for the purposes of VAT of two supplies of services which are identical or similar from the point of view of the consumer and meet the same needs of the consumer is sufficient (at [36]):

> "Having regard to the foregoing considerations, the answer to [the relevant question referred to the CJEU] is that the principle of fiscal neutrality must be interpreted as meaning that a difference in treatment for the purposes of VAT of two supplies of services which are identical or similar from the point of view of the consumer and meet the same needs of the consumer is sufficient to establish an infringement of that principle. Such an infringement thus does not require in addition that the actual existence of competition between the services in question or distortion of competition because of such difference in treatment be established."

180. The next question for the CJEU was whether, where there is a difference in the treatment of two games of chance as regards the grant of a VAT exemption, the principle of fiscal neutrality must be interpreted as meaning that account must be taken of the fact that those two games fell into different licensing categories and were subject to different legal regimes relating to control and regulation. The CJEU concluded (at [51]) that these were not relevant factors.

181. In considering this issue the CJEU noted (at [40]) that under the applicable provision of the VAT Directive member states have a broad discretion as regards the exemption for the taxation of the relevant games since it allows the states to fix the conditions and the limitations for the exemption to apply. However, the CJEU continued (at [41]) to state that, when the member states exercise their discretion in that regard, they must respect the principle of fiscal neutrality inherent in the common system of VAT.

182. The CJEU continued (at [43] and [44]) that in terms of determining whether two supplies are similar:

> "account must be taken of the point of view of a typical consumer (see, by analogy, Case C-349/96 CPP [1999] ECR I-973, paragraph 29), avoiding artificial distinctions based on insignificant differences (see, to that effect, *Commission v Germany*, paragraphs 22 and 23).
>
> Two supplies of services are therefore similar where they have similar characteristics and meet the same needs from the point of view of consumers, the test being whether their use is comparable, and where the differences between them do not have a significant influence on the decision of the average consumer to use one such service or the other (see, to that effect, Case C-481/98 *Commission v France*, paragraph 27, and, by analogy, Joined Cases C-367/93 to C-377/93 *Roders and Others* [1995] ECR I-2229, paragraph 27, and Case C-302/00 *Commission v France* [2002] ECR I-2055, paragraph 23)."

183. The next question (at [52]) was whether or not, in order to assess whether, in the light of the principle of fiscal neutrality, two types of slot machine are similar and require the same treatment for VAT purposes, account must be taken of permitted minimum and maximum stakes and prizes, the chances of winning, the available formats and the possibility of interaction between the player and the slot machine.

184. In considering this the CJEU noted (at [53] and [54]) that if the exemption and the discretion provided to member states:

> "are not to be deprived of all useful effect, the principle of fiscal neutrality cannot be interpreted as meaning that betting, lotteries and other games of chance must all be considered to be similar services within the meaning of that principle. A Member State may thus limit the VAT exemption to certain forms of game of chance (see, to that effect, *Leo-Libera*, paragraph 35).
>
> It follows from that judgment that that principle is not breached where a Member State imposes VAT on services supplied by means of slot machines while exempting horse-race betting, fixed-odds bets, lotteries and draws from VAT (see, to that effect, *Leo-Libera*, paragraphs 9, 10 and 36).

185. However, at [55]:

> "in order not to deprive the principle of fiscal neutrality of meaning and so as not to distort the common system of VAT, a difference of treatment for VAT purposes cannot be based on differences in the details of the structure, the arrangements or the rules of the games concerned which all fall within a single category of game, such as slot machines.

186. Referring back to the earlier passages of the decision at [43] and [44], the CJEU noted at [56], [57] and [58] that:

> "the determination whether games of chance which are taxed differently are similar, which it is for the national court to make in the light of the circumstances of the case (see, to that effect, Joined Cases C-443/04 and C-444/04 *Solleveld and van den Hout-van Eijnsbergen* [2006] ECR I-3617, paragraphs 42 and 45, and *Marks & Spencer*, paragraph 48), must be made from the point of view of the average consumer and take account of the relevant or significant evidence liable to have a considerable influence on his decision to play one game or the other.
>
> In that regard, differences relating to the minimum and maximum stakes and prizes, the chances of winning, the formats available and the possibility of interaction between the player and the slot machine are liable to have a considerable influence on the decision of the average consumer, as the attraction of games of chance lies chiefly in the possibility of winning.
>
> In the light of the foregoing considerations, the answer to [the relevant question] is that, in order to assess whether, in the light of the principle of fiscal neutrality, two types of slot machine are similar and require the same treatment for VAT purposes it must be established whether the use of those types of machine is comparable from the point of view of the average consumer and meets the same needs of that consumer, and the matters to be taken into account in that connection are, inter alia, the minimum and maximum permitted stakes and prizes and the chances of winning."

Fiscal neutrality in this case

187. It is argued by the appellant that there are two relevant comparators for supplies of the Product: the market for flavoured milk products where it is accepted that supplies of Chocolate Nesquik, which the appellant also sells, are zero-rated and supplies of ready-made milk drinks sold by competitors which are also accepted to be zero-rated.

188. Following the approach in *Rank*, the question is whether the supplies of the Product are sufficiently similar to supplies of Chocolate Nesquik and/or ready-made

milk drinks that they should be treated in the same way for VAT purposes. However, our view is that there is an initial question, before making that comparison, as to the appropriate level of category for the comparison.

189. Similarly to the situation in *Rank*, where the UK had an element of discretion as to the precise scope of the VAT exemption in question, the UK has discretion as to which supplies, which were zero-rated in 1991, to continue to zero-rate provided that the provisions are justified by social policy objectives and are in accordance with Community law. In *Rank* it was held that the exemption in question and the UK's discretion as regards the exemption would be deprived of all useful effect if fiscal neutrality meant that betting, lotteries and other games of chance must all be considered to be similar services. A member state may thus limit the VAT exemption to certain forms of game of chance (see 184 above). However, the CJEU noted that, in order not to deprive the principle of fiscal neutrality of meaning and so as not to distort the common system of VAT, a difference of treatment for VAT purposes cannot be based on differences in the details of the structure, the arrangements or the rules of the games concerned, which all fall within a single category of game, such as slot machines (see 185).

190. In our view, this leads to an initial difficult issue in applying the fiscal neutrality principle to these zero-rating provisions of determining the correct level of category within which all sufficiently similar supplies must be treated in the same way. The UK has, in exercise of its discretion to continue to zero-rate supplies (where zero-rated in 1991), set out a general category of supplies which are zero-rated, being supplies of "food of a kind used for human consumption". That general category is then narrowed down by the combined effect of the excepted item and overriding item provisions to allow zero-rating only for certain quite specific categories of supplies of such food.

191. The Court of Appeal in *Sub One* seems to acknowledge this tension between the UK's discretion to set zero-rating boundaries according to social policy and the application of fiscal neutrality. As set out above, the Court of Appeal endorsed the view that the starting point is for the UK to determine the correct border line between zero-rated and standard-rated supplies according to social policy and the principle of fiscal neutrality cannot deprive the UK of its discretion in this respect, referring to *Rank* as authority for this. However, the Court also endorsed the view that this does not mean that the UK can discriminate between objectively similar supplies. The Court of Appeal does not provide any further guidance as to where or how the appropriate line is to be drawn without that being held to deprive the UK of the legitimate exercise of its discretion.

192. It seems clear to use that, as in *Rank*, the UK's discretion would be deprived of useful effect if the principle of fiscal neutrality means that supplies of all types of "food of a kind used for human consumption" must be considered similar. The more difficult question is to what extent fiscal neutrality principles can be held to determine the boundaries of the more specific categories. In that context the initial issue is that, the outcome of the appellant's argument, if successful, would be that, as HMRC point out, supplies of the Product in effect would be treated as though they come within the

zero-rating provisions for cocoa products and milk products notwithstanding that the Product contains no cocoa or milk.

193. We look at this first in the context of the appellant's argument that supplies of all flavoured milk products should be treated in the same way, in particular, having regard to the accepted zero-rating of the appellant's own Chocolate Nesquik. Chocolate Nesquik is not currently zero-rated because it is a flavoured milk product. It is common ground that Chocolate Nesquik is zero-rated on the basis that, although it may be "a powder for the preparation of beverages" within excepted item 4, it falls within one of the permitted overriding categories as "a preparation or extract of cocoa". The powder contains 19% cocoa (or thereabouts). In making this argument, therefore, in effect the appellant is taking the stance that the Product should be treated on the same basis as a product which is zero-rated because it is a cocoa product.

194. In our view, following the approach in *Rank*, it would simply deprive the UK of its discretion, in deciding what foods should be zero-rated, to decide that fruit based powders, with no cocoa content at all, have to be treated in the same way as cocoa based ones. The UK has provided zero-rating for cocoa products including for powders which constitute "preparations" or "extracts" of cocoa. That is the exercise of the UK's discretion in favour of cocoa products. It seems to use that the proposition that all flavoured milk products should be treated in the same way can only viably be tested (on the basis that the argument is that they all service the flavoured milk drinks market) by reference to the wider market for flavoured milk drinks which brings us to the appellant's second argument.

195. The second argument is that supplies of flavoured powders for use only in making milk drinks should be zero-rated (regardless of flavour or precise content of ingredients) as ready-made milk drinks (which are similar to the resulting Nesquik drink) are zero-rated. Our understanding is that such ready-made milk drinks are zero-rated because although they fall within excepted item 4 (as "beverages") they contain sufficient milk to be accepted as "preparations" or "extracts of" milk within overriding item 6. The issue, therefore, is whether the Product ought to be treated in the same way as such ready-made drinks in effect under the overriding category "milk and preparations and extracts thereof".

196. Again it can be argued that it would deprive the UK of its discretion if products which contain no milk at all have to be considered in the same way as such milk products. We do not see this as being as clear cut, however, as the position in relation to the comparison with Chocolate Nesquik. Although the Product is not itself a milk product, it is clear that it is only intended for use with milk to make a milk drink and that is how it is marketed and commonly used. The resulting flavoured milk drink is, we found on conducting a tasting, similar from the consumer's perspective to certain of the ready-made milk drinks. In that context, in our view, that the Product does not itself contain milk is not necessarily fatal to the fiscal neutrality argument without further consideration of the similarity between the supplies of the two sets of products. In effect the question is whether fiscal neutrality can enable supplies of a product, which does not contain milk, to be treated in the same way as supplies of

milk drinks on the basis that the product is solely for use with milk and the end result of the use of the product is a milk drink.

197. Under the principles in *Rank* the issue is whether the relevant supplies are sufficiently similar from the perspective of the average or typical consumer such that they ought to be treated in the same way for VAT purposes. Supplies are similar where they have similar characteristics and meet the same needs from the point of view of such a consumer.

198. Although the *Rank* case concerned supplies of services, we think it clear that the same test applies to supplies of goods. The CJEU noted early on in the decision (see 178) that fiscal neutrality applies to supplies of services and goods and there is no indication that the principles are limited to services.

199. In determining whether supplies of goods meet the same needs of the consumer the question is whether their use is comparable and whether the differences between them have a significant influence on the decision of the average consumer to buy one set of goods or the other. Account must be taken of the relevant or significant evidence liable to have a considerable influence on the consumer's decision. In making this assessment the CJEU cautions that artificial distinctions based on insignificant differences must be avoided (such as, in the *Rank* case, the differences in licensing of the relevant games) as must minor differences, such as in *Rank* differences in the details of the structure, the arrangements or the rules of the games concerned, which all fall within a single category of game. The CJEU held that the factors likely to have a considerable influence on a consumer's decision to play one slot machine game or the other were differences relating to the minimum and maximum stakes and prizes, the chances of winning, the formats available and the possibility of interaction between the player and the slot machine, as the attraction of games of chance lies chiefly in the possibility of winning.

Comparison of the Product with Chocolate Nesquik

200. As set out above, we do not consider the comparison with Chocolate Nesquik as a valid one and that is sufficient to dispose of this point (see 193 and 194). However, we have considered further the similarity issue, in case we are wrong on that. It is clear that the Product and Chocolate Nesquik do have similar characteristics and their use is highly comparable in meeting the needs of the consumer. They are both powders designed to be added to milk for consumption as a milk drink. The formulation of the powders is the same (leaving aside flavouring for a moment) except as regards some differences in nutrients largely arising due to the natural composition of the cocoa in Chocolate Nesquik. The powders are packaged in the same way and are sold in the same way through the same retailers with the same pricing and advertising with exactly the same ultimate market in mind.

201. The powders are recommended to be used in exactly the same way albeit that in practice consumers may more often choose to add Chocolate Nesquik to hot milk than they would the Product which would usually be used in cold milk. We do not, however, see that as a sufficient difference of itself. The essential point is that the

powders satisfy the same needs of the consumer in the sense of providing the means to prepare a glass of fortified flavoured milk drink.

202. The obvious main difference between the product is the flavour and the fact that Chocolate Nesquik is a cocoa based product and the Product is fruit based (strawberry or banana). We agree with HMRC that flavour is likely to be key to the consumer in deciding which powder to buy and that many consumers would view a chocolate product as different to a fruit flavoured one (as further set out in their submissions at 109). We would not, therefore, regard the Product as sufficiently similar to Chocolate Nesquik.

Comparison of the Product with ready- made drinks

203. As regards the comparison of the Product with ready-made drinks, the obvious difference is that Products are of course powders, for adding to milk to make a drink, whereas the drinks are ready formed drinks for consumption as they are. Essentially the appellant argues that Product meets the same needs of the consumer as the ready-made drinks as, in each case, the final consumption is of a milk drink. The test looks to the final act of consumption. Whether the consumer had to make efforts to produce that end result, how often he had to go to the supermarket to buy the product and where the product is stored (the larder or the fridge) has no impact on this test; these factors do not relate to the act of consumption. The Product is an ingredient in a "beverage" and therefore should be taxed in the same way as the "beverage" itself would be (if sold as such). On the other hand HMRC state that such differences are key ones which influence a consumer in which product to pick.

204. In the context of a supply of goods, our view is that the consumer of relevance is the person who receives the supply being the person who buys the product. This may or may not be the person who ultimately consumes the product in the sense of drinking the Nesquik drink or ready-made milk drink. The evidence given, as regards the Product, is that typically the purchaser would be a parent with a view to using the Product to provide milky drinks for children.

205. In that context we cannot see why the test is to be interpreted, as Mr Cordara argues, by reference to the final act of drinking the relevant drink only. At a general level it can be said that clearly the consumer who buys the Product or a ready-made drink is, in each case, buying a product with a view to having the means or providing others (such as family members) with the means to consume a milk drink. However, the question is, looking at the available evidence, what would influence the consumer/purchaser in choosing one product or another to satisfy this need. In our view, in deciding whether to buy a ready-made milk drink or a powder to be used with milk purchased separately, the consumer is likely to be influenced by a number of factors such as how and when the consumer wishes to use the product and the pricing of the product.

206. The following can be identified as the differences between the products:

(1) The Product is sold as a powder. It makes a drink only if added to milk which must be purchased separately. This involves a degree of preparation (of stirring in the powder to a small amount of milk and then adding further milk). Ready-made drinks are ready for consumption as they are.

(2) It follows that in order to use the Product as intended the consumer will need to be somewhere where it has a receptacle such as a glass or cup and a spoon and to have milk available. Some of the ready-made drinks in the market, such as those sold in smaller bottles, are intended to be drunk "on the go" from the packaging in which they are sold. Others, such as those provided in large cartons, could not be very easily drunk without being poured into a glass or cup.

(3) The Product has a long life of around 12 months (whether opened or not). Ready made drinks were described as typically having a life of a few days only as they contain fresh milk.

(4) The Product, as a powder, can be stored in a cupboard or larder whereas the ready-made drinks last for a few days only and require refrigeration to be kept for that long.

(5) The Product is typically more expensive than ready-made drinks but the pricing reflects that it provides many more servings (an average of 20 in a 300gm tub) compared with a maximum of a few servings only in a carton of a ready-made drink.

207. Our view is that, taken together, these differences are likely to have a significant influence on the consumer in making a choice. A purchaser of the Product is buying a powder for use at home/at a base (as it requires refrigerated milk and the use of a cup/glass and spoon) potentially over quite a long period of time. It can be used as and when they/the family want a glass of flavoured milk assuming they have milk available. The Product is a dry store cupboard item which provides a relatively economical way of providing flavoured milk on an intermittent or regular basis depending on the appetite. The purchaser of the Product buys it knowing that some preparation and other shopping (as regards the purchase of milk) is required for its use.

208. A purchaser of a ready-made drink is buying a prepared drink for immediate or relatively immediate consumption either all in one go or in a few servings only but essentially to satisfy an immediate or near immediate desire for a milk drink. The purchaser of a ready-made drinks buys it knowing that nothing needs to be done except by open the relevant packaging and pouring the drink. The differences are further emphasised as regards ready-made drinks in smaller size packaging suitable for drinking there and then when purchased or "on the go". We accept that there is less of a difference as regards other ready-made drinks in larger packaging (which it is unsuitable to drink from) in the sense that they would generally have to be taken home/to a base to be consumed. However, that is not sufficient to affect our conclusion that on the evidence presented supplies of the Product are not sufficiently similar to supplies of such ready-made drinks under the *Rank* test.

Conclusion

209. For all the reasons set out above, we have concluded that the appellant's supplies of the Product in the relevant period are standard-rated supplies. Accordingly the appellant is not entitled to the repayment of VAT accounted for on the relevant supplies. The appeal is dismissed.

210. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this 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.

HARRIET MORGAN
TRIBUNAL JUDGE

RELEASE DATE: 22 FEBRUARY 2016

ANNEX

Group 1 provisions relating to food

"GROUP 1 - FOOD

The supply of anything comprised in the general items set out below, except –

(a) a supply in the course of catering; and

(b) a supply of anything comprised in any of the excepted items set out below, unless it is also comprised in any of the items overriding the exceptions set out below which relates to that excepted item.

General items

Item No

1 Food of a kind used for human consumption….

Excepted items

Item No

1 Ice cream, ice lollies, frozen yoghurt, water ices and similar frozen products and prepared mixes and powders for making such products.

2 Confectionery, not including cakes or biscuits other than biscuits wholly or partly covered with chocolate or some product similar in taste and appearance.

3 Beverages chargeable with any duty of excise specifically charged on spirits, beer, wine or made-wine and preparations thereof.

4 Other beverages (including fruit juices and bottled waters) and syrups, concentrates, essences, powders, crystals or other products for the preparation of beverages.

4A Sports drinks that are advertised or marketed as products designed to enhance physical performance, accelerate recovery after exercise or build bulk, and other similar drinks, including (in either case) syrups, concentrates, essences, powders, crystals or other products for the preparation of such drinks.

5 Any of the following when packaged for human consumption without further preparation, namely, potato crisps, potato sticks, potato puffs, and similar products made from the potato or from potato flour, or from potato starch, and savoury food products obtained by the swelling of cereals or cereal products; and salted or roasted nuts other than nuts in shell.

6 Pet foods, canned, packaged or prepared; packaged foods (not being pet foods) for birds other than poultry or game; and biscuits and meal for cats and dogs.

7 Goods described in items 1, 2 and 3 of the general items which are canned, bottled, packaged or prepared for use –
(a) in the domestic brewing of any beer;
(b) in the domestic making of any cider or perry;
(c) in the domestic production of any wine or made-wine.

Items overriding the exceptions

Item No

1 Yoghurt unsuitable for immediate consumption when frozen.

2 Drained cherries.

3 Candied peels.

4 Tea, maté, herbal teas and similar products, and preparations and extracts thereof.

5 Cocoa, coffee and chicory and other roasted coffee substitutes, and preparations and extracts thereof.

6 Milk and preparations and extracts thereof.

7 Preparations and extracts of meat, yeast or egg.

NOTES:

(1) "Food" includes drink…

(4) Item 1 of the items overriding the exceptions relates to item 1 of the excepted items.

(5) Items 2 and 3 of the items overriding the exceptions relate to item 2 of the excepted items; and for the purposes of item 2 of the excepted items "confectionery" includes chocolates, sweets and biscuits; drained, glacé or crystallised fruits; and any item of sweetened prepared food which is normally eaten with the fingers.

(6) Items 4 to 6 of the items overriding the exceptions relate to item 4 of the excepted items."

HMRC Guidance in VFOOD7740

"**Excepted items: beverages: syrups for the preparation of beverages**

It used to be policy that all syrups for making standard-rated drinks were standard-rated. This implied that the syrups and such like for making zero-rated drinks would therefore be zero-rated.

We now believe that the correct interpretation of the law means that syrups:

used to prepare a wholly new beverage are standard-rated; but those intended to merely flavour a beverage without producing a new product are zero-rated.

Syrups and similar which are designed to be added to, or diluted by, water, milk, or carbonated or soda water to be made up into beverages fall into the first category, and will be standard-rated as falling within excepted item 4.

Syrups and similar which are designed only to flavour beverages such as coffee, tea or alcoholic drinks fall into the second category and are zero-rated. Other syrups and similar may be zero-rated if they do not fall within the excepted items, such as those designed to be made up into drinks which are not beverages (for example sports energy drinks).

Others will be zero-rated because they fall within items 4 to 7 of the items overriding the exceptions, because they are in their own right preparations and extracts of tea, coffee, cocoa, milk and so on."