Neutral Citation Number: [2015] EWCA Civ 1211

Case No: A3/2014/2814

IN THE COURT OF APPEAL (CIVIL DIVISION)
ON APPEAL FROM THE UPPER TRIBUNAL (TAX AND CHANCERY CHAMBER)
NUGEE J - [2014] UKUT 200 (TCC)
ON APPEAL FROM THE FIRST-TIER TRIBUNAL (TAX CHAMBER)
JUDGE MICHAEL TILDESLEY OBE & RUTH WATTS DAVIES FCIPD
MIH - [2013] UKFTT 381 (TC)

Royal Courts of Justice
Strand, London, WC2A 2LL

Date: 26 November 2015

Before :

THE CHANCELLOR OF THE HIGH COURT
LORD JUSTICE PATTEN
and
LORD JUSTICE CHRISTOPHER CLARKE

- -

Between :

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS	**Appellant**
- and -	
MERCEDES-BENZ FINANCIAL SERVICES UK LIMITED	**Respondent**

- -
- -

Mr Owain Thomas and **Mr Matthew Donmall** (instructed by **the General Counsel and Solicitor to HM Revenue and Customs**) for the **Appellant**
Mr Kevin Prosser QC (instructed by **Mishcon de Reya LLP**) for the **Respondent**

Hearing date : 21 October 2015

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Approved Judgment

Lord Justice Patten :

Introduction

1. This is the judgment of the Court.

2. This is an appeal by the Commissioners for Her Majesty's Revenue and Customs ("HMRC") against a decision of the Upper Tribunal (Tax and Chancery Chamber) (Nugee J) released on 2 May 2014. It concerns the proper tax treatment of so-called Agility hire purchase contracts entered into between Mercedes-Benz Financial Services UK Limited ("MBFS") and its customers in respect of the supply of Mercedes-Benz vehicles. The particular issue on which the appeal turns is whether for VAT purposes the Agility contract falls to be treated as a supply of services (which is MBFS's case) or, as HMRC contend, a supply of goods. The resolution of this issue turns on the correct interpretation and application of Article 14 of the Principal VAT Directive (2006/112/EEC) ("the Directive") which, so far as material, provides:

> "1. 'Supply of goods' shall mean the transfer of the right to dispose of tangible property as owner.
>
> 2. In addition to the transaction referred to in paragraph 1, each of the following shall be regarded as a supply of goods:
>
> (a) the transfer, by order made by or in the name of a public authority or in pursuance of the law, of the ownership of property against payment of compensation;
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> (b) the actual handing over of goods pursuant to a contract for the hire of goods for a certain period, or for the sale of goods on deferred terms, which provides that in the normal course of events ownership is to pass at the latest upon payment of the final instalment;
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> (c) the transfer of goods pursuant to a contract under which commission is payable on purchase or sale."

3. The facts are set out in paragraphs 4-16 of the Upper Tribunal Decision which, for convenience, I have reproduced as an Appendix to this judgment. But the following points are of particular relevance:

   (1) the Agility contract is one of three financial products provided by MBFS to its customers in relation to Mercedes-Benz vehicles. The other two are "Hire Purchase" and "Leasing" contracts. Under a Leasing contract, the customer simply hires the vehicle for 36 months in return for a monthly rental payment. There is no option to purchase at the end of the term. Under the Hire Purchase ("HP") contract, the customer is given the option to purchase the vehicle at the end of the hire period usually on payment of a small option fee of £95. Some HP agreements provide for the balance of the price (after payment of a deposit) and the amount of the credit to be paid in 36 equal monthly instalments over the term of the agreement so that only the option fee remains

payable by the customer who wishes to acquire the vehicle. But others provide for lower monthly payments and for a substantial "balloon" payment as the final monthly instalment together with the option fee. In both cases, the customer will have paid the price of the vehicle and the amount of credit by the end of the term so that a failure by him to exercise the option to purchase would be wholly uncommercial;

(2) the Agility agreement, like the HP agreement, provides for a term of 36 months with an option to purchase at the end of the term. Like the Leasing and the HP agreements, in most (if not all) cases, it is also regulated under the Consumer Credit Act 1974. But it differs from the HP agreement in that the monthly payments are calculated by reference to the difference between the purchase price of the vehicle and its anticipated residual value at the end of the term plus interest so that, even when the customer has made all the obligatory contractual payments, a substantial amount of the original purchase price will remain unpaid. If the customer decides at the end of the term that he does wish to exercise the option to purchase, his final monthly payment will therefore be a sum equal to the vehicle's estimated residual value in addition to the £95 option fee. The final monthly payment (described as an Optional Purchase Payment) amounted in the examples given to something in excess of 40% of the original purchase price;

(3) if the customer decides not to exercise the option to purchase, the vehicle is disposed of by MBFS to a sister company under a guaranteed buy-back agreement which means that it takes no risk "on the metal";

(4) where (as in most cases) the HP and Agility agreements are regulated agreements then the customer is given a statutory right of termination under the Consumer Credit Act. If exercised, the most that MBFS can recover from the customer is half the total amount that is payable under the agreement.

4. It is common ground that the Leasing agreement constitutes a supply of services for VAT purposes. There is no provision in the contract for the customer to acquire the property in the vehicle. But the parties are divided as to whether the Agility agreement with its substantial optional payment for the acquisition of the vehicle falls to be treated in the same way.

5. The first submission of HMRC is that, properly construed, Article 14(2)(b) identifies as a supply of goods any contract of hire under which title will normally pass no later than upon payment of the final instalment. In other words, that the reference in Article 14(2)(b) to the contract providing that "in the normal course of events ownership is to pass at the latest …" is concerned to specify when title is to pass rather than whether or not it will pass. If this construction is correct then there is no need to venture into issues of whether, economically or otherwise, the purpose of the contract was to secure the passing of title or the significance for VAT purposes of the optionality of the right to purchase the vehicle. Article 14(2)(b) would catch every hire contract under which the customer is able to acquire title to the goods by no later than the payment of the final instalment.

6. Mr Thomas for HMRC argued before the First-tier Tribunal that this construction of Article 14(2)(b) derived support from the French language version of the text of the Directive which does not refer as such to the normal course of events but states:

> "la remise matérielle d'un bien en vertu d'un contrat qui prévoit la location d'un bien pendant une certaine période ou la vente à tempérament d'un bien, assorties de la clause que la propriété est normalement acquise au plus tard lors du paiement de la dernière échéance"

7. The First-tier Tribunal followed what seems to have become its normal practice of declining to enter into a consideration of any foreign language version of the Directive without the benefit of expert assistance: see e.g. *Volkswagen Financial Services (UK) Ltd v Revenue and Customs Commissioners* [2012] SFTD 190 at [60]. The First-tier Tribunal rejected this argument and it was not pursued on appeal to the Upper Tribunal. We have therefore heard no substantive argument on the point, although HMRC have reserved their right to take the point on any reference of this case to the CJEU.

8. The argument before the Upper Tribunal therefore concentrated on whether the First-tier Tribunal was right to hold that a contract of hire falls within Article 14(2)(b) if, under its terms, the passing of title in the goods is a normal rather than an abnormal event. The First-tier Tribunal had set out it reasons in [91]-[96] of its Decision: ([2013] UKFTT 381 (TC)):

> "91. The Tribunal prefers HMRC's alternative construction of in normal course of events namely that the possible passing of title was an essential feature of Agility rather than an eventuality which may only arise in limited and exceptional circumstances. HMRC's alternative construction did not stray away from the governing principle that the application of Article 14(2)(b) was determined by the terms of contract. The Tribunal's analysis of Agility's terms found that the option to purchase constituted the sole realistic option under the agreement. The transfer of ownership was, therefore, central to the Agility contract, not tangential.
>
> 92. The phrase normal course of events is directed at the legal realities of a contract for sale with an option to purchase. The phrase recognises that under the terms of such a contract ownership might not pass but that possibility did not prevent the contract from being a contract for sale under which ownership normally transferred. Thus the fact that ownership might not transfer under the Agility contract did not preclude it from being a contract for sale. The passing of title was central to Agility which meant that ownership would normally pass under its terms.
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> 93. This Tribunal has arrived at the same conclusion as expressed in *Rodney Hogarth*:

> "What usually happens under a hire purchase transaction is that the customer makes the payments and eventually becomes the owner of the goods, in both cases in accordance with the hire purchase agreement. In my judgment that course of events is one which is referred to in Article 5.4 as 'the normal course of events', and such an agreement is an example of an agreement which 'expressly contemplates' that the property 'will' pass as mentioned in paragraph 1(2)(b). In my judgment the fact that the agreement also contemplates other possible events in which the property will not pass, such as the premature termination of the agreement, does not prevent the agreement from being an agreement which contemplates that the 'will inevitably', but 'will in certain events'".

94. Although Hogarth was concerned with the wording of paragraph 1(2)(b) of Schedule 4 VAT 1994, there was no argument put forward in this Appeal to suggest that the terms of Article 5 14(2)(b) were more restrictive than those of the VAT Act 1994.

95. The Tribunal considers the ratio in Hogarth and HMRC's construction of normal, rather than abnormal were fundamentally different from the Appellant's more likely than not test. The former were looking to what the contracts provided as to when ownership is to pass. Whereas, the Appellant's more likely than not test was about the likelihood of the subsequent exercise of the option to purchase. The likelihood appeared to be determined by some form of risk evaluation based upon a range of extraneous factors not directly related to the terms of contract. In this respect the Tribunal's rejection of a role for risk evaluation in deciding the application of Article 14(2)(b) meant that there was no place for the Accounting Standards in this Appeal which was not concerned with the distinctions between operating and finance leases.

96. The Tribunal also considers that HMRC put forward two other powerful arguments for why the Appellant's position was wrong. First the classification of a transaction as a supply of goods or services was not one that could only be known at the end of the term of the contract. If the supply under the Agility contracts was a supply of goods then VAT must be accounted for on the sale price of the car at the time when it was handed over the customer. Under the Appellant's construction the correct characterisation of the supply under Agility would only be known at contract maturity when a decision was required on the option to purchase. Thus the Appellant's construction

> resulted in a situation where the application of Article 14 did not produce an answer one way or the other at the time the vehicle was supplied. Such a proposition was clearly wrong and offended the principle of legal certainty. Second if the Appellant's interpretation was correct, it would exclude all hire purchase agreements, given the possibility of termination either in the exercise of a right or because of a default.

9. It was common ground before the Upper Tribunal that there is no decision of the Court of Justice directly on the point at issue on this appeal. But the parties were also agreed about a number of general principles which bear on the proper legal approach to the interpretation and application of Article 14(2)(b):

   (1) the question whether a contract falls within Article 14(2)(b) falls to be determined at the date of the contract by reference to its provisions and not with the benefit of hindsight as to whether the customer subsequently chooses (or not) to exercise the option to purchase;

   (2) the concept of supply of goods has to be determined as a matter of EC law rather than in accordance with any particular national law so as to be applied universally across the various legal systems of the EC;

   (3) it is objective in nature being applied without regard to the purposes or results of the transaction in question and, in particular, without regard to the subjective intentions of the taxable person: see *Newey v HMRC* Case C-653/11 at [41]; *Dixons Retail plc v HMRC* Case C-494/12 at [21].

10. The Upper Tribunal also derived from the authorities the following principles: see [25](4)-(6):

> "(4) Consideration of the economic and commercial realities is a "fundamental criterion" for the application of the common system of VAT. Since the contractual position normally reflects the economic and commercial reality of a transaction, the relevant contractual terms constitute a factor to be taken into consideration; but sometimes contractual terms do not wholly reflect the economic and commercial reality of a transaction, in particular if it becomes apparent that the contractual terms constitute a purely artificial arrangement which does not correspond with the economic and commercial reality of the transaction: *Newey* at [42]-[45]. This passage has very recently been referred to and relied on by the Supreme Court in *Secret Hotels2 Ltd v Revenue and Customs Commissioners* [2014] UKSC 16 at [29] per Lord Neuberger.
>
> (5) In a passage cited by Jonathan Parker LJ in *Tesco plc v Customs and Excise Commissioners* [2003] EWCA Civ 1367 (*"Tesco"*) at [41], the Advocate General (Tizzano) said this in his opinion in *Customs and Excise*

Commissioners v Mirror Group plc Case C-409/98 and *Customs and Excise Commissioners v Cantor Fitzgerald International* Case C-108/99:

> "27. In order to identify the key features of a contract, however, we must go beyond an abstract or purely formal analysis. It is necessary to find the contract's economic purpose, that is to say, the precise way in which performance satisfies the interests of the parties. In other words, we must identify the element which the legal traditions of various European countries term the cause of the contract and understand as the economic purpose, calculated to realise the parties' respective interests, lying at the heart of the contract. In the case of a lease, as noted above, this consists in the transfer by one party to another of an exclusive right to enjoy immovable property for an agreed period.
>
> 28. It goes without saying that this purpose is the same for all the parties to the contract and thus determines its content. On the other hand, it has no connection with the subjective reasons which have led each of the parties to enter into the contract, and which obviously are not evident from its terms. I have drawn attention to this point because, in my view, failure to distinguish between the cause of a contract and the motivation of the parties has been the source of misunderstandings, even in the cases under consideration here, and has complicated the task of categorising the contracts at issue."

Jonathan Parker LJ later in his judgment made the point that the "economic purpose" here referred to by the Advocate General is not the same as "economic effect": two transactions may have the same economic effect but that does not necessarily mean that they are to be treated in the same way for VAT purposes: see *Tesco* at [159].

(6) In *MBNA Europe Bank Ltd v HMRC* [2006] EWHC 2326 (Ch) (*"MBNA"*), Briggs J referred to the same passage from Advocate General Tizzano's opinion in saying (at [35]) that the Court is not hidebound by the labels which the parties have chosen to apply to their transactions but must where necessary ascertain the

> "essential character of the transaction in issue". He continued (at [36]):
>
> > "The identification of the "cause" of a contractual transaction, where necessary to establish whether it constitutes a supply, and if so to categorise it as taxable, exempt or specified, may legitimately entail its interpretation by reference to the relevant matrix of background facts known to the parties of the type classically explained by Lord Hoffmann in *West Bromwich* [2005] UKHL 44.""

11. Any analysis of the meaning and effect of Article 14(2)(b) must begin with the words used. Mr Thomas emphasised before the Upper Tribunal, as he did before us, that the focus of the words in dispute is on what the contract "provides" and not with a more general question of what, viewed at the date of the contract, is likely or expected to happen. Since it is unrealistic to envisage a hire contract which provides in terms that ownership will pass "in the normal course of events" by a certain date, that phrase has to be interpreted as descriptive of the effect of the relevant terms of the contract. One approach to this is the timing argument I have mentioned which was raised in the First-tier Tribunal but not pursued on appeal. But HMRC's alternative approach is to treat Article 14(2)(b) as concentrating on the existence as a term of the contract of the right to purchase the goods rather than the likelihood of the option being exercised.

12. Mr Thomas makes the obvious point that the inclusion of both hire contracts and contracts of purchase on deferred terms within Article 14(2)(b) indicates that the Directive cannot be read as limiting the application of Article 14(2) to contracts under which the customer was bound to purchase the goods. An HP contract containing an option to purchase is the obvious type of hire contract to qualify. But Mr Thomas resists reading into Article 14(2)(b) the need (even on an objective basis) to make any further inquiry as to the inherent likelihood of the option being exercised. The contract, he submits, falls into the Directive's extended definition of a supply of goods if the acquisition of title is the normal method of performing the contract which is to be inferred from the existence of the option (absent any contractual provisions to the contrary) rather than some kind of objective determination of the economic probabilities involved. The judge in the Upper Tribunal thought that the reference in Article 14(2)(b) to the contract providing that "in the normal course of events ownership *is to pass*" was inconsistent with the argument that it was intended to catch most types of option: see [32] of the judgment of the Upper Tribunal. But Mr Thomas's response to this would be that it proves too much and that the words "is to pass" have to be read as a piece with the preceding words "in the normal course of events". The whole phrase is descriptive of a hire contract which, absent special circumstances, permits ownership to be acquired. That construction does not require one to look further than the terms of the contract itself in order to identify whether such a contractual mechanism exists.

13. The Upper Tribunal took the view that Article 14(2)(b) calls for an economic analysis of the transaction:

> "In my judgment the discernible policy purpose behind the inclusion of certain contracts of hire in Art 14(2)(b) is to tax transactions where the customer has in reality agreed to buy the goods as if they were contracts of sale, even though in law the customer is not contractually obliged to complete the purchase. This explains why the language of Art 14(2)(b) refers to the ownership of goods passing in the normal course of events, or normally – it is not concerned with every contract under which there is a possibility of the ownership passing, but only with those contracts where this can be described as the normal outcome."

14. This is obviously a possible interpretation of the descriptive phrase "in the normal course of events" but it poses difficulties in defining how it is to be accommodated within the established principles of construction which require the determination of whether the supply is one of goods or services to be made at the date of the contract and to exclude any consideration of the customer's subjective intent in opting for that method of financing his acquisition of the vehicle. As Nugee J himself recognised, the test of economic reality, if it is to be workable, needs to be able to identify which types of hire contract with an option to purchase constitute a supply of goods simply on an objective assessment of the contract at the date when it is made and without reference to any available evidence as to the percentage of Agility customers who do in fact choose to exercise the option to purchase. This means that the focus has to be on the provisions of the contract itself in order to determine whether ownership will pass "in the normal course of events" and it brings one back to the difficulty identified by Mr Thomas in his submissions that the contract itself does not specify whether the option is or is not likely to be exercised.

15. The Upper Tribunal's answer to this conundrum was to resort to the test of economic purpose explained by Advocate General Tizzano in his opinion in the *Mirror Group* case quoted earlier:

> "48. What I have found most helpful is the guidance given by Advocate General Tizzano cited and followed in *Tesco*. This requires one to find the contract's "economic purpose", that is to say, "the precise way in which performance satisfies the interests of the parties"; or the element (termed in some legal systems the cause of the contract) which is the "economic purpose, calculated to realise the parties' respective interests, lying at the heart of the contract." It seems to me to follow that the question under Art 14(2)(b) is whether the contract is one whose economic purpose is for the customer to acquire ownership of the goods. This is to be identified by looking at the interests which performance of the contract satisfies; or, as I suggested in argument (a suggestion adopted by Mr Prosser) by looking at what the contract is designed to achieve: compare the formulation in sch 4 para 1(2)(b) of VATA which refers to "agreements which

… contemplate that the property … will pass" (although this has its own difficulties: see below).

49. In the case of the equal instalment HP agreement, it is easy to see that this test is satisfied. Although there is no legal obligation on the customer to exercise the option to purchase, performance of the contract will in fact lead to the customer paying MBFS the entire purchase price of the vehicle together with interest over 3 years, at the end of which he is able to acquire the ownership of the vehicle for a minimal fee. One does not need to examine the marketing material, or the subjective intentions of the parties, to see that the interests which performance of the contract satisfies are (i) the customer's interest in being able to finance the acquisition of a vehicle by having 3 years to pay the purchase price by instalments, with interest on the reducing balance, and then being in a position to acquire the vehicle at no extra cost (beyond a minimal fee) and (ii) MBFS's interests in receiving the purchase price, together with interest, and having security for payment in the shape of retention of ownership until the price has all been paid. Put another way, the contract is designed to achieve sale of the vehicle to the customer with the customer being given time to pay and MBFS being given security; the structure of the contract is such that it can be said that it contemplates that property will pass. Such a contract would appear to be the paradigm example of a contract within Art 14(2)(b): indeed, as Mr Thomas said, if HP contracts are not within the first limb of Art 14(2)(b) it is very difficult to see what sort of contract might be.

50. Equally in the case of the balloon type of HP agreement. As I have said it was not disputed by Mr Prosser that such a contract would fall within Art 14(2)(b), and I agree. Here too performance of the contract will lead to the customer paying the entire price of the vehicle by the end of the 3 year period, and it seems to me that the interests of the parties which performance of the contract will satisfy are the same.

51. This is so even though (assuming the agreement is a regulated one) the customer has a right to terminate the contract early; and even though as a matter of fact a significant number of customers exercise this right. This is not because, as Mr Prosser at one stage submitted, the right to terminate is a right under statute rather than under the contract. I do not think this makes any significant difference: the agreement itself refers prominently to the right to terminate, and as Mr Thomas said even if the

rights are statutory they form part of the terms on which the transaction takes place. It cannot matter whether the statute is regarded as directly modifying the terms of a contract, or as giving a statutory right outside the contract: the effect is the same, which is that a customer under a regulated agreement has a right to terminate it early on payment of the specified amount.

52. Rather in my judgment the reason why early termination rights do not prevent the contract being one within Art 14(2)(b) is because the exercise of a right to terminate the contract early is not a performance of the contract, but a means of avoiding performance. In other words when asking the question what are the interests of the parties that performance of the contract satisfies, one assumes that the contract will be performed, not brought to an early end, even if early termination is lawful rather than a breach of contract. I derive this simply from the way in which Advocate General Tizzano describes the task of finding the contract's economic purpose; but it is also reinforced by the wording of Art 14(2)(b). If one is asking what a contract provides for "in the normal course of events" this in my judgment requires assuming that the contract will be performed, not prematurely terminated.

…..

63. For the reasons I have given above, I accept Mr Prosser's submission that the FTT made an error of law in their interpretation of Art 14(2)(b). It is not sufficient for a contract to come within Art 14(2)(b) for it to contain a provision under which the hirer has an option to acquire the ownership of the vehicle at the end of the hire period, and that such acquisition is *a* normal outcome. In order for a contract to come within Art 14(2)(b) it must be *the* normal outcome of the contract, this being determined in accordance with the guidance given by Advocate General Tizzano by reference to the economic purpose of the contract, that is by looking at the parties' respective interests which performance of the contract satisfies.

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78. Before coming to the FTT's findings in detail, I should say that I myself would have no difficulty in accepting both Mr Thomas's and Mr Prosser's characterisation of the contract as correct. Mr Thomas is plainly right that the Agility contract is a method of purchasing a vehicle. By paying all the contractual instalments, the customer does acquire the right to buy the vehicle. By that stage he has already paid the deposit (if there is one) and, by

means of the monthly instalments, has also paid off a substantial part of the purchase price (in the examples given in paragraph 13 above either 57.5% or 51.4%), leaving a residual payment to be made. As Mr Thomas submitted, in this respect it is very similar to the balloon type of HP contract, where equally the customer by paying the monthly instalments acquires the right to purchase the vehicle and by the final month has paid off a similar amount of the capital (in the example given in paragraph 7 above 56%). The only difference is that in the HP contract the customer is by the terms of the contract obliged to pay the balloon payment (subject, at any rate if it is a regulated agreement, to his statutory right to terminate the agreement); whereas in the Agility contract the customer is under no obligation to make the final payment of capital as this is structured as the option payment. As Mr Thomas says this seems a very nice distinction on which to characterise the Agility contract differently from the balloon type of HP agreement.

79. To that extent it seems to me indisputable that one of the economic interests which the Agility contract serves is the interest of the customer in being able to acquire the vehicle in a more affordable way than paying the full cash price upfront. Rather than finding, for example, £22,355 for a new C-class car, the customer can pay £516.20 per month for 3 years and then £11,450. It is easy to see that this may be a more attractive way of purchasing a car for some customers; and the (agreed) fact that if a customer shows no interest in purchasing a vehicle he is recommended a Leasing contract also serves to demonstrate that one of the purposes of the Agility contract is to enable customers to buy vehicles in this way if they want to.

80. Equally however for my part I would unhesitatingly accept that Mr Prosser is right that under an Agility contract the customer is not committed to the purchase at the outset. He is not committed legally because the option to purchase is an option which he is under no obligation to exercise. Nor would I conclude that he is committed economically: performance of the contract requires him to pay the 36 monthly instalments, but still leaves a substantial payment to be made. It does not seem at all a foregone conclusion that the customer will in fact exercise the option. The option payment is calculated to be equal to the anticipated residual value of the vehicle; but the actual value of the vehicle after 3 years will depend on the then state of the market for second-hand Mercedes vehicles which may not be as predicted. So

there is no guarantee that it would make economic sense for the customer to exercise the option. But even if the vehicle is then worth its anticipated residual value, it is not difficult to see that some customers might not have £11,450 readily available; or might prefer in any event to start a new contract paying several hundred £ a month for a new vehicle rather than laying out over £10,000 for a 3-year old one.

81. In these circumstances, I would myself have no difficulty in accepting that another of the economic interests which the contract serves is the interest of the customer in being able to choose, 3 years down the line, whether to complete the purchase of the vehicle or whether to forego that opportunity. The fact that many of the customers (on average 50%) do not in fact acquire the vehicle would appear to show that this is a real, and not merely theoretical, interest.

…..

104. Mr Thomas summarised his case on the facts as being that the FTT was entitled to come to the view that the Agility contract had features which supported the analysis that the economic purpose of the transaction was a sale of goods. For reasons already given I have no difficulty with the proposition that one of the purposes of the contract was to enable the customer to purchase the goods in a more affordable way than buying them outright. But this is not a complete or adequate description of the economic interests which performance of the contract serves. The contract also serves to give the customer a (real and not illusory) choice after 3 years whether to proceed with the purchase or return the vehicle, together with provisions designed to protect MBFS in the event that the customer chooses not to purchase the vehicle. This seems to me the true and only reasonable conclusion from the facts and I have been unable to find anything which would justify the FTT's apparent factual findings to the contrary.

105. Mr Thomas also submitted that the economic reality of the Agility contract was indistinguishable from that of the balloon type of HP contract. The only difference between them was that in the HP contract, the balloon payment was one that was due under the contract (but which in the case of a regulated agreement the customer could in practice avoid paying by exercising his statutory right to terminate the contract early) whereas in the Agility contract the customer had a contractual right not to pay the balloon payment. This was, he said, too fine a

> difference to affect the characterisation of the contract. There is undoubtedly some force in this point, but in the end the question remains what is the economic purpose of the Agility contract in the sense explained by Advocate General Tizzano.
>
> 106. As explained above, the economic purpose of the contract is to be found by identifying the precise way in which performance satisfies the interests of the parties, and I have already set out the way in which the Agility contract satisfies the interests of the parties (see paragraphs 79 to 83 above). In summary it does so by affording the customer an opportunity to purchase but without committing him to do so, and by giving MBFS a return on the finance it provides in circumstances where either the vehicle will be purchased or it will be returned at no risk to MBFS.
>
> 107. I do not think this can be characterised as in effect a contract for sale of the vehicle. It is a contract which may well lead to a sale of the vehicle but equally may well not. In line with the views I have expressed above as to the scope of Article 14(2)(b), it is not in my judgment a contract under which ownership is to pass in the normal course of events."

The grounds of appeal

16. HMRC's primary challenge to the reasoning of the Upper Tribunal is directed at its adoption of the test of economic cause as the correct principle to be applied in relation to the meaning and effect of Article 14(2)(b). Advocate Tizzano's opinion was delivered in the context of two references from the English High Court concerning the interpretation of the phrase "the Leasing or letting of immovable property" in Article 13B(b) of the Sixth Directive which provides for various exceptions from VAT:

> "13B. Without prejudice to other Community provisions, Member States shall exempt the following under conditions which they shall lay down for the purpose of ensuring the correct and straightforward application of the exemptions and of preventing any possible evasion, avoidance or abuse:"
>
> …
>
> (b) the Leasing or letting of immovable property ...."

17. Mr Thomas submits that in order to determine whether a contract amounted to the Leasing of immovable property it was perfectly understandable to articulate a test of economic purpose which could be operated across all member states regardless of the idiosyncrasies of national laws on the subject. But the same approach, he says, is inapplicable in the context of Article 14(2)(b) where the issue is not the characterisation of a particular type of contract (e.g. whether the contract is a lease of

immovable property or, in the present context, a contract for the hire of goods) but how effect should be given to a deeming provision which is designed to treat as supplies of goods contracts which would not satisfy the provisions of Article 14(1): i.e. would *not* (whether as a matter of economic analysis or otherwise) amount to a transfer of the right to dispose of the tangible property as owner.

18. The argument for HMRC is that the economic cause is simply the wrong tool to use in order to decide whether a contract which does not qualify under Article 14(1) can nevertheless be treated as a supply of goods because it contains terms under which "in the normal course of events" ownership will pass. The characterisation of the contract is a prior question which determines whether the contract falls into Article 14(1) or Article 14(2)(b). If the answer is that it falls into the latter then the question whether is satisfies the 14(2)(b) test is not one of economic cause but simply a consideration and analysis of the terms of the contract.

19. HMRC's second ground of appeal is that even as a matter of economics there were no good grounds for distinguishing between the HP balloon contract and the Agility contract. Although the Agility contract does not *require* the customer to pay the balance of the purchase price and interest as part of the final instalment unlike in the case of the HP balloon contract, there is a statutory right of cancellation under the balloon contract which effectively creates the same level of optionality as exists under the Agility contract.

20. The Upper Tribunal distinguished the two by treating the right to terminate not as part of the performance of the balloon contract but rather as a means of avoiding performance: see [52] of the Decision. But, say HMRC, this in fact ignores the economic congruity between the two types of contract and is therefore inconsistent with the Upper Tribunal's own determination of the principle to be applied to determine the operation of Article 14(2)(b).

21. Ground 3 of the appeal is that the Upper Tribunal's application of the economic purpose test effectively re-writes Article 14(2)(b) and disregards its essentially contingent nature. Although the final instalment of the purchase price is defined as an optional payment under the Agility contract, it is no different in this respect from any other regulated HP agreement, none of which commit the customer to purchase the goods or (because of the right of termination) to pay the full price of the goods.

22. For this reason, HMRC contend that the only satisfactory approach consistent with the need for legal certainty is to treat all contracts which contemplate that property will pass at the latest upon payment of the final instalment as falling within Article 14(2)(b). For this purpose, the optionality or not of paying the full price which is the only contractual distinction between the HP balloon and the Agility contracts is immaterial. In each case title "is to pass" upon the exercise of the options following the making of the final payment.

23. HMRC's fourth ground of appeal is that the Upper Tribunal failed to pay due regard to the principle of legal certainty. In its submissions to the Upper Tribunal Mr Thomas contended and Nugee J seems to have accepted that an interpretation of "in the normal course of events" which imported a test of what was likely or expected would be unworkable. But the Upper Tribunal's formulation of the economic purpose

test as turning on the "normal outcome of the contract" (see [63] quoted earlier) in effect re-introduces a probability based test.

24. HMRC point out the difficulties which they say a tax authority will have to determine in a consistent, fair and predictable way whether a hire contract containing an option to purchase does or does not have the economic purpose of "committing" the customer to a purchase of the vehicle: see [106] of the Decision of the Upper Tribunal. By contrast, the interpretation of Article 14(2)(b) proposed by HMRC would, they say, permit the easy determination of that issue simply by reference to the existence of the option and the terms upon which it is exercisable.

25. The final ground of appeal relates to what the Upper Tribunal said in [42] about the policy purpose behind Article 14(2)(b). Mr Thomas submitted that this part of the Upper Tribunal's reasoning is circular because there was no evidence before the Upper Tribunal as to what Article 14(2)(b) was intended to achieve and the Upper Tribunal has therefore derived the policy purpose from its interpretation of the language of Article 14 itself.

A reference

26. The Upper Tribunal declined to refer the interpretation of Article 14(2)(b) to the CJEU. In our view, it was wrong not to do so. In the absence of any direct guidance about the interpretation of Article 14(2)(b), we have reached the conclusion that the issue is not *acte clair*. Having heard the arguments of Mr Thomas and of Mr Prosser QC for MBFS, we therefore indicated to them that we proposed to make a reference. It seems to us that although Article 14(2)(b) is directed in terms to what the relevant contract of hire provides, there is much less certainty as to whether the qualifying phrase "in the normal course of events" requires a tax authority to do no more than to identify the existence of an option which is not exercisable later than upon payment of the final instalment or to go further and determine the economic purpose of the contract in accordance with the test outlined by Advocate General Tizzano in his opinion in the *Mirror Group* case.

27. We therefore require guidance from the CJEU as to whether that is the appropriate test to adopt and, if not, what is the correct interpretation and application of Article 14(2)(b). We envisage that as part of the reference the Court will consider HMRC's argument about timing on which we have not heard full argument but which seems to us to have some obvious attraction in terms of legal certainty.

28. Once this judgment has been made available to the parties, we will invite the parties to liaise with the Court with a view to agreeing the questions which will be contained in the reference.

APPENDIX

4. I propose first to give a brief account of the facts which were either agreed, or apparent from the terms of sample agreements in evidence before the FTT, or otherwise not disputed, without at this stage dealing with those factual findings of the FTT that are criticised in MBFS's appeal. I do not propose to set out the entirety of the Statement of Agreed Facts which were agreed by the parties for the FTT hearing: they can be found set out in the Decision at [30]-[44].

5. MBFS is a subsidiary of Daimler AG. It offers financial products to its customers. Since 1 August 2007 when Agility was launched, the three options given to the customer are "Hire Purchase" (**"HP"**), "Agility" and "Leasing" contracts. Under each of them, the customer obtains the use of a Mercedes Benz vehicle and makes monthly payments to MBFS for a specified period; under HP and Agility the customer also has the option at the end of the period to acquire the vehicle. If a customer has decided at the outset that they would like to purchase the vehicle, an HP product may be recommended; if they have decided they do not wish to, a Leasing product will be recommended; if they are undecided or would like to keep their options open, the Agility product will be recommended.

6. Sample agreements of each of the three types were put before the FTT. The simplest is the Leasing agreement. This is described as a "Hire Agreement regulated by the Consumer Credit Act 1974". The particular example in evidence was for the hire of a new Mercedes-Benz LCV Sprinter 3 (a type of van) for a period of 36 months, with equal monthly rental payments due of £435.42 a month. The agreement contains no option to purchase the vehicle, and at the end of the 36 months the customer is obliged to return it to MBFS. If the vehicle has travelled more than a specified allowed distance, the customer will become liable for an excess distance charge. The customer is also obliged to keep the vehicle properly maintained in accordance with the manufacturer's recommendations and the agreement contains a detailed statement of "vehicle return standards" specifying the condition that the vehicle should be in when returned. It is common ground that this agreement does not constitute a supply of goods for VAT purposes, but is a supply of services.

7. The HP Agreement takes the form of an agreement for hire with an option to purchase at the end of the hire period, exercisable for a small fee called an "Option to purchase fee", typically of £95. Some HP agreements provide for equal monthly payments: one of the sample agreements in evidence (described as a "Hire Purchase Agreement regulated by the Consumer Credit Act 1974") was for the hire-purchase of a Mercedes-Benz C-Class car where the amount of credit was £23,555 and the payments due were 36 equal monthly instalments of £791.00. Other HP agreements provide for lower monthly payments for the first 35 months with a substantial "balloon" payment due as the final monthly payment: the example in evidence (also described as a "Hire Purchase Agreement regulated by the Consumer Credit Act 1974") was for the hire of a Mercedes Benz LCV Vito van with a total cash price of £18,517.45 of which £2,415.32 (13%) was to be paid by way of deposit, leaving just over £16,000 to be financed. This was payable by 36 monthly payments of £328.31 (totalling £11,815.56, made up of £7,957.13 capital (43%) and £3,858.43 interest), together with a balloon payment of £8,145 (44%) payable with the final instalment. Although not directly comparable with the first example (as the capital financed is

much lower), it can be seen that the effect of the balloon payment is to reduce the monthly payments significantly. Being agreements regulated under the Consumer Credit Act 1974 (**"CCA"**), the agreements specify certain financial information on their face including the amount of credit, the APR, the total payable, the total cash price of the vehicle and the total charge for credit.

8. The HP agreement is drafted on the basis that the customer is obliged to make all the monthly payments, including the balloon payment if there is one. It does not oblige the customer to pay the £95 Option to purchase fee, but if the customer has made all the contractual payments, he would by the end of the contract period have paid the entire cash price of the vehicle so it would make commercial sense for him to pay the £95 to acquire the vehicle.

9. However if the agreement is a regulated agreement (as the example agreements in evidence were), then the CCA gives the customer certain statutory rights. One of these is the right to terminate the agreement. If this right is exercised, the maximum that MBFS can claim is half the total amount that would be due under the agreement, so if this has already been paid, no more is payable: see ss. 99 and 100 of the Act. The HP Agreement contains a notice of these rights as follows:

> **TERMINATION: YOUR RIGHTS**
>
> You have a right to end this agreement. To do so, you should write to the person you make your payments to. We will then be entitled to the return of the goods and to half the total amount payable under this agreement, that is £….. If you have already paid at least this amount plus any overdue instalments and have taken reasonable care of the goods, you will not have to pay any more.

10. The HP Agreement obliged the customer to keep the vehicle properly maintained in accordance with the manufacturer's recommendations, and if the agreement was determined (either by the customer, or by MBFS on the customer's default) then the customer could be liable to compensate MBFS if the vehicle was not returned in good condition, repair and working order; but there was no annexed statement of vehicle return standards as there was with the Leasing agreement. Nor was there any allowed distance specified, or obligation to pay an excess distance charge if it were exceeded.

11. It is common ground between the parties that an HP agreement, whether of the equal instalment type or of the balloon type, is a supply of goods for VAT purposes, although they do not agree on the reason why this is so.

12. The Agility agreements in evidence have some similarities to both the Leasing agreement and the HP agreements. Like the HP agreements, they are described as a "Hire Purchase Agreement regulated by the Consumer Credit Act 1974", and contain a period of hire of 36 months with an option to purchase thereafter; and, being regulated agreements, they contain a notice of the customer's rights including the right to early termination, and a statement of financial information including the amount of credit, the APR, the total amount payable, the total cash price of the vehicle and the total charge for credit. Like the Leasing agreement, the Agility agreements contain a specified allowed distance and require the customer to pay an excess distance charge if the vehicle is returned having travelled more than the allowed

distance; and a detailed list of vehicle return standards against which the condition of a vehicle would be measured if returned.

13. The structure of the payments under an Agility agreement is as follows. Unlike the HP agreement, the payment due on exercising the option to purchase (called the "Optional Purchase Payment") is a substantial payment. It is calculated to be equal to the anticipated market value of the vehicle at contract maturity (taking into account the anticipated mileage), or "residual value". Since there is a considerable demand for second-hand Mercedes-Benz vehicles, the residual value is a substantial proportion of its initial value: the first example in evidence is of an LCV Sprinter with a cash price of £22,325.00, a deposit of £3,325 (15%) and an Optional Purchase Payment of £9,500 (42.5%). The monthly payments are then set to pay off the difference between the cash price (less deposit) and the residual value, together with interest. In this example this leads to 36 monthly payments of £373.35 (totalling £13,440.60 of which £3,940.60 is interest and £9,500 the balance of capital). The corresponding figures for the second example (a C-Class car) are cash price of £23,555, deposit of nil, Optional Purchase Payment of £11,450.00 (48.6%), and 36 monthly payments of £516.20 totalling £18,583.20 (of which £6,478.20 is interest and £12,105 the balance of capital (51.4%)). If the option to purchase is exercised, a fee of £95, called the Purchase activation fee, is payable as well as the Optional Purchase Payment.

14. If an Agility customer does not exercise the option to purchase, the vehicle is returned to MBFS. MBFS has a guaranteed buyback agreement with a sister company which owns the used car network in the UK. This means that MBFS can dispose of the returned vehicles at retail value and does not take any risk on "the metal". MBFS is therefore neutral as to whether an Agility customer exercises the option or not. 3 months before the end of the contract, MBFS sends the customer a "Maturity Pack" asking them if they wish to return the vehicle, purchase the vehicle outright or purchase the vehicle and use it as a deposit for a new vehicle. The percentage of Agility customers returning their vehicles on maturity rather than purchasing them has fluctuated from about 25% to about 75%, with an average percentage of 50%.

15. HP customers are not sent the same list of options on maturity. The "Welcome Pack" which they are given at the outset of the contract tells them that the "Option to Purchase" fee will be debited from their account in the last month, and that "once you've made all your payments, your Mercedes-Benz is yours to keep"; the option fee is taken by direct debit.

16. The FTT found as a fact that there was a similar high rate of return under HP agreements as under Agility agreements relying on what Mr May, who was the former Chief Financial Officer of MBFS and who gave oral evidence before the FTT, had said. In its Grounds of Appeal MBFS asserted that this was incorrect and based on a misunderstanding of Mr May's evidence; but there is no note of the oral evidence and Mr Prosser QC, who appeared for MBFS, accepted that there was no material before me on which I could reject this finding of the FTT.