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De Voil Indirect Tax Intelligence

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NEWS IN BRIEF

Legislation 2
Government Publications 2
European Commission 5
Court of Justice of the European Union 5
Tribunals 6

EDITORIAL

Subsidy: What is it? 6

CASE AND COMMENT

Infraction proceedings against Ireland and Sweden: Implications for UK VAT Groups 11

PRINCIPLE OF PROPORTIONALITY

Unfair? Or just harsh? 14

PLACE OF SUPPLY

Duty suspended goods: not necessarily outside the scope of VAT 17

CUSTOMS

Who has the burden to prove entitlement to GSP preference? 20

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Letterpart Ltd • Size: 240mm x 162mm • Date: February 1, 2013 • Time: 11:27

NEWS IN BRIEF

Legislation

Climate Change Levy (Combined Heat and Power Stations) (Amendment) Regulations 2013SI 2013/Draft

These draft amending regulations re-introduce from 1 April 2013 the provisions that previously applied before the introduction of the combined heat and power (CHP) levy exemption certificate (LEC) system in respect of partly-exempt CHP stations, by amending the calculation of the limit on the quantity of electricity such stations may produce and supply directly for the purposes of the exemption from climate change levy (CCL). Budget 2011 announced the ending of the CHP "indirect supplies exemption" and "CHP LECs" with effect from 1 April 2013.

Government Publications

Revenue & Customs Brief 37/12 – VAT: Supplies made under finance leases – EON Aset Menidjmunt – no immediate changes to whether goods or services – no impact on input tax blocked on finance leases of cars

HMRC have issued RCB 37/12 dated 3 January 2013. The full text is set out below.

"Purpose of this brief

It confirms to taxpayers who make finance lease supplies, or who receive such supplies in relation to business cars and block some of the input tax incurred from deduction, that no current action is needed in relation to the EON case.

Readership

Businesses that make supplies of capital goods under finance lease agreements and businesses that incur input tax on supplies of cars under finance lease agreements and block some of that input tax from deduction.

Introduction

Under UK VAT law hire purchase (HP) agreements are considered to be supplies of goods because they expressly envisage that title to the goods being hired will pass at the end of the hire term. Finance lease (FL) agreements do not provide for title to pass and are therefore treated as supplies of services.

The CJEU recently delivered its decision in the case of EON Aset Menidjmunt, C-118/11, (EON). Comments made in the decision suggest that, because the risks and rewards of ownership largely pass to the hirer in FL agreements, and because this is recognised in international accounting standards, supplies under FL agreements may be supplies of goods rather than supplies of services. This has created uncertainty in the finance leasing sector.

No change of treatment at this time

HM Revenue & Customs (HMRC) is considering representations made by industry representatives and has not reached a final conclusion on whether the EON decision means that FL supplies are supplies of goods rather than supplies of services or, if so, what features are decisive in determining whether a supply is of goods rather than of services. Until and unless HMRC make a contrary announcement taxpayers should continue to treat hire supplies as set out in currently published HMRC guidance. If there is any future change of policy then HMRC will only apply any changes from a future date and will not require taxpayers to make any retrospective accounting adjustments.

Input tax block on FL cars

The EON decision has also raised questions in relation to the input tax block as it applies to FL cars. HMRC can confirm that whether the eventual VAT treatment of FL supplies is as goods or as services FL

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cars will continue to have a 50 per cent input tax block applied to them.

Where taxpayers are supplied cars for use in their business then unless the cars are stock in trade (for example, demonstrator cars at car showrooms), the car is central to their business (for example, driving instructors) or the car is not made available for private use, the input tax they incur is subject to a block on deduction. Normally input tax is wholly blocked but where the supply received is a "letting on hire" (such as under an FL) the block applies at 50 per cent, rather than at 100 per cent, of the tax incurred.

Whether FL supplies are eventually concluded to be supplies of goods, rather than supplies of services, will not affect the fact that they are "lettings on hire". Consequently no change to input tax blocked on FL supplies can be needed.

Issued 3 January 2013"

HMRC announce new non-executive directors

HMRC have announced the appointment of three new non-executive board members, as part of ongoing governance arrangements.

Volker Beckers and Norman Pickavance joined the main board on 1 January 2013. John Whiting will take up a position on the board from 1 April 2013. The three will take on posts that became vacant after John Spence left last year, Phil Hodkinson left at the end of January this year and Ian Barlow's success in the competition to become HMRC's lead non-executive in September 2012.

In addition to main board roles, Volker Beckers will chair a new Scrutiny Committee, Norman Pickavance will join the People, Nominations and Governance Committee and John Whiting will chair the Audit and Risk Committee from 1 April 2013.

HMRC also announced the appointment of Edwina Dunn, Janet Williams, Leslie Ferrar and Paul Smith to further strengthen HMRC board committees. Edwina Dunn will take up an adviser role to the main board, Janet Williams will be appointed to the Scrutiny and People, Nominations and Governance Committees, and Leslie Ferrar and Paul Smith will take up roles on the Audit and Risk Committee.

Notice 6 – Merchandise in baggage

HMRC have issued a revised (January 2013) edition of Notice 6. It updates the statistical threshold below which formal entries are not usually required.

Notice 60 – Intrastat General Guide

HMRC have issued a revised (January 2013) edition of Notice 60. It includes a warning that it is expected that Croatia will be joining the EU from 1 July 2013. This means that businesses will need to include any goods dispatched to or arriving from Croatia from this date onwards on Supplementary Declarations (see paragraphs 2.5 and 6.1). In addition, paragraph 20.1 has been amended to reflect that the threshold for using the low value consignment simplification procedure will be £160 from 1 January 2013.

Notice 143 – A guide for international post users

HMRC have issued a revised (January 2013) edition of Notice 143. It has been updated to reflect the reduction in the level of the relief available for items sent as gifts, from £40 to £36 with effect from 1 January 2013.

Notice 235 – Outward processing relief

HMRC have issued a revised (December 2012) edition of Notice 235. Changes include:

- clarification of wording to paragraphs 1.4 (What rights do I have in relation to a customs decision), 2.4 (Putting IP goods into OPR), 3.2

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(Types of OPR authorisation) and 3.6 (Simplified authorisation for repairs); and

- a change to paragraph 1.5 (email enquiry address)

Notice 252 Valuation of imported goods for customs purposes, VAT and trade statistics

HMRC have published a revised (January 2013) edition of Notice 252. Amendments include advice on changes to the treatment of buying commission for import VAT purposes, how to revalue goods that have devalued whilst in a customs warehouse and the treatment of surcharges relating to Air Transport Costs.

Notice 700/17 – Funded pension schemes

HMRC have issued a revised (January 2013) edition of Notice 700/17. Paragraph 2.9 has been amended to include guidance on the recovery of VAT on management costs by professional trustees who are appointed to run a pension scheme.

Notice 727/3 – Retail schemes: how to work the point of Sale Scheme

HMRC have published a revised (January 2013) edition of Notice 727/3. It has been amended to take into account the change in the capping provisions from 3 to 4 years.

Notice 727/4 Retail schemes: How to work the apportionment schemes

HMRC have published a revised (January 2013) edition of Notice 727/4. It has been amended to take into account the change in the capping provisions from 3 to 4 years.

HMRC target outstanding VAT returns in latest campaign

From 28 February, HMRC will investigate businesses which, despite reminders, have one or more VAT return outstanding. HMRC expects to have to chase some 50,000 businesses in its new "VAT Outstanding Returns" campaign.

See press release HMRC (NAT) 05/13 dated 9 January 2013 (http://hmrc.presscentre.com/Press-Releases/Businesses-warned-on-late-VAT-returns-685cb.aspx)

Customs Information Paper (13) 01 Wine: New procedures for declaring VI documents – Supplementary information

HMRC have published CIP (13) 01 dated 16 January 2013. It provides additional detail for the introduction of the new CHIEF measure for VI documents accompanying consignments of wine and extends the implementation date until 1 March 2013.

Customs Information Paper (13) 02 Tariff Preference: extended derogation for Falkland Islands fishery products

HMRC have published CIP (13) 02 dated 16 January 2013. It announces that the derogation from normal rules of origin for certain fishery products exported from the Falkland Islands has been extended to 31 December 2013.

Customs Information Paper (13) 03 – Time Limits for Community/common transit movements

HMRC have published CIP (13) 03 dated 16 January 2013. This paper provides clarification of the rules under which customs at offices of departure will set the time limit for Community/common transit movements.

Imports: New External Temporary Storage Facility approval

HMRC has published a new External Temporary Storage Facility (ETSF) approval document, which has been designed as a result of the ERTS and temporary storage policy review conducted between August 2011 and February 2012. This document will replace

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existing ERTS approvals and be used for all new ETSF approval applications from 14 January 2013.

For further details, seehttp://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageImport_ShowContent&propertyType=document&id=HMCE_PROD1_032549

European Commission

Customs: strengthening the security of the supply chain

On 8 January 2013, the Commission adopted a Communication on Customs Risk Management and the Security of the Supply Chain. It sets out a strategy to enable customs to better tackle risks associated with goods being traded in international supply chains. The proposed new EU approach will supplement national work by integrating a wider scope of information and intelligence from many sources. For further information see the press release (IP/13/7, available soon) and the Communication (COM/2012/793) (http://ec.europa.eu/taxation_customs/resources/documents/customs/customs_controls/risk_management/customs_eu/com_2012_793_en.pdf).

Court of Justice of the European Union

BGZ Leasing sp zoo v Dyrektor Izby Skarbowej w Warszawie

In *BGZ Leasing sp zoo v Dyrektor Izby Skarbowej w Warszawie, Case C-224/11; 17 January 2013 unreported* a Polish case, a leasing company (B) required its customers to insure the goods which it leased to them, and offered to arrange such insurance. It treated the insurance charges as exempt from VAT under Article 135(1)(a) of EC Directive 2006/112/EC. The tax authority issued a ruling that the insurance was ancillary to the principal supply of leasing, and was liable to the standard rate of VAT. B appealed, and the case was referred to the ECJ, which issued judgment in favour of B, holding that "the supply of insurance services for a leased item and the supply of the leasing services themselves must, in principle, be regarded as distinct and independent supplies of services for VAT purposes". Where the lessor "insures the leased item itself and reinvoices the exact cost of the insurance to the lessee", this was an insurance transaction within Article 135(1)(a).

European Commission v Kingdom of Spain

In *European Commission v Kingdom of Spain, Case C-360/11; 17 January 2013 unreported* the European Commission formed the opinion that Spanish VAT law had applied a reduced rate of VAT to broader categories of medical and pharmaceutical products than was provided for by Directive 2006/112/EC, and applied to the ECJ for a declaration to that effect. The ECJ delivered judgment in favour of the Commission, holding that Spain had failed to fulfil its obligations under Article 98.

Woningstichting Maasdriel v Staatssecretaris van Financiën

In *Woningstichting Maasdriel v Staatssecretaris van Financiën, Case C-543/11; 17 January 2013 unreported* a Netherlands case, a local authority demolished a library and sold the land to a housing association. The tax authority issued a ruling that the supply was exempt from VAT under Article 135(1)(k) of Directive 2006/112/EC (and was therefore liable to Netherlands "transfer duty" rather than to VAT). The purchaser appealed, contending that the land was "building land" which was excluded from the exemption. The case was referred to the ECJ for a ruling on the interpretation of Article 135(1)(k). The ECJ held that the exemption under Article 135(1)(k) did not include a supply of "land which has not been built on following the demolition of the building

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situated on it, even where, at the time of that supply, improvement works on the land, apart from that demolition, had not been carried out, where it is apparent from an overall assessment of the factual circumstances surrounding that transaction and prevailing at the time of supply, including the intention of the parties when it is supported by objective evidence, that, at that time, the land at issue was in fact intended to be built on, a matter which is for the referring court to determine".

Tribunals

South African Tourist Board v HMRC

In *South African Tourist Board v HMRC* (*2012*) *TC02431* the South African Tourist Board (SATB), which was a statutory body, registered for VAT and reclaimed input tax. HMRC issued a ruling that only 15% of the input tax was reclaimable, on the basis that 85% of SATB's income came from the South African Government and did not represent consideration for taxable supplies. SATB appealed. The First-tier Tribunal reviewed the evidence in detail and dismissed the appeal, applying the principles laid down in *Turespaña* (*VTD 14568*). Judge Mosedale disapproved the earlier decisions in *Netherlands Board of Tourism* (*VTD 12935*), and *Austrian National Tourist Office* (*VTD 15561*), observing that "even if neither body were a statutory body, if the funds provided by the respective governments were earmarked for a purpose and could not be used for anything else, it would be difficult to see that there was an economic activity, or a direct link between 'supply' and "consideration"".

Taylor Clark Leisure plc v HMRC

In *Taylor Clark Leisure plc v HMRC* (*2012*) *TC02443* a company (T), which was the representative member of a VAT group and had accounted for VAT on income from bingo and gaming machines, submitted a repayment claim covering the period from 1973 to 1998, contending that it should have treated the relevant income as exempt. HMRC made the repayment in 2009, but subsequently issued assessments to recover the tax on the basis that the claim had been made outside the three-year time limit laid down by VATA 1994,s 80(4). T appealed. The First-tier Tribunal dismissed the appeal (but gave T leave to apply for a further hearing to consider the principle of "legitimate expectation"). Judge Reid also observed that the company (C) which had made the relevant supplies had left T's group in 1998, and held that C, rather than T, would have been entitled to any repayment.

Usha Martin (UK) Ltd v HMRC

In *Usha Martin* (*UK*) *Ltd v HMRC* (*2012*) *TC02444* HMRC issued an assessment on a company (U) in 2006. U appealed. In January 2012 HMRC withdrew the assessment. U applied for costs, and applied for a direction that the VAT Tribunal Rules 1986 (SI 1986/590), rule 29 should apply to the proceedings rather than the Tribunal Procedure (First-Tier Tribunal) (Tax Chamber) Rules 2009 (SI 2009/273), rule 10. Judge Scott granted the application, observing that "the case was sisted for very long periods, both before and after 1 April 2009, and that primarily at the request of HMRC". She concluded that "in order to achieve fairness and justice, in the particular and unusual circumstances of this case, the 1986 Rules should apply".

David Rudling and Alan Dolton
LexisNexis

EDITORIAL

Subsidy: What is it?

There is a problematic word in Article 73 of the VPD: "subsidies" (regarding which I also use "subsidy" throughout this editorial). Article 73 defines the taxable amount as "everything that constitutes consideration obtained … by the supplier,

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in return for the supply, from the customer or a third party, including *subsidies* directly linked to the price of the supply" (emphasis supplied).

We are familiar with the continuous debate about what may or may not be third party consideration, usually in the context of a discussion as to whether a party paid its own costs or was a third party paying costs on behalf of another, but the subsidy aspect goes a little wider, and drags charities and other NFP bodies into the debate. It opens the possibility of a provider of funds towards a social enterprise being treated as the provider of a subsidy which could then be regarded as part, or all, of the consideration for the supply. This can affect the output tax payable, or the values used in a partial exemption calculation (if the subsidy is exempt or zero rated), so it is clearly vital to know when a subsidy does arise.

One potentially startling aspect of what I say above is the comment that the subsidy could cover *all* of the price (so the recipient of the supply pays nothing). This seems very difficult to equate with the idea of a subsidy to start with. We would normally think of a subsidy supporting a reduction of the effective price to the consumer rather than providing all of it, but case law does not support that restrictive view. Further, we might be surprised about what that means when interpreting the criterion that the subsidy must be "directly linked to the price of the supply". If there is, say, a "list price" which is then reduced for those who qualify for a subsidy by the same value as the subsidy the supplier receives, then it is fairly clear that the subsidy is directly linked to the price and thus to the supply. It is *for* the supply. But if the subsidy is 100% it could beg the question as to how it can be linked to the price. Does there need to be a price list which applies to sales but which is effectively suspended for the customer if the subsidy covers the cost in full? Does there need to be evidence of a price charged prior to the subsidy being offered, and perhaps reintroduced if the subsidy is withdrawn, in order to evidence a precise affect of the funding and thus reveal it to be a subsidy, or is that unnecessary, as long as it is possible to demonstrate that the subsidy pays for the supply?

Do these questions lead us to wonder what the difference can be between a "subsidy" and a "grant"? After all, a grant is regarded as a gift made towards the provision of good works which benefit a (usually) charitable cause. It is not regarded as consideration for the activity, and not therefore indicative of a supply being made. But a grant will allow something to be done, usually for somebody (or a collection of "somebodies") either for nothing or for a reduced charge to the recipient. As that is the case, there seems to be no logical reason to distinguish a grant from a subsidy. Grants provide deficit funding which enable actions to be taken. These actions could be supplies, for which the grant is inevitably a subsidy. So, how do we draw the line between a subsidy and a grant?

It seems that the only point of logical distinction would be the reference to the sum being directly linked to the price of the supply. Are grants subsidies which *are not* directly linked to the price of the supply, and is that an easy criterion to determine?

Experienced readers will have deduced by now that we are in the territory of the well known UK/CJEU case *Keeping Newcastle Warm – C-353/00* (*Newcastle*), and the less well known Belgian/CJEU case, *Office des produits Wallons ASBL – C-184/00* (*Wallons*), so it is worth looking at how these broadly dealt with the conceptual challenges referred to above.

Newcastle is one of those happy cases where it takes very little time to come to a conclusion as to what the answer is, though then providing the intellectual underpinning for that answer is not as easy. Nevertheless, the CJEU's decision (somewhat dismissively termed, it has to be said) that the subsidies were part of the consideration (or actually all of it) had the imprint of rightness about it. How could

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it be otherwise, given the following summarised facts? In this case, sums were "granted" to enable households in deprived areas (presumably) to obtain "free" advice on insulation and energy use. The household was the "applicant" for the grant, but the grant was paid direct to the supplier. It happened to be a flat rate of £10 hypothecated to each specific customer, and was thus not a single preordained figure covering all users, and not a pure "cost matching" model. It was thus clear that the money was paid on behalf of a beneficiary, and the only reason that the payment came direct to the supplier, and not via the customer was to avoid abuse, just as often happens when insurance companies directly procure replacement goods on behalf on the insured.

But whilst we know instinctively that this fell within the subsidy definition, we still need a theoretical distinction which tells us why it would not be a pure grant. The CJEU itself did not bother to attempt that, but the Advocate General did. The AG, in summary, said that a grant towards the general running costs of a charity (say) would not be a subsidy linked to the price of an individual supply, irrespective of the unavoidable fact that such a grant would inevitably impact on the prices charged (or whether a price is charged) to a recipient. But the facts of the *Newcastle* case provided the other different paradigm which shows where a subsidy does arise. Whilst this kind of analysis by comparison is helpful, it engenders two potential criticisms. First, reasoning by example is often little more than an illustration of an assertion (which in my view was the case with the AG's comments, except where he refers to the criteria in *Wallons* which I explore below). Second, it runs the risk of leaving a vast gap in the middle into which other examples fall, thus creating a "no man's land" in which the AG's opinion gives us nothing to go on. What, for instance, determines if a grant is towards the general running costs of a charity? Does that have to be back office costs? Can it be towards the costs of running a specific operation? Sadly, we are not effectively guided on that.

Turning to the other major precedent – *Wallons* – do we find more helpful guidance? Here the CJEU itself went to greater effort to set out an intellectual framework for answering the question, and it is worth quoting extensively from it before deciding how helpful it might be:

> "12. However, the mere fact that a subsidy may affect the price of the goods or services supplied by the subsidised body is not enough to make that subsidy taxable. For the subsidy to be directly linked to the price of such supplies, within the meaning of Article 11A of the Sixth Directive, it is also necessary, … that it be paid specifically to the subsidised body to enable it to provide particular goods or services. Only in that case can the subsidy be regarded as consideration for the supply of goods or services, and therefore be taxable.
>
> 13. In order to establish whether the subsidy constitutes such consideration, it should be noted that the price of the goods or services must, in principle, be determined not later than the time of the triggering event. It should also be noted that the undertaking to pay the subsidy made by the person who grants it has as its corollary the right of the beneficiary to receive it, since a taxable supply has been made by the latter. That link between the subsidy and the price must appear unequivocally following a case by case analysis of the circumstances underlying the payment of that consideration. On the other hand, it is not necessary for the price of the goods or services – or a part of the price – to be ascertained. It is sufficient for it to be ascertainable.
>
> 14. It is therefore for the referring court to establish the existence of a direct link between the subsidy and the goods or services at issue. That makes it necessary to verify at an early stage that the purchasers of the goods

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or services benefit from the subsidy granted to the beneficiary. The price payable by the purchaser must be fixed in such a way that it diminishes in proportion to the subsidy granted to the seller or supplier of the goods or services, which therefore constitutes an element in determining the price demanded by the latter. The court must examine, objectively, whether the fact that a subsidy is paid to the seller or supplier allows the latter to sell the goods or supply the services at a price lower than he would have to demand in the absence of subsidy.

15. In the main proceedings and in view of the fact that, according to the framework agreement, OPW carries out a number of activities, the referring court must verify whether each activity gives rise to a specific and identifiable payment or whether the subsidy is paid globally in order to cover the whole of OPW's running costs. In any event, it is only the part of the subsidy identifiable as being the consideration for a taxable supply that may, in appropriate cases, be subject to VAT.

16. …

17. Moreover, in order to determine whether the consideration represented by the subsidy is identifiable, the national court may either compare the price at which the goods are sold in relation to their normal cost price, or examine whether the amount of the subsidy has been reduced once those goods are no longer produced. If the factors examined are significant, it must be concluded that the part of the subsidy allocated to the production and sale of the goods in question constitutes a subsidy directly linked to the price. In that regard, it is not necessary for the subsidy to correspond exactly to the diminution in the price of the goods supplied, it being sufficient if the relationship between the diminution in price and the subsidy, which may be at a flat rate, is significant."

Adopting the CJEU's numbering, let us see what conclusions arise. Paragraph 12 requires the payer of the subsidy to intend to subsidise a "particular service". So he has at least to know what he is funding. But that is true of most grants other than core funding for a charity that undertakes a range of activities. It is true by definition of a restricted grant, except, perhaps, cases where the grant is restricted to a selection of activities but does not relate to only one activity. My view is that this paragraph alone, whilst sounding like common sense, does not get us much further forward.

Paragraph 13 says you have to know what your prices are before you can draw up a budget for the subsidy. Again, it is hard to see that ever failing to arise in a well-regulated situation. It says that the recipient of the payment must have the right to receive it, presumably granted by the subsidy payer (rather than imposed on the subsidy payer, since of course that would not arise). This "link" (what link?) must be ascertained on a case by case basis (which does not assist the definition at all). And then we are told that there is no need to ascertain what the consideration is, as long as it is ascertainable. This seems to mean that the subsidy provider need not even find out what the unit price will be as long as he could do if he was curious. It is hard to see how that would ever be impossible, and if the payer need not know the level of the subsidy, how does that make the position any different to making a grant?

Paragraph 15 seems to suggest that a "subsidy" that covered "the whole of" the general running costs of the charity would not be a "subsidy" for our purposes. This is not a helpful remark if it implies that only such completely indiscriminate grants are to be taken out of the definition of subsidy applicable to Article 73.

Paragraph 14 says that a court needs to find out (at an early stage – though quite what that is supposed to mean I cannot tell) that the purchasers of the service

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benefit from the subsidy. But, as mentioned above, such a benefit is inevitable with any kind of grant support. But then we come to concepts which sound more promising. We are told that the subsidy must have the effect of reducing a *fixed* price such that the consumer *would have paid* a higher price were it not for the subsidy. Here at last we have a basis for the "price list" approach to the issue. We have to demonstrate that there *was* a price to the consumer, and this has been reduced (perhaps to nil) by the funds received from the third party. Paragraph 17 provides a tool kit which a court can use to determine the point made in paragraph 14.

Here, finally, we seem to have a point on which we can secure our definition. Just as a price reduction in retail "sales" can only be based on an earlier higher price having been demanded for the discounted goods (in which case there is legislation determining how long the previous price had to be deployed) it seems that the "subsidy" interpretation of third party funding requires a "before and after" comparison. Either the subsidy reduces a previous higher price, or the price rises after the withdrawal or reduction of the subsidy, or both.

But there is a cloud over all of this. In *Newcastle,* the case in which one's gut reaction was that the situation *had* to be one of a subsidy arising, there was in fact no previous full price. All there was was an assumed price per unit, and a system whereby the beneficiary had to apply for the benefit of the grant which was then paid as a subsidy to the provider.

This disquieting point brings me to a very recent decision by the FTT, *Groundwork Cheshire TC02407,* decided in December 2012. It is a brief decision relating to payments from Entrust (a quango) to a Groundwork body's trading company to provide consultancy at nil charge to businesses, in relation to such things as resource efficiency. Before launching into the analysis applied here, there are a few points worth making. The kind of service provided seems fairly similar to that applying in *Newcastle.* The service was provided by a trading subsidiary rather than a charity (though of course, that was at the choice of the charity). And the taxpayer was arguing on the side of the payment being a subsidy, whereas HMRC was arguing that the payment was outside the scope as a grant, which was the opposite of the taxpayer and tax collector stances in both *Newcastle* and *Wallons.* The two CJEU cases related to supplies to final consumers, whereas *Groundworks* is about supplies to business, so it is immediately obvious why these differences arose.

As with the earlier cases, the price to the final consumer was reduced to nil. In this case the price of each service was different, varying according to the needs of the each recipient, so there was no prepackaged "commoditised" product which, it can be argued, was the case in both *Newcastle* and *Wallons.* Each recipient of the services was told how much their service had cost Entrust (indeed, they could not have reclaimed the VAT without knowing this, but oddly, no discussion is made of how the output tax was dealt with between Groundworks and customers). Entrust on the other hand had no interest in the value per company. Its only interests of a pure financial nature were twofold: that there was a finite total budget for support, and their support could only match against costs actually incurred by Groundworks. These two features are usually regarded as strong indicators of an outside-scope grant, not as indicators of consideration for a supply.

But the tribunal supported the taxpayer's view and held that the Entrust payments were a taxable subsidy. How so?

It appears that the tribunal addressed the guidance in *Wallons* (having adopted the view that *Newcastle* added nothing) and saw that the conditions were all met. The condition as to there being a need for a price to have been affected by the subsidy compared to what it otherwise was, was answered thus:

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> "43. No price is payable by clients to Groundwork. It is therefore artificial to consider whether the price is fixed in such a way that it diminishes in proportion to the payment made by Enworks, or that the subsidy constitutes an element of the price charged to clients. Looked at overall the price that would be payable by clients is clearly related to the payment made by Enworks. It is that payment which enables Groundwork to provide a free service. For the same reason the payment made by Enworks can be said to constitute an element of the price that would be charged by Groundwork to its clients.
>
> 44. We consider that each activity carried out by Groundwork gives rise to a specific and identifiable payment. Work done for a client pursuant to the Enworks programme can be traced directly to a monthly payment made by Enworks. The more work done for clients, the greater that payment will be. The relationship between the work done and the payment made is clearly identifiable. Again, whilst overheads which are recovered from Enworks are not allocated to clients, they could easily be allocated. As such the payment made in relation to each client is identifiable. The relationship between the payment from Enworks and the provision of a free service to clients is significant. The payment is not made globally to cover the whole of Groundwork's running costs."

So, the one convincing point in the CJEU's analysis in *Wallons* is dismissed as simply not applying in this context, and the rest of the justification repeats circumstances which do no more than define a situation redolent of a restricted grant.

If we are to accept this decision as being correct then we have little justification in treating any grant, apart from core funding of a charity with at least two distinguishable activities, as being outside the scope of VAT. The problem then is that we will have entered an era when HMRC will look for grants to attack as being "consideration" and will probably do so where the result is a taxable supply to a final consumer. It will be interesting therefore to see whether HMRC decides that this adverse decision is a blessing dressed up as a defeat.

Graham Elliott
Withers LLP

CASE AND COMMENT

Infraction proceedings against Ireland and Sweden: Implications for UK VAT Groups

Two opinions of Advocate General Jääskinen in cases concerning VAT groups (namely cases C-85/11 and C-480/10), if followed by the Court of Justice European Union ("ECJ"), should be of interest to existing and prospective VAT groups. In the former case, the European Commission infracted Ireland for allowing non-taxable persons to be members of a VAT group. The Advocate General confirmed that Irish law, like the UK's VAT grouping provisions (ss 43–43C Value Added Tax Act 1994), complies with EU law in that respect. In the latter case, the Advocate General, in infraction proceedings against Sweden, opined that Swedish law was not compliant with EU law by restricting VAT grouping to entities in the financial sector. Sweden's case is of greater interest as it may allow claims to be made that the UK provisions, by restricting eligibility for VAT grouping to bodies corporate, are unduly restrictive.

The purpose of the VAT grouping provisions

In both cases, the Advocate General stated that the purpose of the VAT grouping provisions is to simplify administration and combat abuse. The opinion in Case C-85/11 explains that the abuse aimed at is "the splitting up of one economic operator among several taxable persons so

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that each may benefit from a special scheme" such that "independence" is purely a legal technicality". The Advocate General went on to state that "the legislative history of the provisions establishing VAT groups reveal no other aims". Member states may, however, adopt measures needed to prevent tax evasion or avoidance through the use of the grouping provisions.

Businesses have the freedom to decide whether or not they form a VAT group and achieve administrative simplicity. Whether administrative simplicity is achieved can essentially only be determined on a case by case basis. Businesses are best placed to decide.

The effect of VAT grouping

Once a VAT group is created, it results in there being a single taxable person. The single taxable person is all respects comparable to a taxable person consisting of a single entity. The principle of fiscal neutrality requires that they be treated alike.

The Advocate General in both cases observed that VAT grouping does involve advantages. VAT groups may enjoy cash-flow advantages. Non-taxable persons can acquire goods from other group members tax free. Input tax incurred on external purchases is recoverable if the group uses the inputs for making taxable supplies and not to the extent that there is no taxable use or there is exempt use. Overheads are nevertheless inputs of the single taxable person.

VAT grouping facilitates the freedom to choose whether to purchase goods from independent third parties or incur costs in-house in producing the same inputs. If the latter option is chosen, fiscal neutrality requires that there should be no discrimination between producing inputs in-house or by outsourcing them to a group member. At paragraph 48 of Case 85/11 the Advocate General stated

> "Where an economic operator is not entitled to deduct input VAT incurred in a purchase, it might be economically advantageous for it to produce the goods or services itself. For example, a bank that is not entitled to deduct VAT might benefit economically if it produces IT services needed for its banking activities internally rather than buying them from a third party. However, if the VAT grouping option is available, it may outsource its IT service provision to a subsidiary belonging to the group and still gain the same advantage."

VAT grouping does not expand or restrict rights under the VAT system. As such, VAT grouping promotes fiscal neutrality. For example a holding company, which may be a non-taxable person, can only recover input tax on costs, including overheads, incurred for the taxable supplies of the VAT group, not otherwise. Restriction of entitlement to input tax would put the holding company at a disadvantage in comparison to other corporate structures.

Grouping does not only entail advantages: it carries responsibilities. A non-taxable person who is VAT grouped is subject to regulation under the VAT rules. The UK, like Ireland, creates joint and several liability for group members, including the non-taxable person. On behalf of Ireland it was submitted that the tax authority has recourse to recovering tax from the non-taxable group member, which might own valuable assets, where it would otherwise not have those rights.

Eligibility for grouping

(a) Non-taxable persons

In Ireland's case, the analysis of the VAT grouping referred to above led the Advocate General to conclude that Ireland, and it follows the UK, was not acting contrary to the provisions of article 11 of the Principal VAT Directive by allowing non-taxable entities to be a VAT grouped. The Commission's concern that entirely non-taxable entities would be entitled to VAT grouping was dismissed as being hypothetical. The Advocate General's

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Letterpart Ltd • Size: 240mm x 162mm • Date: February 1, 2013 • Time: 11:27

opinion was further underpinned by the history and drafting of the VAT grouping provisions in the Second, Sixth and Principal VAT Directives. Each referred to "person" and not a "taxable person" in contrast to other provisions which specifically referred to taxable persons.

(b) Any person

Article 11 of the Principal VAT directive does not restrict VAT grouping to bodies corporate. It refers to "any persons established in the territory … who, while legally independent, are closely bound to one another by financial, economic and organisational links". The issue arises whether entities which are not bodies corporate are eligible to be VAT grouped.

The Advocate General's opinion in Case 408/10 makes clear that although grouping is optional, once a member state decides to allow grouping it must follow the wording of the directive. Article 11 does not impose any limitations on eligibility other those referred to above. In particular, it refers to "any person". Therefore the UK does not have the discretion to limit VAT grouping to bodies corporate. Although Sweden's case was concerned with a restriction to a particular business sector, that does affect the overriding principle underpinning the Advocate General's opinion.

A further effect of a member state exercising the option to allow VAT grouping is that the principles of VAT, including the principles of fiscal neutrality and equal treatment engage. In Sweden's case, breach of those principles reinforced claims that a provision does not give full effect to the Principal Directive. In the UK, for example permitting Limited Liability Partnerships (formed under the Limited Liability Partnership Act 2000) to be members of a VAT group, yet denying that right to general partnerships, or limited partnerships constituted under the Limited Partnerships Act 1907 must be at risk of being contrary to the express wording of Article 11 and the principles of fiscal neutrality and equal treatment. Although general and limited partnerships are not legal persons, their members would undoubtedly be persons bound by financial, economic and organisational links. Strictly, therefore, the right to be grouped belongs to the partners, assuming they wish to exercise it. Similar issues arise for charities (not constituted in the form of a company limited by guarantee, which can belong to a VAT group), unincorporated associations, trusts and individuals otherwise eligible for VAT grouping by virtue of having the requisite financial, economic and organisational links.

The possible extension of VAT grouping to persons other than bodies corporate was recognised in a consultation on VAT grouping in 1995 and during debates in Parliament on the Finance Bill 1999. Since then there have been significant developments in the fundamental principles of VAT, in particular the principle of fiscal neutrality. Such developments, combined with the ECJ's judgement in case C-408/10, should give Her Majesty's Revenue and Customs cause to amend the UK's VAT grouping so that they fully comply with EU law.

Conclusion

The Advocate General's opinions in both cases appear compelling. It would be surprising if the ECJ does not follow them. The ECJ's decisions will prevail, although the Advocate Generals' opinion(s) may still carry force to the extent the ECJ does not depart from them. The ECJ's decisions should appear relatively soon. Assuming the ECJ follows the Advocate General's opinions, the decision in *case C85/11* will support the status quo; but the decision in case *C-480/10* should provide fuel for litigation in suitable cases if HRMC do not extend the right to VAT grouping to non-bodies corporate.

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Letterpart Ltd • Size: 240mm x 162mm • Date: February 1, 2013 • Time: 11:27

PRINCIPLE OF PROPORTIONALITY

Unfair? Or just harsh?

Some years ago, an insurance company (Commercial Union I think) used the slogan "we won't make a drama out of a crisis". I've not sure that a crisis is preferable to a drama (assuming that one can be made out of the other), and wonder whether "we won't make a crisis out of a drama" would be equally meaningful (or meaningless).

I also wonder whether the same could apply to the expression "not merely harsh but plainly unfair" as used by Simon Brown LJ in *International Transport Roth GmbH v Home Secretary* [2003] QB 728 in the context of the principle of proportionality as applied to a penalty regime relating to haulage drivers and companies whose vehicles contained illegal immigrants. Some businesses might be forgiven for thinking that they would prefer a regime which was merely unfair, as long as it was not plainly harsh.

One such business is *Total Technology* (*Engineering*) *Ltd* (*"TT"*) (*[2011] UKFTT 473* (*TC*) and *[2012] UKUT 418* (*TCC*)). TT had an excellent tax compliance record until 2008, when a small proportion of the total VAT due (£476 out of a total of £125,769 in period 5/08, and £331 out of a total of £108,626 in 11/08) was paid late. The late payments were registered as defaults, although neither gave rise to a surcharge (the first gave rise to a surcharge liability notice, and the second was less than HMRC's threshold of £400). However the payment for a subsequent return – period 6/09 – was submitted a day late, and incurred a surcharge of some £4,260.

TT appealed against the surcharge, both on the grounds that it had a reasonable excuse and that the surcharge was disproportionate. The appeal on reasonable excuse grounds appears to have been rather half-hearted, and was quickly dismissed by the First-tier Tribunal. On the proportionality question, TT relied on *Enersys* (*[2010] UKFTT20* (*TC*)), another case in which payment was made a single day late. The FTT reviewed and applied the factors in *Enersys* which were considered relevant to the question of proportionality, as follows:

- The degree of culpability

TT had said little more than that the default was not deliberate and was linked to the "unwieldy" accounting system. Consequently the tribunal was unable to give any weight to this factor.

- The number of days of default

Since one day was the minimum possible period of delay, it followed that it must weigh in TT's favour.

- The absolute amount of the penalty, and the inexact correlation of turnover and penalty

The tribunal considered that a penalty of over £4,000 for "extremely high" for a company with annual profits in the region of £50,000.

- The absence of any power to mitigate

The FTT made no comment on this, other than to state "in *SKG*[1] the Tribunal said 'without such power the [default surcharge] regime arguably goes "further than is necessary" '"

The FTT also took into account TT's excellent compliance record; the fact that, as a result of the first chargeable default being under the £400 threshold, TT "went directly from zero to £4,260"[2]; and the fact that in the first two defaults the amount of payment which had been made late was minimal. The appeal was allowed.

The decision was, however, reversed by the Upper Tribunal, which went into some detail on the principle of proportionality, and then applied the principle with particular reference to the factors considered by the FTT.

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The principle of proportionality

This principle arises, said the UT, from the jurisprudence of both the European Court of Justice ("ECJ") and the European Court of Human Rights ("ECHR").

In terms of ECJ law and jurisprudence, a Member State is obliged to take the necessary legislative and administrative measures required to ensure the collection of all the VAT due on its territory. Since the measures are not harmonised, a Member State has a wide discretion in the application of such measures. Nevertheless, a measure must:

- be suitable for the purpose for which the power has been conferred;
- be necessary in the sense that the purpose could not have been achieved by some other means less burdensome to the person affected; and
- be proportionate in the narrower sense that the burdens imposed by the exercise of the power must not be disproportionate to the object to be achieved.

In the same way, the European Convention on Human Rights, whilst entitling a person to the peaceful enjoyment of his possessions, does not preclude a State from enforcing "such laws as it deems necessary to control the use of property in accordance with the general interest or to secure the payment of taxes or other contributions or penalties". Once again, there is a "wide margin of appreciation" in the State's rights to impose such laws, subject to the proviso that those laws are not "devoid of reasonable foundation".

The UT considered that it was not necessary to decide that the default surcharge as a whole was disproportionate (although if it was, that fault could be relied upon by any person upon whom the penalty was imposed); it was necessary to consider whether the penalty in any particular case was disproportionate. In doing so, the UT listed the factors considered by the FTT, and added a few of its own. It also set out the advantages of the scheme as perceived by HMRC.

1 The degree of culpability

The UT considered that the failure to take into account the degree of culpability did not amount to a breach of the proportionality principle, apparently on the basis that a system which did take it into account would place "a huge and disproportionate" burden on HMRC, since they would have to make a judgement in each case.

Comment

It would seem that the question of whether a measure imposes a burden "disproportionate to the object to be achieved" applies to burdens on the State as well as to burdens on the taxpayer. However, it is odd that the UT did not comment on the regime which is due to replace default surcharge from a date to be announced (FA 2009 Sch 55 and 56), and which imposes higher penalties according to the degree of culpability, provides for reductions for disclosure and empowers HMRC to make reductions in "special circumstances".

2 A trader who is late but has a reasonable excuse is not penalised, even if payment is further delayed

The UT regarded this not a breach of the proportionality principle, but as a failure of HMRC to procure the passing of legislation addressing this point. It appears to have been addressed in the new regime referred to above.

3 The regime does not distinguish between traders who are a day, a week, or a month late

The UT saw this as a reflection of the aim of the legislation (to ensure compliance with the requirement to file and pay by the due date. The question was not whether a more coherent regime would make such a distinction, but whether the penalty for the failure was proportionate.

Comment

A person who pays nearly all his VAT liability by the due date incurs only a minor surcharge (ie one based on the

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Letterpart Ltd • Size: 240mm x 162mm • Date: February 1, 2013 • Time: 11:27

amount outstanding). By contrast, a person who pays all his VAT liability nearly by the due date (i e one day late) is subject to a surcharge on the full amount. For example a person who pays £9500 of a £10,000 liability on the due date will (assuming a surcharge rate of 10%) will be liable to a surcharge of £50. A person who pays the full £10,000 on the following day will be liable to a surcharge of £1,000. It may be that one or other of the surcharges is proportionate, but it is difficult to see how both can be. Perhaps the question here is whether the regime breaches the principle of equal treatment.

4 Potential hardship is to be disregarded

The UT considered that the surcharge related to tax unpaid, and not to any other measure such as the profitability of the taxpayer. Although a fairer regime might be designed, it did not mean that the current regime was so unfair as to be disproportionate.

Comment

In accepting that a fairer regime might be designed, the UT clearly considered that the current regime was (or could be) unfair. It suggests, therefore, that to be disproportionate, a regime has to be more than "plainly unfair"; it has to be sufficiently unfair.

5 Previous compliance record disregarded

The UT did not see that this gave rise for any concern, since any previous compliance record must have been compromised (by at least one default) before any surcharge could be imposed.

6 There is no maximum penalty

The UT saw this as a "real flaw" in the regime, but nevertheless considered that the penalty of £4,260 in the instant case was "of a wholly different character" from the £130,000 in the *Enersys* case, and although it was substantial it was not "devoid of reasonable foundation".

Comment

It is not clear in what sense the £4,260 was of a "wholly different character" to the amount in the *Enersys* case; clearly it was a much smaller figure, but this is no more than a reflection of the amount of tax due and therefore, indirectly, the relative size of the companies. Since the surcharge relates to tax unpaid (and not to any other measure – see 4 above) it is not clear in what respect the *Enersys* case can be distinguished.

7 There is no power of mitigation

The UT considered this point at two levels. In terms of the structure of the regime as a whole, it might be reasonable to say that the principle of proportionality obliged the UK to adopt the least onerous measure, and therefore to provide for a power of mitigation. On the other hand, the regime would then become much more cumbersome, which was something that the original Keith Report had specifically sought to avoid. The UT concluded that the reasonable excuse defence "strikes a fair balance between fairness to the taxpayer and the effective and economical deployment of the State's resources." If it was wrong on this point, it appeared to consider that mitigation should only apply to exceptional cases.

From the viewpoint of the individual concerned, the UT said that the fundamental question was whether the penalty was disproportionate; "The relevance of a power to mitigate is that an unreasonable penalty can be reduced and the question of proportionality of the penalty then falls to be answered by reference to the penalty as mitigated. Accordingly, we do not consider that the absence of a power to mitigate a penalty renders the regime non-compliant with the principle of proportionality. It is the level of the penalty, if anything, which will bring about that result."

Comment

As far as the first point is concerned, the UT seems effectively to be saying that "HMRC are far too busy to consider whether a penalty is fair". As the UT

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Letterpart Ltd • Size: 240mm x 162mm • Date: February 1, 2013 • Time: 11:27

pointed out at the beginning of the decision, counsel for HMRC had a "well-resourced and well-informed team to help him", while the appellant did not have that luxury. On that basis, it is not clear why considering the fairness of a penalty should be such a burden on HMRC when they have to consider mitigation in other cases. The UT also seems to consider that reasonable excuse is a fair proxy for mitigation, despite its clear limitations and the number of cases which have failed the reasonable excuse test but which are likely to have been mitigated if it had been possible.

On the second point, the UT seems to suggest that you use mitigation to reduce an unreasonable penalty, and then you look at the reduced penalty to see if it is disproportionate. It is difficult to see what benefit this approach has over simply looking at a penalty and considering whether there are any reasons why it should be reduced.

Conclusion

In a way, this case reminds me of the *Proctor and Gamble case* (*[2009] STC 1990, CA*) in which Mummery LJ observed "I think that most children, if asked whether jellies with raspberries in them were "made from" jelly, would have the good sense to say "Yes", despite the raspberries." I wonder what most people would answer if asked "is it reasonable for a business to be deprived of 10% of its annual profit for paying a bill one day late?" I'm not sure that they would have to delve too deep into the realms of proportionality to come up with an answer.

1 This appears to be a reference to *SKG* (*London*) *Ltd [2009] UKFTT 341* (*TC*). However the quotation actually comes from *Greengate Furniture Ltd* (*VAT Decision 18280*). In *SKG*, the Tribunal said "the Tribunal is left in doubt as to whether or not the statutory provisions for the penalty for late filing of a return under regulation 4 of the Regulations and the defence of reasonable excuse provided by section 118(2) TMA, without an explicit power in the Tribunal (or HMRC) to mitigate the penalty, satisfy the requirements of the Human Rights law principle of proportionality."

2 This point was previously made in *Neshama* (*2011*) *TC01254*, where the Tribunal said "We are somewhat perturbed by HMRC's policy of not assessing small penalties. The legislation provides initially for small penalties which later escalate for a good reason. That is that the smaller penalties serve to make the taxpayer aware that delay will cost him something – to provide a small shock so that a later large blow may be avoided."

David Rudling
LexisNexis

PLACE OF SUPPLY

Duty suspended goods: not necessarily outside the scope of VAT

Businesses involved in the sale and purchase of goods stored in customs warehouses on duty suspension arrangements may assume that such transactions are outside the scope of VAT. However, the ECJ has confirmed that this is only the case if Member States have enacted legislation to bring such sales outside the scope of VAT.

In *Daňové riaditel'stvo Slovenskej republiky v Profitube spol. s r.o.*(*Case C-165/11*), the European Court of Justice (ECJ) held that the sale of goods which are stored in a customs warehouse on duty suspension arrangements and which remain in the warehouse before and after the sale, by an EU business to another EU business, is subject to VAT unless the Member State in which the warehouse is situated has chosen to enact legislation to exempt the sale.

Letterpart Ltd • Typeset in XML • Division: DVITI_201 • Sequential 17

Letterpart Ltd • Size: 240mm x 162mm • Date: February 1, 2013 • Time: 11:27

Goods may be imported into the European Union using suspension arrangements provided for in the customs rules, without acquiring the status of Community goods, so that no duty is due. Article 98 of the Customs Code provides that a warehousing procedure may be used to allow the storage in a customs warehouse of non-Community goods, where such goods shall not be subject to import duties. Article 114 of the Customs Code provides that the inward processing procedure may be used to allow non-Community goods intended for re-export from the customs territory of the Community to not be subject to import duties. The inward processing procedure may be used, for example, to allow goods to be processed, assembled or repaired.

In 2005 and 2006, semi-finished steel products were imported from non-member state Ukraine, on behalf of a Slovakian company, Profitube, and placed under a duty suspension arrangement in Slovakia (a Member State). The goods were placed under a customs warehousing arrangement at first, and then under an inward processing arrangement in order to be processed into structural steel. The goods were then sold by Profitube to another Slovakian company, Mercurius, but were again placed under the customs warehousing arrangement. During all of these transactions, the goods remained in the same customs warehouse.

Following a VAT audit on Profitube, the Slovakian tax authorities requested payment of VAT on the sale between Profitube and Mercurius, as it considered the sale to be a normal supply of goods. Profitube took the view that the sale was not subject to VAT; it argued that as the goods were not considered Community goods under Customs law (having been in duty suspension arrangements), the goods also did not fall within the scope of the VAT rules.

Four questions were referred by the Slovakian Supreme Court to the ECJ. The two key questions were restated by the ECJ as follows: "when goods from a non-member country are placed under the customs warehousing procedure in a Member State, and are then processed under inward processing arrangements in the form of a system of suspension and have subsequently been sold and placed once again under the customs warehousing procedure, remaining throughout the whole of those transactions in the same customs warehouse situated in the territory of the Member state, [is] the sale of such goods …subject to VAT and, if so, what is the chargeable event"?

Article 2 of the VAT directive in force at the time (the "Sixth Directive") provides that the following shall be subject to VAT: (1) The supply of goods of services effected for consideration within the territory of the country by a taxable person acting as such, and (2) the importation of goods.

The ECJ first considered whether the goods were imported goods. Article 7 of the Sixth Directive which deals specifically with imports provides that where goods are placed under arrangements such as customs warehousing and inward processing arrangements, the place of import of the goods is the Member State within the territory of which they cease to be covered by those arrangements. In this case, however, as the goods had not left the customs arrangements at the date of the sale to Mercurius, the ECJ found that they did not fall to be imports under the VAT provisions.

The ECJ then considered whether the sale of goods fell within Article 2(1) of the Sixth Directive, that is, did they constitute a supply of goods effected for consideration within the territory of the country by a taxable person acting as such? The ECJ found that three of the four criteria were easily met: a) there was a supply of goods that is, the transfer of the right to dispose of tangible property as owner, b) the goods had been supplied for consideration, and c) Profitube was a taxable person registered for VAT.

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Letterpart Ltd • Size: 240mm x 162mm • Date: February 1, 2013 • Time: 11:27

However, the place of supply question (that is, "within the territory of the country") required more detailed consideration. At the date of sale, the goods were located in the public customs warehouse used by Profitube, situated in Slovak territory. Article 3(2) of the Sixth Directive states that "within the territory of the country" corresponds to the territorial scope of the EC Treaty for each Member State. Article 229 EC sets out the territorial scope of the EC Treaty.

The ECJ explained that Article 229 has special provisions for certain specific territories, and that Article 3(3) of the Sixth Directive expressly excludes certain national territories from the scope of that directive. However, the ECJ concluded that none of these provisions state that customs warehouses, public or private, are not "within the territory of the country" if they are situated in the territory of a Member State. In addition, the Customs Code does not establish a special status for customs warehouses.

As a result, the ECJ found that a customs warehouse is "within the territory of the country" where it is situated in the territory of a Member State. Therefore, a sale such as that at issue is subject to VAT under Article 2(1) of the Sixth Directive, with the chargeable event taking place at the date on which the supply of goods is effected. The ECJ further noted that Article 2(1) of the Sixth Directive does not make any distinction according to whether a supply concerns Community goods or not.

The ECJ also considered Article 16(1) of the Sixth Directive, which provides that Member States may exempt from VAT supplies of goods intended to be placed under a customs warehousing procedure or inward processing arrangements, provided that those transactions are not aimed at final use and/or consumption and that the amount of VAT due on cessation of the arrangement corresponds to the amount of tax which would have been due had each of those transactions been taxed within the territory of the country.

Both the ECJ and the Advocate General noted that Article 16(1) of the Sixth Directive clearly confirms the interpretation that, in principle, a supply of goods placed under a suspensory customs arrangement, effected for consideration by a taxable person in a customs warehouse situated in the territory of a Member State, is subject to VAT under Article 2(1) of the Sixth Directive.

The ECJ held that it was for the national court to verify whether the Slovak Republic has made use of the facility in Article 16(1) to exempt the sale from VAT. Given that the legislation provides that Member States may enact legislation to exempt the sales of goods in customs warehouses from VAT, this decision is not surprising.

The VAT directive (2006/112) that is currently in force contains a similar provision (Article 156) for Member States to take special measures to exempt certain transactions from VAT, which include the supply of goods that are intended to be placed under customs warehousing arrangements or inward processing arrangements.

EU businesses that are involved in the sale of goods that are stored in customs warehouses on duty suspension arrangements should therefore take care to seek advice on whether VAT will be payable. The UK has enacted legislation so that in certain circumstances, the supply of "eligible goods" that remain subject to a warehousing regime following the supply, shall be treated as taking place outside the UK. However, this is not necessarily the case in all Member States. Therefore, it is advisable that businesses that buy and sell goods stored in EU customs warehouses should seek VAT advice in the Member State in which the warehouse is situated.

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Letterpart Ltd • Size: 240mm x 162mm • Date: February 1, 2013 • Time: 11:27

CUSTOMS

Who has the burden to prove entitlement to GSP preference?

The Court of Justice of the European Union gave further guidance on this matter on 8 November 2012 in *Case C438/11, Lagura Vermögensverwaltung GmbH v Hauptzollamt Hamburg-Hafen***.**

The case was a reference for a preliminary ruling concerning the interpretation of Article 220(2)(b) of Council Regulation (EEC) No 2913/92 of 12 October 1992 establishing the Community Customs Code ("the Customs Code") in proceedings concerning the post-clearance recovery from Lagura of import duties relating to the importation of shoes.

Law

The Customs Code

Article 220 of the Customs Code provides:

> "1. Where the amount of duty resulting from a customs debt has not been entered in the accounts … or has been entered in the accounts at a level lower than the amount legally owed, the amount of duty to be recovered or which remains to be recovered shall be entered in the accounts within two days of the date on which the customs authorities become aware of the situation and are in a position to calculate the amount legally owed and to determine the debtor (subsequent entry in the accounts)…
>
> 2. … subsequent entry in the accounts shall not occur where:
>
> …
>
> (b) the amount of duty legally owed failed to be entered in the accounts as a result of an error on the part of the customs authorities which could not reasonably have been detected by the person liable for payment, the latter for his part having acted in good faith and complied with all the provisions laid down by the legislation in force as regards the customs declaration;
>
> Where the preferential status of the goods is established on the basis of a system of administrative cooperation involving the authorities of a third country, the issue of a certificate by those authorities, should it prove to be incorrect, shall constitute an error which could not reasonably have been detected within the meaning of the first subparagraph.
>
> The issue of an incorrect certificate shall not, however, constitute an error where the certificate is based on an incorrect account of the facts provided by the exporter, except where, in particular, it is evident that the issuing authorities were aware or should have been aware that the goods did not satisfy the conditions laid down for entitlement to the preferential treatment.
>
> The person liable may plead good faith when he can demonstrate that, during the period of the trading operations concerned, he has taken due care to ensure that all the conditions for the preferential treatment have been fulfilled.
>
> …"

Regulation (EEC) No 2454/93

Article 94 of Commission Regulation (EEC) No 2454/93 of 2 July 1993 laying down provisions for the implementation of the Customs Code ("the Implementing Code" provides:

> "1. Subsequent verifications of certificates of origin Form A … shall be carried out at random or whenever the customs authorities in the Community have reasonable doubts as to the authenticity of such documents, the originating status of the products concerned or the fulfilment of the other requirements of this section.

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Letterpart Ltd • Size: 240mm x 162mm • Date: February 1, 2013 • Time: 11:27

> 2. For the purposes of implementing the provisions of paragraph 1, the customs authorities in the Community shall return the certificate of origin Form A and the invoice, if it has been submitted, … to the competent governmental authorities in the exporting beneficiary country giving, where appropriate, the reasons for the enquiry. Any documents and information obtained suggesting that the information given on the proof of origin is incorrect shall be forwarded in support of the request for verification.
>
> If the said authorities decide to suspend the granting of the tariff preferences … while awaiting the results of the verification, release of the products shall be offered to the importer subject to any precautionary measures judged necessary.
>
> 3. When an application for subsequent verification has been made in accordance with paragraph 1, such verification shall be carried out and its results communicated to the customs authorities in the Community … The results shall be such as to establish whether the proof of origin in question applies to the products actually exported and whether these products can be considered as products originating in the beneficiary country or in the Community.
>
> …"

Regulation (EC) No 980/2005

Article 1 of Council Regulation (EC) No 980/2005 of 27 June 2005 applying a scheme of generalised preferences (OJ 2005 L 169, p. 1) provides:

> "1. The Community scheme of generalised tariff preferences … shall, from the date of entry into force of this Regulation until 31 December 2008, apply in accordance with this Regulation.
>
> 2. This Regulation provides for:
>
> (a) a general arrangement,
>
> …"

Article 2 of Regulation No 980/2005 states that "[t]he beneficiary countries of the arrangements referred to in Article 1(2) are listed in Annex I". The Macao Special Administrative Region of the People's Republic of China ("Macao") is among those beneficiary countries and territories, set out in Annex I to that regulation.

Under Article 7(2) of Regulation No 980/2005, "Common Customs Tariff *ad valorem* duties on products listed in Annex II as sensitive products shall be reduced by 3.5 percentage points". Shoes, categorised as a sensitive product, are among the products listed in Annex 2 to Regulation No 980/2005 and, accordingly, are covered by the preferential arrangements provided for in that regulation.

Under Annex I to Regulation No 980/2005, tariff preferences have been removed for shoes from the People's Republic of China.

Facts and procedure

Lagura imported shoes into the European Union between February and September 2007 and made customs declarations for the release of the goods for free circulation within the European Union. Attesting to the origin of the goods, certificates of origin Form A were attached to the customs declarations, showing that the goods came from Macao and that they had been produced by S and V, companies which had their head offices in that region. On the basis of those certificates, the duty charged by German Customs on the shoe imports was applied at the preferential rate of 3.5%.

After receiving information that certain goods originating in China had been wrongly declared as coming from Macao, in order to avoid payment of a non-preferential import duty, German Customs arranged for an application to be

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made to the competent Macao authorities for subsequent verification of the certificates in accordance with Article 94 of the Implementing Code. In the course of that verification, the Macao authorities confirmed that they had issued the certificates of origin for the goods in question but they were unable to verify the accuracy of the content of those certificates, as the companies who provided the information as exporters had ceased production and had therefore been closed down. Nevertheless, the Macao authorities did not invalidate the certificates of origin.

As the subsequent verification had not confirmed the origin of the goods, German Customs held that they were of unknown origin. Accordingly, by three import duty notices respectively dated 21, 22 and 25 August 2008, German Customs claimed, on the basis of Article 220(1) of the Community Customs Code, recovery of the difference between the customs duties calculated on the basis of the preferential rate of duty (3.5%) and those calculated on the basis of the normal rate of duty (7%).

Lagura brought proceedings before the Finance Court Hamburg, invoking *inter alia* the principle of the protection of legitimate expectations, in accordance with Article 220(2)(b) of the Customs Code.

The Finance Court was uncertain as to which party must bear the burden of proving that the certificate of origin was based on a correct or incorrect account of the facts by the exporter and decided to stay the proceedings and to refer the following question to the Court for a preliminary ruling:

> "In the circumstances of the case before the referring court, that is to say, where the authority of the non-member country is no longer able to verify whether the certificate issued by it is based on a correct account of the facts, is the person liable for payment to be denied the protection of legitimate expectations provided for in the second and third subparagraphs of Article 220(2)(b) of the Community Customs Code where the circumstances on account of which it is impossible to clarify whether the content of the certificate of origin is correct fall within the sphere of control of the exporter, or is the transfer of the burden of proof, in the context of the third subparagraph of Article 220(2)(b) of the Customs Code, from the customs authority to the person liable for payment subject only, or rather, to the condition that clarification is impossible because it is outside the control of the authority of the exporting [State] or caused by carelessness wholly attributable to the exporter?"

Judgment

The purpose of subsequent verification is to check the accuracy of the origin indicated in the certificate of origin [17].

If subsequent verification does not confirm the origin of the goods as stated in the certificate of origin, it must be concluded that those goods are of unknown origin and that, in consequence, the certificate of origin and the preferential tariff were wrongly granted [18].

Impossible to verify – burden of proof of correct account of the facts

In bilateral preference, where it is impossible to verify, as a result of negligence wholly attributable to the exporter, it is for the importer to prove that the EUR.1 movement certificate issued by the export authorities was based on a correct account of the facts given by the exporter. Such a requirement constitutes a derogation from the generally accepted rules on the allocation of the burden of proof, under which, in bilateral preference, it is, in principle, for the import customs authorities, who wish to rely on Article 220(2)(b) in order to carry out postclearance recovery, to adduce in support of their claim the evidence that the incorrect certificates were issued because of the inaccurate account of the facts provided by the exporter (see

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Case C-293/04 Beemsterboer Coldstore Services, paragraphs 39 to 46) [21]–[22].

The Court determined the way in which the interpretation of Article 220(2)(b) of the Customs Code provided by the Court in *Beemsterboer Coldstore Services* should be applied to unilateral preference such as the GSP system of generalised tariff preference afforded by Regulation (EC) No 980/2005.

A situation where the customs authorities of the importing State had to prove the inaccuracy of the facts provided by the exporter, but were unable to do so owing to the exporter having ceased its activities, could create a risk of conduct incompatible with the objectives of the generalised tariff preferences scheme. Even if the cessation of production represents, in principle, an everyday economic decision, the possibility cannot be excluded that it could nevertheless constitute improper behaviour on the part of the exporter, designed to circumvent the rules of the generalised tariff preferences scheme, through being used by that exporter as a means of concealing the real origin of goods originating from a State which is not admitted to the preferential arrangements. The Court held that the European Union cannot be made to bear the adverse consequences of the wrongful acts of exporters [32].

In cases such as that of *Lagura*, the burden of proving that the certificate of origin was based on a correct account of the facts provided by the exporter rests with the importer [38].

Binding assessment of the export authorities

The certificates of origin in question were not invalidated by the competent Macao authorities.

In relation to agreements between the European Union and non-member countries, such as association agreements or free trade agreements (bilateral preference), the Court has held that the system of administrative cooperation can function only if the customs authorities of the State of import accept the determinations legally made by the authorities of the State of export [34].

However, the requirement for the customs authorities of the Member States to take into account the assessments made by the customs authorities of the exporting country does not arise in the same way where the preferential scheme is established not by an international agreement binding the European Union to a non-member country on the basis of reciprocal obligations, but by a unilateral EU measure [35].

The Court held that, under the scheme of generalised tariff preferences established unilaterally by the European Union, the assessment made by the authorities of the exporting State as to the validity of certificates of origin Form A cannot be binding upon the European Union and its Member States when the customs authorities of the importing State continue to harbour doubts as to the true origin of the goods, despite the fact that those certificates of origin have not been invalidated [36].

If the customs authorities of the importing State, in proceedings for post clearance recovery, could not require proof that the certificate of origin was based on a correct account of the facts by the exporter, that would undermine the objective of the subsequent verification [37].

Therefore the Court held that in cases of unilateral preference the import customs authority is not bound by the assessments of the export authorities.

In answering the Finance Court's question the Court held that Article 220(2)(b) of the Customs Code must be interpreted as meaning that if, owing to the fact that the exporter has ceased production, the export authorities are unable, through a subsequent verification, to determine whether the certificate of origin Form A that they issued is based on a correct account of the facts by the exporter, the burden of proving that the certificate was

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based on a correct account of the facts by the exporter rests with the importer [41].

Comments

The Court has repeatedly held that it is the responsibility of traders to make the necessary arrangements in their contractual relations in order to guard against the risks of an action for post-clearance recovery (See Case *C-97/95 Pascoal & Filhos*, paragraph 60; *Case C299/98 P CPL Imperial 2 and Unifrigo v Commission*; and *Beemsterboer Coldstore Services*, paragraph 41).

Where the importer obtains from the exporter, on or after conclusion of the contract, all the necessary evidence confirming that the goods come from a State which is a "beneficiary country" vis-à-vis the relevant tariff preference scheme, including documents establishing origin, this can reduce the risk of an action for post-clearance recovery. This is the main lesson of the Court's jurisprudence.

It has been said before that the prudent importer should adopt the policy of "Know Your Supplier". For the importer, the profitability of the commerce will often depend upon entitlement to preference. The importer can legitimately request that the exporter provide contemporaneous evidence of entitlement to preference as a condition of sale. Then the importer should be in a better position to deal with subsequent verification if necessary.

In *Beemsterboer Coldstore Services*, the Court held that the customs authorities of the importing State cannot be required to prove that the exporter made false declarations when it transpires that the exporter has not kept the documents relating to the goods in question for at least three years, notwithstanding the obligation laid down in the applicable preference rules. In such circumstances, it is impossible for those authorities to establish whether the information provided by the exporter for the issue of the EUR.1 certificates was correct or not (*Beemsterboer Coldstore Services*, paragraph 40). In such circumstances the onus is not on the importing customs authorities to prove that the incorrect certificates were issued on the basis of false declarations by the exporter.

In Case *C-409/10 Afasia Knits Deutschland* the importer had argued that the rule in *Beemsterboer* should be qualified in the circumstances of *force majeure* where the exporter was not negligent and was not responsible for the absence of the documents relating to the goods. The Court did not disapprove of the argument in principle.

It is now possible to summarise the Court's guidance on the issues of proof of preferential origin; the binding nature of assessment as to the correctness of the account of facts given by the exporter; and the burden of proof.

1 Preferential rates are only granted provisionally upon presentation of an origin certificate Final entitlement to preference is subject to subsequent verification.
2 In cases of bilateral preference, the assessment made by the export authorities is binding on the import customs authority.
3 In cases of unilateral preference, the assessment made by the export authorities is not binding on the import customs authority.
4 Where subsequent verification is impossible, in cases of bilateral preference, the burden of proof is on the import customs authority unless the exporter is negligent.
5 Where subsequent verification is impossible, in cases of unilateral preference, the burden of proof is on the importer whether or not the exporter is negligent.

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