TC03311

Appeal number: LON/2004/1028 & TC/2010/05601

Value Added Tax - Input tax - Failure of derogation dealing with retail sales made through non-registered representatives to provide for any deduction in respect of input tax for costs borne by representatives, whilst nevertheless rendering the Appellant (on selling to those representatives) liable to VAT by reference to the retail open market selling price received by the representatives - whether the derogation, the UK statutory provision implementing it or the Notice of Direction, applying the derogation to the Appellant could be varied by us – reference of this question to the European Court of Justice - further issue of whether the derogation itself was unlawful and should be set aside, an issue that can only be determined by the ECJ – reference of that issue to the ECJ with an indication that the derogation was not proportionate since it imposed additional tax in excess of any calculation of the tax avoided but for the derogation, once the representatives incurred costs that had suffered VAT – additionally the derogation occasioned "sticking tax", and an element of unfair competition between the Appellant and its representatives, and those selling through normal VAT-registered retailers

FIRST-TIER TRIBUNAL
TAX CHAMBER

AVON COSMETICS LIMITED **Appellant**

-and-

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

Tribunal: JUDGE HOWARD M. NOWLAN
ANDREW PERRIN

Sitting in public at 45 Bedford Square in London on 10 – 17 December 2013

Roderick Cordora QC and David Scorey, instructed by Pinsent Masons LLP on behalf of the Appellant

Melanie Hall QC and Nicola Shaw QC instructed by HMRC on behalf of the Respondents

DECISION

Introduction

1. This was a Value Added Tax ("VAT") appeal that involved a claim by the Appellant to a repayment of a significant amount of VAT since the claim related to numerous past VAT periods. Were the Appeal eventually to be allowed, the total VAT refunded, ignoring interest, would apparently be in the region of £14 million. We were asked, however, to deal with the Appeal as a matter of principle, without paying regard to the calculations for any particular years.

2. The points in dispute fall into the two categories of, first, whether the Appellant was right to claim that at present it is being seriously disadvantaged by the manner in which it is being charged to VAT, which the Appellant claims is incoherent and in breach of at least two of the fundamental principles of the VAT system. The second topic is whether we, or indeed even the ECJ, are able to grant any redress, should we decide the first point in favour of the Appellant.

3. The Appellant's grievance all related to the adjusted way in which VAT can be charged (following a derogation that the United Kingdom was authorised to make by the EU Council in 1985, from the way in which VAT would otherwise be charged) on companies effecting their sales by selling to non-VAT registered individuals, who in turn sold to the ultimate customers. The effect of the derogation has been to permit the United Kingdom to require traders selling through such representatives to compute their output tax liability by taking the open market retail sales prices receivable by the representatives in place of the lower consideration actually received on the prior sale to the representatives by the traders. The grievance was that the derogation completely disregarded any costs incurred by the representatives, and thus disregarded any input tax in respect of these costs which would have been deductible had the representatives been VAT-registered.

4. The Appellant claims that this method of calculating its VAT liability has breached the parameters within which derogations should have been requested and authorised, in that it increases the Appellant's liability to VAT by more than could possibly be claimed to have been the tax potentially avoided under the ordinary rules, prior to the derogation. It also breaches two further fundamental principles by occasioning "sticking tax", i.e. VAT that is actually suffered at the business level, resulting in the total tax charged being tax in excess of the amount that should ultimately be suffered by end-customers in accordance with the fundamental principle of VAT. It also occasions unfair competition with the VAT-registered high street retailers, by imposing more tax on those governed by the derogation where the representatives suffered costs, a perverse result when part of the justification for the derogation was that it occasioned unfair competition in the reverse direction.

The Appellant's facts in outline

5. As is reasonably well known, for many years the Appellant has operated the business model of selling its products to numerous representatives, (usually referred to as "Avon

ladies") who in turn make the retail sales to their customers. The Avon ladies are given a discount from the "brochure prices" of either 20% or 25% when they buy from the Appellant so that unless they pass on some of that discount to their customers, the 20% or the 25% is the ladies' gross profit.

6. The vast majority of the Avon ladies have very modest turnover and so are not registered for VAT purposes. The ordinary consequence of this, had the United Kingdom not been authorised to introduce a derogation from the normal VAT rules, would have been that VAT would have been charged on the Appellant, and the considerable number of other companies that pursue the same marketing model, only on the consideration received by such companies, and no VAT would have been charged in respect of the retail sales themselves. It was considered from a very early date that this would undermine one of the basic principles of VAT, namely that the tax should generally extend to the retail stage in the supply chain, and the absence of VAT at the retail stage would also give companies selling in this manner an unfair competitive advantage over sales made through ordinary high street shops and countless other retailers, all of whom account for VAT in respect of their retail sales. Accordingly to avoid these two undesirable results the United Kingdom sought the derogation that we mentioned in paragraph 3 above which enables HMRC, once it has served what is known as a Notice of Direction ("NoD") on any particular company to which the terms of the derogation apply, to compute that company's VAT liability by reference to the open market retail sales values of its products and not by reference to the company's actual, usually discounted, sales receipts.

7. The Appellant has no objection to its output VAT liability being geared to the representatives' higher retail selling prices, and in other words no remote complaint about the general objective of ensuring that VAT applies through to the retail stage in the supply chain. The Appellant's objection is that the derogation potentially creates a problem in any case where the representatives incur costs that would ordinarily have been deductible as input tax, had the representatives been registered for VAT purposes. The complaint is naturally that if VAT is to be charged up to the retail sales value, it offends the neutrality of the VAT system if costs at that stage are disregarded in calculating the Appellant's VAT liability (occasioning "sticking tax" at the level of the business).

8. The Appellant has not strictly advanced its case in relation to all costs incurred by the Avon ladies, but has focused on a significant cost charged to the Avon ladies by the Appellant itself. The relevant cost is one that has always arisen under the Appellant's business model, and one that was indeed drawn to the attention of HM Treasury by the Appellant in 1973 when it became clear that VAT would be charged and the first version of the derogation was under discussion. The cost in question is that the Appellant sells demonstration items to the Avon ladies, enabling the Avon ladies to demonstrate the perfumes, hand lotions etc. (and a considerable number of other products which we will mention in due course) to their customers. For reasons that we will explain below, it has been fundamental to the Appellant that these items are actually sold, and not given, to the Avon ladies, though as we will describe below, the selling price is somewhat lower than the discounted price generally charged for ordinary retail items that the ladies will on-sell to their

customers. Naturally when the Appellant sells the demonstration items, it accounts for VAT on the consideration received. The Appellant's present complaint is that if it is charged to VAT in respect of the goods that are on-sold to customers (i.e. the general retail sales and not its sale of the demonstration items) by reference to the notional sales consideration receivable by the non-VAT registered representatives, so increasing its VAT liability, it is wrong that the derogation disregards the way in which the Avon ladies suffer business costs in buying the demonstration items, with the Appellant being precluded from diminishing its increased VAT liability under the derogation by the input tax associated with those costs.

9. We were given figures for year 2011, which illustrated by how much the Appellant's VAT liability had been increased by the derogation that looked through to the retail selling prices, the relevant figure being £6,926,113. That figure would however have been reduced by £1,392,884.92 to a net increased figure of £5,553,228, had symmetrical treatment been accorded to those costs incurred by the Avon ladies that had suffered VAT, i.e. to the cost of demonstration items.

10. We consider that the Appellant's grievance has been well established, and that the terms in which the derogation was sought have wrongly resulted in the infringement of various fundamental VAT principles in a quite unnecessary manner, and they have wrongly failed to achieve the very object for which the derogation was sought in a proportionate manner.

The problem in devising a remedy

11. The difficulty that we face, however, is that the principal cause of the present unfairness is the feature that, in responding to the United Kingdom's request for a derogation, the authorisation of the derogation by the EU Council itself dealt only with Article 11 of the Sixth Directive and just enabled the United Kingdom to introduce a measure that simply adjusted the computation of consideration and paid no regard to costs at all. As will emerge from the text that we quote below, the United Kingdom's statutory provision that implements the permitted derogation in United Kingdom law appears to us to be precisely in accordance with the authorisation, and in other words it permits the consideration to be adjusted and makes no reference to costs. And the NoD that applies the adjusted basis for calculating its VAT liability to this particular Appellant precisely reflects that same feature of just adjusting the sale consideration. Whilst we might regard this treatment as unfair or incoherent, we cannot dispute that interpreting the authorisation and the statutory provision realistically, the NoD achieves the precise effect that is authorised, and there is a very respectable argument that HMRC would simply be precluded from giving relief for the input tax about which the Appellant complains.

12. The Appellant asks us to interpret either the United Kingdom statutory provision or the NoD by inserting the symmetrical requirement that when the Appellant's output liability is uplifted to the open market retail price, a corresponding deduction should be given for costs at the retail level in respect of which input tax deductions would have been available had the representatives been VAT registered. We accept that we are at liberty to interpret domestic

legislation, and the NoD in a manner that better reflects the treaty and Directive principles, but we are far from clear that it is open to us to doctor either the United Kingdom statute or the NoD by completely changing the substance of the derogation. This is particularly the case in the light of the requirement that derogations be applied and interpreted strictly, and the fact that, were we effectively to modify the derogation, this is a course that should actually require the United Kingdom to apply to the EU Commission and Council for a modified derogation. We do, however, consider that the wording that we are asked by the Appellant to imply is coherent, it merely drags back the derogation to ensure compliance with fundamental VAT principles that have been ignored, and it certainly does not extend the ambit of the derogation. It is indeed entirely consistent with the objective that we consider should have been sought when the derogation was requested. For this reason, and because the point to which we now turn renders it inevitable in our view that we must refer this case to the ECJ, we propose to request guidance from the ECJ as to whether it is appropriate to imply the wording that the Appellant suggests either into the terms of paragraph 2 Schedule 6, or at least into the Appellant's NoD.

The more radical challenge

13. Whilst we have very serious doubt that we should interpret the statute or the NoD in the manner requested by the Appellant, there is another challenge in this case. That further challenge is that the very authorisation itself should be declared invalid because it breached the fundamental rule of increasing the VAT chargeable by more than the coherent calculation of the VAT avoided, the avoidance of which was the reason for the grant of the derogation. As we have already described, the derogation occasions "sticking tax" at the business level, and tilts the unlevel playing-field in the other direction by actually charging more tax on those companies that are subjected to the derogation and whose representatives incur retail costs, than the tax charged on the normal VAT-registered high street retailers.

Practical considerations

14. Whilst we consider that there is very considerable force to this further contention, we have no jurisdiction ourselves to declare the derogation unlawful and this can be done only by the ECJ. We will therefore refer this issue to the ECJ. Since it follows that the case will have to be referred to the ECJ, we conclude that we should also refer the questions concerning the possible solution to the present problem by inserting wording into either the United Kingdom statute or the NoD in the manner that we mentioned in paragraph 12 above. The relevance to referring these points of possible interpretation to the ECJ is also occasioned by the largely pragmatic observation that in terms of common sense it would be more satisfactory for this Appeal to be resolved by an adjustment that would ensure that the Appellant paid tax on the right amount for all periods, in other words on approximately the £5.5 million in 2011 (and appropriate figures for other years). It may be that similar results could be achieved if the Appellant succeeded in establishing the most radical of its claims, namely that the whole derogation had been invalid from the outset. If however success on that basis involved the conclusion that all the tax charged since 1985 under the derogation on the considerable number of companies that were said to have been taxed on this basis was

shown to have been wrongly charged, the result would appear to be excessive, and one that the ECJ might for that very reason be unwilling to contemplate. This is why, difficult as the points of interpretation are in relation to the terms of the United Kingdom statute and the NoD, there is a practical and common sense desire to solve the present problem by that route, rather than by the more radical claim concerning the validity of the derogation.

The relevant three provisions, i.e. the authorisation, the statutory provision and the terms of the NoD

15. Following a failed invalid attempt to introduce a derogation to deal with sales through unregistered persons in 1981, the UK received a temporary authorisation in 1985 to derogate from Article 11 of the Sixth Directive, and that became a permanent authorisation in 1987. Its very simple terms were that:

> *"By way of derogation from Article 11A(1)(a) of the Sixth Directive, the United Kingdom is hereby authorised to prescribe, in cases where a marketing structure based on the supply of goods through non-taxable persons results in non-taxation at the stage of final consumption, that the taxable amount for supplies to such persons is to be the open market value of the goods as determined at that stage."*

16. Pursuant to this derogation, what is now paragraph 2 of Schedule 6 to the VAT Act, 1994 was enacted, providing as follows:

> *"Where:-*
>
> *(a) the whole or part of a business carried on by a a taxable person consists in supplying to a number of persons goods to be sold, whether by them or others, by retail, and*
>
> *(b) those persons are not taxable persons,*
>
> *the Commissioners may by notice in writing to the taxable person direct that the value of any such supply by him after the giving of the notice or after such later date as may be specified in the notice shall be taken to be its open market value on a sale by retail."*

17. The terms of the NoD issued to the Appellant, initially in June 1985, was in virtually identical terms, reading as follows:

> *"In pursuance of paragraph 3 of Schedule 4 of the Value Added Tax Act 1983 the Commissioners of Customs and Excise hereby DIRECT that after 1 July 1985 the value by reference to which Value Added Tax is charged on any taxable supply of goods:-*
>
> *(a) by you to persons who are not taxable persons within the meaning of section 2 of the Value Added Tax Act 1983,*
>
> *(b) to be sold, whether by persons mentioned in (a) above or others, by retail,*

shall be taken to be its open market value on a sale by retail."

The facts in more detail

18. The Appellant's trade involves selling not only toiletries, make-up, skincare products and perfumes but numerous other items such as clothing, children's toys and jewellery. Although some sales are made directly to customers over the internet, it remains the case that the vast majority of sales are still made through the famous Avon ladies.

The practical reality of the different sales expectations and practices by the various Avon ladies

19. As will be obvious to anybody, the level of activity and the personal objectives of Avon ladies vary enormously. We were told that at any one time there are likely to be about 170,000 Avon ladies in the United Kingdom, but with new ladies constantly being enrolled and others dropping off, it was suggested that in a twelve-month period as many as 300,000 ladies will have been engaged at some time in the year.

20. It was estimated that about 17,000 of the annual average of 170,000 Avon ladies will have been selling for a fairly long period and that they will have developed a sizeable clientele and would thus be selling considerable quantities of product. At the other end of the scale, there are probably Avon ladies who occasionally acquire product, not with a view to selling it in a commercial sense at all but simply to buying it for their own use, or perhaps to give it, or to sell it at a discount or at their cost to relatives, and possibly very close friends. Others might sell slightly more widely, possibly in their office or other workplace, or in their immediate locality.

The sales arrangements

21. Avon ladies can purchase product either in anticipation of obtaining orders from their normal customers, or more usually the ladies will canvass orders from their customers first, showing the customers the available products from the customer sales brochures prepared for each "campaign". Whichever of those two approaches is followed, the Appellant then sells and delivers the ordered product to the Avon lady in question, charging the brochure price minus a discount of either 20% or 25%, the 25% applying to the larger orders placed.

22. The initial and natural application of the NoD therefore in the case of a sale by the Appellant to one of the Avon ladies of a product at £80 for which the brochure price was £100 would be for the Appellant's VAT to be calculated by reference to the £100.

The present agreed formula application of the NoD

23. The Appellant and HMRC have for some years arrived at two perfectly sensible and uncontentious modifications to the way in which the NoD is applied. The first of these adjustments acknowledges that insofar as some Avon ladies are purchasing product for their own use, then the terms of the NoD do not apply to those sales at all because the relevant ladies are the ultimate customers; they are not contemplating selling the products purchased

on a retail basis, and are not holding them or dealing with them in any business sense. Accordingly the NoD is simply inapplicable to the sales in this category and therefore the Appellant's VAT should be calculated in the ordinary way as regards these sales, in other words to be chargeable in respect of the actual £80 received in the above example by the Appellant from the Avon lady, i.e. in that case the ultimate customer.

24. The second equally-sensibly agreed adjustment to the calculations made pursuant to the NoD is that while it is appropriate to charge the Appellant VAT in respect of the £100 where it is supposed that the Avon lady in question will have sold the product at the brochure price, there will be many ladies who themselves offer discounts either to maximise sales or as a slight favour to friends. HMRC has long accepted that in these circumstances it is unrealistic to charge VAT on the Appellant by reference to the price of £100, when in many cases the Avon ladies will have sold at a discount.

25. Some complex calculations are obviously involved to deal with the above two factors, not least because strictly accurate figures would require the Appellant and HMRC to know what every Avon lady who purchased product actually did with it, and there is no way in which the Appellant's basic feedback from the Avon ladies would produce that information. We understand, however, that in an entirely sensible way, the Appellant and HMRC periodically re-visit the facts and the evidence and this leads to a revised figure used in calculating the percentage uplift to use when applying the NoD.

26. There is no present dispute about the above two factors that are taken into account, and the formula used to derive the appropriate percentage uplift at which to charge the Appellant to VAT. The principal reason for mentioning these two points is that both parties appeared to accept, and we certainly agree, that these two sensible adjustments involve no sort of implicit change to the terms of the NoD. They are simply a sensible application of the principle to the facts that arise, and they are thus uncontentious.

The demonstration items

27. The Appellant's witnesses explained that the Appellant usually had 18 sales campaigns a year. A sales brochure would be prepared for each campaign, designed to enable the Avon ladies to show their customers what they could order in that particular campaign, and how much the various items would cost. On the occasion when each brochure was sent to the Avon ladies, in preparation for the next campaign, the ladies were also sent a different brochure that was not intended to be shown to customers, the purpose of which was to indicate to the Avon ladies the new products that would be available two campaigns later. Thus if the main brochure related to campaign 6, the other brochure would be showing the new products that would become available for the first time in campaign 8. The name of this other brochure was changed from time to time, but the various names, First Look, Link and Hello Tomorrow all reflected the obvious purpose of this brochure.

28. That second brochure also enabled the Avon ladies to order "demonstration" items of the proposed new products so that they could test or simply look at the intended new

products, and when they came to market the available items for campaign 8 they could have in their possession relevant samples to show or demonstrate to their potential customers.

29. The practice in relation to the demonstration items was for the Appellant to sell them, pursuant to orders placed in response to an order form contained in the relevant brochure, at a profit (roughly a gross margin of 40% over cost, and at a margin that left little net profit by the time all the administrative costs had been incurred) but nevertheless at a greater discount than the 20% or 25% discounted brochure price that would apply two campaigns later when the same products became generally available to customers. Consistent with the purpose of the demonstration items, the Appellant always made it clear that each Avon lady could only acquire one demonstration item. It was also stressed that the Avon lady should not sell the demonstration items to customers. It was appreciated that some of the Avon ladies might simply purchase their single allocation of demonstration items for their own use. The Appellant could not prevent this from happening, though it was not the intention of providing the demonstration items, and of course once one had been purchased of any particular product, the Avon lady in question would not be able to order any other repeat item, at the price charged for demonstration items.

30. The VAT implications of the sale of the demonstration items raised a number of points, most of which were obvious. First, the Appellant itself accounted for VAT on selling the relevant items to the representatives, naturally deducting any input tax attributable to its own purchase or other related costs or to the manufacturing costs.

31. The Appellant then contended that insofar as a demonstration item was purchased for the intended purpose of enabling the Avon lady to demonstrate the item (say a new perfume or a new hand cream) to her customers, such that the demonstration item would neither be sold nor retained for own use, then it would obviously follow that had the representatives been VAT-registered, the input tax would have been deductible in computing the representatives' net VAT liability. Indeed in the case of the few Avon ladies who were registered for VAT purposes, the relevant input tax associated with the purchase of demonstration items was deductible.

32. Both parties agreed that where Avon ladies purchased demonstration items, simply intending to retain and use them themselves, and not to use them for demonstrating new product at all, then the obvious VAT implication would be that those ladies would rank as the "end customers", buying for personal consumption and not for business use, and they should simply suffer the VAT inclusive cost, without any thought of claiming an input deduction for the related VAT. Equally obviously since the demonstration items were definitely intended not to be re-sold, and we understood that they were virtually never re-sold, then there would be no possible issue of the derogation applying to the Appellant's sales of these items. It was agreed that it would have been plainly wrong to uplift the Appellant's actual consideration receipt to the retail open market value figure when the demonstration items were not going to be sold to anyone by the representatives.

33. This present dispute revolves entirely around the fact that while VAT-registered Avon ladies account for VAT in respect of their retail items by treating their sale consideration received as their output liability, and then deducting the input tax in relation to the purchase of both the retail items and the demonstration items used for marketing purposes, the derogation that uplifts the Appellant's VAT liability in respect of its own sales of "retail product" to the non-registered Avon ladies simply uplifts the Appellant's actual sales receipts to the formula calculation of the retail sale prices received by the Avon ladies. It either forgets or ignores the cost of the demonstration items used for demonstration purposes that would have qualified for input deduction in the hands of the registered Avon ladies. Reverting to the figures given in paragraph 9 above, the financial significance of this is that the Appellant's VAT liability for the year 2011 was uplifted by approximately £7 million under the application of the derogation and the NoD, whereas it would have been increased by only £5.5 million if a deduction had been given for the relevant input tax, as the Appellant contends it should have been given.

34. We might mention that when it was conceded that no such deduction would be appropriate when the Avon ladies simply retained and used the demonstration items themselves, and did not use them for demonstration purposes at all, we would have expected it to be extremely difficult for the Appellant and HMRC actually to agree on the proportion of the VAT associated with the demonstration items that should (at least on the Appellant's claim) be deductible, and the balance that should just be part of the cost to end-consumers when the products were simply retained and used by the Avon ladies. Surprisingly, however, we were told that for the period from September 1997 to December 2013, and for the year 2011 the figures had actually been agreed by the parties and that for the former period the percentage of the relevant VAT referable to items used for demonstration purposes had been 49.81% and for the year 2011 50.12%. How these figures had been calculated and agreed to the accuracy of two decimal places struck us as fairly astonishing. We emphasise, however, that the rough figure of £1.4 million that the Appellant claimed should coherently have been deductible in respect of the input tax associated with the demonstration items was indeed the correct percentage of that amount, pursuant to the agreed calculation just mentioned.

35. We mentioned in paragraph 18 that the Appellant's business was not confined to toiletries, skincare products and perfumes but that it now extended to clothes, children's toys, jewellery and other items. Although the demonstration items seemed to be most relevant to items such as perfumes and toiletries, we were told that demonstration items were still relevant, and were still available in relation to the other products. Whilst the ability to sample the scent in a perfume spray was obviously vital, such that retail outlets such as Boots and obviously the department stores were always able to demonstrate perfumes in a similar manner, the Appellant provided demonstration items to illustrate clothes, children's toys and jewellery. The fair point was made that it was difficult to detect from a brochure whether clothes felt soft to the touch, and whether children's toys and jewellery looked to be of good quality, and sales would be at reduced levels if customers had to rely solely on what the picture of the item looked like in the brochure.

Whether the failure of the derogation to give any deduction for input tax referable to costs incurred by the Avon ladies was unfair, and HMRC's suggestions as to how any problem, if there was one, might be eliminated

36. The Appellant had suggested at one point that in discussions HMRC had conceded that the present structure was unfair. This led, in cross-examination of one of the Appellant's witnesses, to a firm denial that HMRC had ever conceded that there was any present unfairness or incoherence in the way in which the derogation operated. We will defer mentioning some of the points in this context until we summarise the parties' various contentions and give our decision. At this point, however, and since the points had been put to the Appellant's witnesses, we will simply record the Respondents' claim that they had never conceded that anything was remotely unfair (not that this is particularly relevant) and we will mention two suggestions advanced by HMRC that HMRC suggested would enable the Appellant to avoid any of the disadvantage that the Appellant perceived to exist.

37. The first suggestion was that the Appellant might simply give the demonstration items to the Avon ladies, and if that change required the Appellant to diminish the discount given in respect of orders of retail items in order to leave the Appellant's own net profits at an unchanged level, then such a change could be made. HMRC focused, in other words, on the fact that the Appellant was deliberately choosing to make some profit (albeit modest) out of the sales of the demonstration items, and if it only did what Boots did and just gave the items to its Avon ladies as Boots gave the demonstration items to its employees (as the Respondents rather inexplicably suggested), the problem would disappear. The Respondents also appeared to consider that the Appellant’s grievance only arose because it was actually selling the demonstration items at a profit, as distinct from at cost or at a loss. The reality of course is that the grievance would exist at whatever price at which the demonstration items were sold, though obviously it would be reduced in significance as the price was reduced.

38. The reference just made to what Boots were doing was of course completely misplaced and we will have to revert to that when dealing with the contentions. For present purposes, however, the Appellant's finance director's reaction to the suggestion about giving the demonstration items to the Avon ladies was that the suggestion was contrary to the philosophy underlying the long–standing practice of selling such items at a modest profit, and that were the Appellant to make the suggested change then it would shortly become insolvent.

39. The point about the business philosophy just mentioned was that the Appellant considered that if the Avon ladies had to pay a modest amount for a demonstration item it would make them far more likely to use it as intended, and more likely thus to enhance sales figures. If it was just given, the lady could ignore it and fail to use it as intended and the whole point of the demonstration item would be undermined.

40. More relevantly, however, the Appellant has always conceded very considerable flexibility to how the Avon ladies acted, and for instance there was no obligation to sell any product; no obligation to sell product at the brochure prices, and in the case of demonstration

items no strict obligation (as opposed to "marked encouragement") to use the demonstration item for its obviously intended purpose. This acquiescence in flexibility doubtless reflected the reality that it would be impossible to police any alternative structure that sought to be more prescriptive. In this context it was notable that the one constraint that could be, and that was, rigorously enforced (because the Appellant was the seller in relation to demonstration items) was that each Avon lady could only purchase one demonstration item of each product.

41. The consequence of the inability even to prevent Avon ladies from simply buying and using demonstration items themselves was that if the Appellant switched over to HMRC's suggestion of giving away the demonstration items, there would then be nothing to stop countless more ladies signing up as Avon ladies, simply to take free demonstration items and to do little else. Accordingly the finance director suggested that the result would be that the Appellant would probably be rendered insolvent. We agree and we also say that the suggestion was, with respect, impractical. It is also fair to observe that if the change was made and the discounts given to Avon ladies on retail product were reduced in a theoretical effort to leave the Appellant's profits unchanged, the reductions in the discount would diminish the incentive to sell the retail product, and the whole change would undermine the appeal of the selling structure to the people most critical to the Appellant's business model, namely the profit-earning incentives of the high-earning Avon ladies. In short, this first suggestion was completely unworkable.

42. The second suggestion was that the Appellant could suggest that all the Avon ladies became VAT-registered. This was an even more extraordinary suggestion because first it revealed that HMRC accepted that the input tax in relation to demonstration items (or at least the rough 50% of that tax mentioned in paragraph 34 above) was properly deductible, and that therefore the derogation (in trying to simulate the treatment of registered and non-registered representatives) was failing to achieve its object if there was an additional problem with selling through non-registered representatives that would disappear if the representatives registered. More immediately significant, however, is the point that if 300,000 Avon ladies were all asked to become registered for VAT purposes, the vast majority would cease to act as Avon ladies, the Appellant would instantly lose its business, and were those two expectations wrong then HMRC would be landed with having to deal with 300,000 new VAT registrations and a mountain of completely pointless administration.

43. There is, however, a more general point to make in relation to the suggestion that the Appellant could have changed its business model to circumvent problems, albeit that HMRC denied that there were problems in any event. That more general point is that when the Appellant has had a business model that has been in existence for many years prior to the accession of the United Kingdom to the Common Market, and when the only VAT problem of which the Appellant complains results from the fact that an ill-thought out derogation from the fundamental principles of VAT has led to an incoherent result, and moreover a result that could so easily have been avoided, it is quite inappropriate to talk of changes that the Appellant might make to its business structure. When a properly crafted derogation could have been designed to achieve a coherent result, a result that would not have imposed

additional VAT costs on the Appellant's marketing structure than those properly calculated costs that are imposed on the selling arrangements of all the Appellant's competitors, we consider that the apt summary is that HMRC and the United Kingdom should have crafted a non-discriminatory derogation that would have applied entirely coherently to the Appellant's long-standing business model.

44. In terms of approaches that the Respondents advanced in relation to the Appellant's business model, we should mention one final point, albeit that we immediately record that the Respondents' counsel later accepted that the suggestion had been wrong, and that it was withdrawn. It is however of some marginal continuing significance to which we will revert, and since it was put to one of the Appellant's witnesses, we will just record it. The suggestion initially was that the Avon ladies were not "in business", and reference was then made to some remarks in an earlier Avon Cosmetics appeal when it was suggested that an earlier witness for the Appellant had conceded that the Avon ladies were not in business. We accept that in the case of the most extreme example where an Avon lady might purchase goods solely for her own use, it would be apt to say that that particular lady was not "in business" or that at any rate her purchases would be amongst those to which the derogation would not apply for the simple reason that her purchases would not have been made for onward sale on a retail basis. Beyond that, though, and we will revert to this in giving our decision, we consider it to be perfectly obvious that those Avon ladies purchasing product in order to sell it to customers are in business. We accept that the United Kingdom enables small traders to avoid VAT registration if they wish, because the turnover level at which registration becomes compulsory is set at quite a high level. Ignoring that separate issue, however, it is perfectly clear that where an economic activity is conducted, it is within the potential ambit of VAT, however occasional and however modest the activity might be.

The two Portuguese derogations

45. We understand that in Portugal there are also a number of organisations that sell similar products through numerous representatives, acting as principals, in rather the way that the present Appellant operates. The difference between the arrangements in Portugal and the United Kingdom is that because the turnover threshold for registration was much lower in Portugal than in the United Kingdom, the representatives in Portugal were all VAT registered, albeit that they were making similarly modest sales and profits to the Avon ladies.

46. Portugal sought a derogation to deal with the sales made through these numerous representatives, but naturally its effect was different, since the representatives in Portugal were taxable persons. The effect of the Portuguese derogation was simply to make the entity selling to all the representatives responsible for the whole of the tax on both its own, and the representatives' turnover. There were in fact two derogations sought by Portugal. It seems to us that the first was quite adequate to pass all the calculations from the representatives (i.e. including sales and other costs) to the principal entity. We are unaware of the detail, and of whether the sales to the representatives both dropped out of account, as with a group registration. There was obviously perceived to be some slight defect with the first derogation and the second appears to have been sought to make it absolutely clear that

the principal entity was to be responsible for not only the transactions of the representatives that occasioned output tax liability but also entitled to all the appropriate VAT consequences where costs attracting input tax had been incurred.

47. The Portuguese precedent seems to be fairly material to us, albeit that again the Respondents claimed that it was irrelevant. To us its relevance is that while it started from a different place, with all the representatives theoretically being liable to be registered and to pay VAT in the ordinary way, the end result is precisely the result that the Appellant says could and should have been achieved in the case of the United Kingdom derogation.

48. We might just qualify that comparison with the Portuguese precedent since the Portuguese derogation applied to all costs that had attracted VAT. In this Appeal the Appellant's basic complaint just addresses the input tax referable to demonstration goods. The Respondents reported that the Appellant had reserved its case in relation to other costs. While we imagine that in the Appellant's case, any "other costs" will turn out to be minimal, we fail to see that a principled approach could apply just to some costs and not others. We quite understand that a derogation, in part designed to ensure the prevention of avoidance of tax, and in part designed to simplify the system, might include some rule that disregarded minimal costs of no real significance, but that is not a question for us to consider. For present purposes, we simply conclude that the Portuguese precedent seems to be highly material because, albeit that it started from a different place, it achieved the end coherent result that could have been sought by the United Kingdom in the present case. We also make the point, and this becomes particularly obvious when we turn to the wording that the Appellant suggests we should insert, by implication, into either the United Kingdom statute or the NoD, that we must proceed on the basis that in substance the Appellant's claim really relates to all costs that have been subjected to VAT, and not just to the one very significant identified cost.

The expert evidence

49. We should record that both parties produced expert evidence, designed to show, it seemed, whether or not it was appropriate to conclude that the Appellant's main competitors were the high street shops such as Boots, Superdrug and others. The evidence consisted of economic analysis more suitable in a major merger before the Competition authorities, in that much of it was designed to show not only whether a marginal long-term price rise of the Appellant's products might result in some loss of customers but whether in fact the beneficiary of any such lost customers would be Boots and the other high street shops or rather others such as the supermarkets, major department stores or the internet sellers.

50. Although the Respondents had challenged the general conclusion said to emerge from the expert evidence given on behalf of the Appellant, namely that, precisely as the Appellant itself claimed, the major beneficiary of the loss of custom by the Appellant would indeed be the high street shops such as Boots, the Respondents' principal contention was that the whole of the evidence in relation to whether the derogation had been designed to eliminate unfair competition, and whether indeed it was now occasioning unfair competition in the other

direction, was completely irrelevant. The Respondents' reasoning was that Article 27 of the Sixth Directive only enabled the Commission and the Council to authorise a derogation from the basic VAT rules in one of two circumstances. One was for the purpose of simplifying the administration of VAT, whereupon it had to be shown that the derogation made very little difference to the level of tax charged. The other situation in which a derogation could be authorised was for the purpose of preventing evasion or avoidance of tax. Following the second of the *Direct Cosmetics* cases before the ECJ it was clear that "avoidance" did not require the persons affected by the proposed derogation to have done anything deliberate or artificial for there to be "avoidance". It was enough that a particular marketing method, such as that employed by the organisations that sold through non-registered representatives resulted in an avoidance of tax at the retail level, contrary to one of the basic objectives of the VAT system. The Respondents therefore contended that the derogation had been sought and obtained simply to prevent the avoidance of VAT at the retail stage, and that considerations of unfair competition were completely irrelevant.

51. Before commenting on the expert evidence, we confirm that we accept that under Article 27 of the Sixth Directive derogations could only be given on one of the two bases just indicated and that in this case, the derogation sought by the United Kingdom was plainly designed to deal with an avoidance of tax, rather than a simplification measure. In our decision we will address the validity of the derogation by first addressing whether it sought and achieved its intended result, and whether or not it produced any effects in excess of the objective of eliminating the perceived avoidance of tax.

52. Whilst we accept that the validity of the derogation must fundamentally be tested in the way just indicated, we nevertheless consider the Respondents' claim that the feature of unfair competition was altogether irrelevant on the initial grant of the derogation was unrealistic. There was undoubtedly very considerable comment in both *Direct Cosmetics* cases (dealing, as they did, with this same derogation) and it is perfectly obvious when reading those cases that even if the derogation was introduced to stop an avoidance of tax, it was also justified by the fundamental principle of ensuring that entities performing similar activities in competition should suffer tax in the same manner. In this context, not only was the object of avoiding unfair competition a factor that influenced the grant of the derogation, but it was simply assumed as obvious that, without the derogation, there would be unfair competition if VAT was not charged on the retail sales made though the non VAT-registered representatives, when it was inevitably so charged on all the competitors. No complex economic studies had to be analysed to prove that point.

53. In the present case, we will be perfectly content in our decision to address the validity of the derogation principally by considering, as the Respondents contended that we should, whether it achieved the objective to which it was directed, and whether it avoided doing that in some excessive way. We do however consider it to be significant that everyone, including HMRC, considered it obvious when the derogation was sought that without the derogation there would be unfair competition, and we fail to see now why obvious unfair competition in the other direction should be disputed, and said to be irrelevant. We consider it obvious that the Appellant's present grievance occasions unfair competition and that this is

just obvious. For that reason, we are going to disregard the whole of the expert evidence. For what it was worth, we accept, as the Appellant's counsel suggested, that even the Respondents' expert witness had not disputed the claim by the Appellant's expert witness (and most certainly the informed claim by the Appellant itself) that Boots and the high street shops were the Appellant's principal competitors. For our part, we consider that all those entities, the high street shops, the supermarkets, the department stores, internet sellers and the companies selling through non-VAT registered representatives are all in competition, and we are not concerned to identify the Appellant's principal competitor.

54. The two decisive factors to us are the following. First, it is a fundamental objective of the VAT structure that entities trading in a particular way should be taxed in a consistent manner. "Consistent" means absolutely consistent and not just "roughly similar". We entirely accept that there are occasions when similar end results can be achieved by traders, and the VAT treatment can differ because the chosen structures themselves differ. An obvious example is the common situation where we have to consider whether all parties are acting as principals or whether one is simply acting as agent for another. That is not the situation here. The companies selling to Boots and the high street retailers, the supermarkets and the department stores are all selling to entities that themselves sell as retailers, and suffer VAT when registered. The Appellant does precisely the same thing. It sells to its representatives who sell as retailers, and the tax in relation to the retail activity should be identical. The other point that we consider to be decisive is that if the derogation was justified in part, on its introduction, by precluding unfair competition, its validity should certainly now be questioned when the present complaint is that the derogation has caused unfair competition by tipping the "playing-field" in the other direction.

The contentions on the part of the Appellant

55. The contentions on behalf of the Appellant were that:

- the asymmetry occasioned by the derogation and the way in which VAT is charged on the Appellant is incoherent in that it pays regard to the ultimate consideration received by the retailers on selling to end-customers, and brings that into charge in the hands of the Appellant, but then it completely ignores cost at the level of the retailers;

- the result of that asymmetry is that the cost of VAT in respect of the disregarded costs is a cost borne at the business level, and not treated as any form of deduction in charging VAT on the end customers, so that the total VAT charged in the supply chain actually exceeds the proper amount of VAT in respect of the supplies to the end-customers;

- this incoherent result was and should have been obvious, not least because so far as the Appellant was concerned, the very feature of the Avon ladies bearing costs in relation to the purchase of demonstration items had been explained to HM Treasury in 1973;

- quite apart from that information, the feature that the deduction of input tax at each business level is a fundamental and obvious feature of the VAT system is so central that it is extraordinary for a derogation to ignore this feature;

- the simplest way to alleviate the problem is for the Tribunal to interpret either the United Kingdom statutory provision that enacts the derogation, or any NoD issued to a taxpayer whose non-registered representatives incur any costs at the retail level, to include wording requiring the up-lift in output tax provided for to be matched either by a deduction for input tax that would have been deductible at the retail level by VAT-registered traders, or simply to diminish the uplift in the output tax by that amount;

- in the alternative, no NoD should have been issued to any company where the imposition of tax pursuant to the NoD would have breached the principle of neutrality and occasioned unfair competition;

- if the Tribunal felt unable to imply such an adjustment to the statutory wording or the NoD in the manner considered in the previous bullet point but one, then the case should be referred to the ECJ, with a request that the ECJ decide whether the authorisation granted to the United Kingdom and the derogation were invalid on the grounds that:

    - the derogation manifestly exceeded its proper scope by increasing the charge to VAT by more than any proper calculation of the tax avoided, which avoidance occasioned the grant of the derogation;

    - the derogation occasioned "sticking tax", thereby breaching one of the fundamental features of the VAT system;

    - whilst a derogation was indeed designed to introduce some measure that would inherently depart somewhat from the ordinary application of the VAT rules, it was still improper to breach the fundamental principle just addressed if that was quite unnecessary, and in no way required by the legitimate objective of simply eliminating the perceived properly quantified tax avoidance; and

    - it was wrong, in introducing a measure in part justified by the objective of precluding unfair competition by traders in a similar situation to go to the other extreme of actually creating an equivalent unfairness in the other direction.

The contentions on the part of the Respondents

56. It was contended on behalf of the Respondents that:

- the terms of the United Kingdom statute that introduced the derogation, and the terms of the NoD issued to the present Appellant were unambiguous and their plain wording

precluded HMRC from treating the Appellant in any other manner than the derogation prescribed, i.e. by adjusting the Appellant's output liability to the formula calculation of the retail selling price, and without giving any credit for costs;

- whilst European law contemplated that courts could interpret domestic provisions quite liberally in order to conform them to the basic requirements of European law, it was clear that derogations had to be interpreted strictly and not varied;

- the feature that a derogation might be inconsistent with one of the general principles of the VAT system was not surprising since the very purpose of derogations was to depart from those strict rules for one of the two reasons for which derogations could be introduced in accordance with Article 27 of the Sixth Directive;

- input tax could in any event only be claimed by VAT-registered persons and the Avon ladies were not VAT-registered;

- it was for the Appellant to structure its business model to achieve the tax result that it considered to be appropriate, not for HMRC or the United Kingdom to tailor its tax regime to the strange business practice of a particular taxpayer;

- the explanation for the feature that no deduction had been given in respect of any costs borne at the retail level was that the derogation that the United Kingdom government had sought had always been just a derogation from Article 11 of the Sixth Directive, dealing with the measure of consideration for output tax purposes, and no derogation had been requested in relation either to input tax or to deem the Appellant and its non-VAT registered representatives to be one person for VAT purposes;

- the validity of the derogation had to be judged by reference to the type of derogation that had been asked for, and where a derogation was sought to prevent an avoidance of tax, the principal matter to consider was whether the derogation had indeed achieved the purpose, and no more than the purpose for which it had been requested.

Our decision

57. As we indicated in the Introduction, there are two fundamental issues in this case. The first is whether we consider that the Appellant's complaint is justified, in the sense that something has gone seriously wrong in the way the Appellant is being subjected to VAT. The second is whether we, or indeed the ECJ, can give some redress.

Whether the Appellant's complaint and claim are justified

58. In terms of the first issue, we are quite clear that the Appellant was rightly complaining that the way in which it was being charged to VAT, whilst arguably strictly correct under the terms of the derogation, the statutory provision and the terms of the NoD, was nevertheless incoherent.

59. The Respondents had continuously disputed this. They challenged one of the Appellant's witnesses who claimed that an HMRC officer had at some time admitted that the result was unfair to the Appellant, and said that this had never been conceded. Nor was it now conceded. They suggested that it was always for every taxpayer to organise its affairs in such a way that they achieved the fair tax result that they desired. At one time they argued that the Avon ladies were not conducting a business at all. It was always suggested that if only the Appellant had done what Boots did, namely give the demonstration items to their representatives just as Boots gave their demonstration items to their employees, then all would be well. We were even told that the same point could be made in relation to the supermarkets, in that they were giving the demonstration items to their branches, so why could the Appellant not do the same thing? We had the suggestion that all the Avon ladies could seek registration (a rather two-edged contention because, beyond obviously being completely impractical, it did at least indicate that the present problem resulted from the extraordinary treatment provided under the derogation, rather than some structural problem that would still arise if the Avon ladies were VAT registered). We were even taken to various authorities that illustrated that there could be two structural ways of organising a business or effecting a transaction, and that it was perfectly possible that even though the overall result of the two might be similar, it might nevertheless follow that the VAT treatment of the two could differ and differ entirely coherently. We agree. That different treatment should not arise, however, when the two business models are identical.

60. We reject all the various suggestions and claimed explanations for the problems encountered by the Appellant mentioned in the previous paragraph.

61. Starting with the contrast made with the presumed marketing arrangements operated by Boots and other high street shops, the Respondents appeared to contrast the position between Boots and their employees, with that between the present Appellant and its representatives, treating Boots and the Appellant as conducting the same role in the supply chain, and the Boots employees and the Avon ladies as also conducting the same role as each other. This completely missed the point that in the Boots situation, the equivalent entities to the Appellant are the various suppliers of toiletry and perfume products, such as Chanel, L'Oréal etc. Boots are the retailers, performing the function that the Avon ladies perform. Boots are not performing the present Appellant's role at all, and the Boots employees should simply be disregarded because they are merely the channel through which Boots operates, and in no way a party to some separate transaction. As to the reference to the supermarkets giving product to their branches, that is simply an extraordinary suggestion.

62. We have no idea whether Chanel, L'Oréal and others give or sell demonstration items to Boots, and indeed they may simply assume that Boots will take a few perfume bottles out of the large quantities that Boots buy, and just use those for demonstrating the perfume in the Boots shops. Whatever route is chosen the VAT results are always coherent. If Chanel and L'Oreal charge Boots for demonstration items or general stock some of which is not sold but used for demonstration purposes, then of course Boots secure an input deduction for the VAT charged on the supplies. Indeed Boots obtain input deductions for all their other costs

that have been subjected to VAT. And if Chanel and L'Oréal give Boots demonstration items, then no VAT is charged and none is recoverable.

63. The only difference between the Boots situation and the present Appellant's situation is that there is a practical and obvious reason why the Appellant could not just give the demonstration items to the Avon ladies in order to solve the problem about sticking tax that arises when they are sold. And this is the plain fact that because the retailers in the Appellant's case are women who use perfumes and cosmetics and might very well just keep and use demonstration items if they were provided for no charge, with an ever-escalating number of women signing up as Avon ladies to acquire free products, the suggestion of the Appellant giving such items to the Avon ladies is simply impractical. The position in the case of Chanel and Boots, should Chanel or any of the other suppliers actually just give demonstration items to Boots is that Boots is a corporate entity that does not itself actually use perfumes. And so in the Boots situation, items given for the clear business purpose of demonstrating the product and hopefully enhancing sales, occasions no equivalent problem to the one that has always dictated the Appellant's understandable business model of not giving product to thousands of ladies.

64. The problem that then emerges in the Appellant's case is perfectly obviously that when demonstration items are sold to the Avon ladies, just as they may be sold by Chanel and L'Oréal to Boots, Boots and the Appellant's VAT-registered Avon ladies all secure input deductions for the VAT charged on the supplies, while the asymmetrical nature of the VAT treatment under the derogation fails to achieve the equivalent for the Appellant when demonstration items are sold to the non-registered Avon ladies. That would be entirely unproblematic if the derogation did not apply, so that both the Avon ladies sales and their costs were all irrelevant for VAT purposes. But when the Appellant is required under the derogation to account for the additional VAT that would have been chargeable on the sales by the Avon ladies as if for output purposes they had been registered, it is the incoherence in the terms of the derogation in not consistently attributing input tax to the Appellant that causes the asymmetry and the present grievance, not some strange feature of the Appellant's business model.

65. A further point repeatedly made by the Respondents is that when the derogation had been requested simply seeking a modification to the rules in Article 11, dealing with the calculation of consideration, and no request had been made about input tax, it was suggested that if the further request had been made to concede a deduction for input tax in respect of the representatives' costs, this might have been seriously problematic. It was suggested that when the Commission notified all other member states that the request for a derogation extended to conceding a deduction for input tax when the costs were incurred by non-registered persons, the other members might have thought such a proposal quite radical. More generally the same point was made in that the Respondents repeatedly suggested that there was something incoherent in seeking to confer on the Appellant in this case an input deduction when that would be in respect of costs incurred by persons who were not registered. It was explained to us that the ability to deduct input tax was something only of relevance to taxable persons which was why the Appellant's present whole claim was so

extraordinary. Having regard to the fact that the whole purpose of the derogation was to do, in relation to the output side of the calculations, the very thing that the Respondents seemed to think was so radical, in other words to charge VAT on the turnover of non-registered persons (not that any complaint is made of that feature) the radical feature in the present case is to refrain from achieving the same symmetrical result in relation to costs, rather than worry about consistently giving an input deduction for costs incurred by non-registered persons.

66. The above point is so obvious that it is slightly embarrassing to be explaining it. There is nothing complex about the point in issue. Perceiving the problem is not rocket science. The error in the present case is basically identical to the example of seeking to charge income tax on net profit by calculating the gross receipts and forgetting about the costs.

67. Our unhesitating conclusion in relation to the first issue here is that the VAT treatment of the Appellant under the derogation is unfair. By "unfair" we do not mean unfair in some vague manner. We will deal with this in more detail when addressing the derogation that the United Kingdom sought back in 1985. What we mean by unfair is that the derogation does not counteract the perceived avoidance of VAT in the case of sales through non-VAT registered representatives in a proportionate manner. It imposed more additional tax than any realistic calculation of the VAT said to be "avoided". It occasioned "sticking tax", or a lack of neutrality by not reflecting the inputs associated with the purchase of demonstration items, in the ultimate calculation of VAT payable by the Appellant. It created an element of potential unfair competition between the Appellant and its representatives and all other entities selling through taxable retailers. The derogation therefore needlessly and wrongly undermined two fundamental tenets of the VAT system in order to occasion this unfairness, and there has not been mentioned to us any conceivable reason why that was thought necessary or appropriate.

The interpretation of the NoD, the statute, or the derogation to eliminate the present problem

68. We have made it clear that we consider that the Respondents' case in relation to the introductory issue of whether the imposition of VAT on the Appellant was both unfair and inconsistent with some of the cardinal principles of VAT was completely untenable.

69. When we turn, however, to the highly relevant questions of whether paragraph 2 Schedule 6 was correctly cast in terms of complying with the derogation that the United Kingdom was given for the purpose of taxing traders who sold through non-registered representatives; whether HMRC should have refrained from issuing an NoD on any trader whose representatives were incurring material costs for which no deduction would be given, and whether we can interpret para 2 Schedule 6, or the terms of the NoD to confer an entitlement on the Appellant to the coherently deserved deduction for input tax, it is the Appellant that faces the major difficulty.

70. If at this stage we treat the terms of the European authorisation as unchallengeable, it is obviously extraordinarily difficult for us to find any fault in the terms of paragraph 2 Schedule 6 because it provides exactly what the United Kingdom has been authorised to

provide. Similarly the NoD can be issued to taxpayers when two very simple conditions have been satisfied, and they have been satisfied in the case of the Appellant. The apparent effect then of the NoD is simply to adjust the consideration actually received by the Appellant, and to substitute for its sales receipts the amount prescribed by the NoD, namely the open market retail sales value, all calculated in the two sensible ways described above. And it is extremely difficult to see that the UK Parliament or HMRC have taken any wrong step in fully implementing the arrangements authorised by the derogation.

71. We find it difficult to conclude that HMRC should be precluded from issuing a NoD, containing the terms of the one issued in this case, even where it might have been well known in advance that it would occasion perhaps unintended results, and a result that certainly offends at least two fundamental VAT principles. Whilst that may be so, the difficulty is that it is perfectly clear that both the authorisation from Europe and the matching terms of paragraph 2 Schedule 6 clearly inserted no additional requirement to the effect that the NoD should not be issued in the Appellant's circumstances. Paragraph 2 Schedule 6 laid down the conditions that had to be satisfied for an NoD to be issued, and they were satisfied in this case. We accordingly find it difficult to reach a conclusion to the effect that it was somehow wrong for HMRC to issue the NoD to the Appellant.

72. The Appellant's suggestion was the pragmatic and sensible suggestion of saying that the simplest way of solving the present problem was for us to interpret the United Kingdom statutory provision and the NoD as if they concluded with words (after adjusting the Appellant's output tax liability) that either gave the Appellant a matching deduction for amounts that would have been deductible input tax had the Avon ladies been VAT registered, or simply diminished the uplift in output tax by an amount equal to the relevant deductible items. We will ignore at this point the reasons why we say that that suggestion was pragmatic and sensible, and in some senses a suggestion designed to assist the Respondents, and just address the suggested interpretation on its merits.

73. We firstly note that the suggested and obvious insertion into the terms of the NoD immediately reveal that the Appellant's case goes somewhat wider than it appeared at the outset, in that initially the contention had simply referred to the particular costs incurred in purchasing the demonstration items. In this case, those are obviously the costs that are presently seen to be the only significant actual costs. It seems to us, however, that since the Appellant's case is all founded on a claim that the legislative structure should be entirely coherent, it immediately becomes clear that the Appellant's claim must relate to all relevant costs, and not just to the particular costs that have so far been identified to be material.

74. The respective contentions of the parties in relation to our liberty to embark on a fairly extreme exercise of "innovative purposive interpretation" were as follows.

75. The Respondents contended that derogations had to be construed particularly strictly. They ought also to be construed in the context of the derogation that was sought, namely an adjustment to the terms of Article 11 of the Sixth Directive, which referred solely to the calculation of the Appellant's consideration receipts, and not to any other subject matter.

Were we to interpret the NoD to require only the “net” extra VAT cost arising at the level of the Avon ladies to be attributed to the Appellant, so occasioning an end result somewhat similar to that achieved in the case of the Portuguese derogations, that result should have necessitated the obtaining by the United Kingdom of a different derogation, preceded of course by a new application for such new derogation to be authorised by the Council.

76. The Appellant contended that there was no evidence, and indeed no suggestion, that the United Kingdom had actually deliberately sought to request a derogation that had the intended effect of creating an asymmetry. The Respondents certainly seemed to suggest that they considered there to be nothing particularly defective about the derogation that they had sought, and that it was only the Appellant's unique and voluntary choice of a strange business model that occasioned the problems, but they certainly did not suggest that the asymmetry had been created deliberately. Proceeding from that observation, the interpretation that the Appellant was asking for was then a permissible one for the following reasons. Firstly courts were asked and authorised to interpret domestic legislation fairly liberally in order to ensure compliance with European directives. Of course in the present case we were considering a derogation that obviously itself authorised some departure from the normal VAT rules, but when there was no indication that the derogation was positively meant to create an asymmetry by ignoring costs, no objective of creating "sticking tax" and no objective of occasioning an element of unfair competition between identical business models, the claimed interpretation would conform the derogation to the fundamental VAT principles in a way that we were encouraged to do. Secondly, in terms of our interpreting a derogation, and supposedly doing that strictly, it was at least claimed that a distinction should be drawn between the impermissible case of extending the derogation, and as suggested here, of limiting it, and dragging it back to the basic principles of VAT that the authorisation had perhaps inadvertently failed to note.

77. We also note ourselves that the Respondents did not advance any suggestion as to why the derogation had been sought in the particular manner. There was, in other words, no suggestion that the United Kingdom government had thought it inappropriate to concede a deduction for the input tax associated with costs because such a course would lead to excessive complication, and numerous claims for very small items. Had such a reason been advanced, it might or might not have justified the decision to request an asymmetrical derogation, whose terms would otherwise have plainly been incoherent. However not only was no suggestion advanced that this thought had influenced the request for the derogation in the first place, but it appeared to be asserted that this had simply not been a consideration. Further, in this context we note that the formula adjustments that HMRC and the Appellant have periodically agreed for some time, and even the percentage split in the costs of demonstration items used for demonstration purposes, and those simply purchased for own use, already involve complex calculations that require some knowledge of what happens at the level of the various non-VAT registered representatives. If the parties are able to agree the relevant figures in relation to those matters (down to two decimal places of a single percentage point!!), a practical approach to the calculation of costs should not be that difficult. In any event, none was mentioned.

78. We understand the contentions by both parties. We have decided to refer this question of whether some such claimed wording can be added, by implication, into the terms of the statute or the NoD, to the ECJ. For our own part, we consider that the requested insertion, manifestly sensible as we agree that it is, is too extreme for us to sanction it without guidance from the ECJ that this is permissable. It is not as if the legislation is dealing with one concept, and we are asked to imply some slight expansion or adjustment to that one concept. We are asked to modify the effect of the derogation that has been granted, and while we concede that the modification merely takes the form of cutting down the offensive features of the derogation, and it seeks to drag it back to ensure compliance with general VAT principles, the disregard of which we find inexplicable, we still consider that it is a major variation of the derogation that, without guidance from the ECJ, we cannot sanction.

79. There is another reason why we choose to refer any such possible matter of interpretation to the ECJ. This is that while the Appellant asks us to add the suggested wording either to the United Kingdom statutory provision or to the terms of the NoD, we cannot ignore the plain fact that the terms of the statute and the NoD do precisely reflect the terms in which the United Kingdom was authorised to introduce the derogation. Accordingly if we say that it is appropriate to imply the relevant wording into either the statute or the NoD, it follows in reality that we are also importing the same flexibility into the very authorisation by the EU Council, and in substance we are modifying the authorisation. At the very least we are representing that by inserting the wording into the statute or the NoD we are not doing anything not contemplated and not permitted by the authorisation, which of course amounts to adjusting the authorisation itself. Since we consider that this is properly a matter solely for the ECJ, we refrain from implying the relevant wording into either the statute or the NoD because of the implicit consequential re-interpretation of the authorisation itself. This is properly a matter for the ECJ and not for us.

The question concerning the validity of the derogation itself, and whether it should have been requested and granted in the terms chosen

80. We turn now to what has been described as the more radical question. This no longer addresses whether we can imply some wording into the domestic provisions, but whether we consider the entire derogation and its authorisation to be unlawful.

81. We have no jurisdiction to declare the derogation itself to be void. The ECJ does have such jurisdiction. The two tasks for us to undertake are therefore first to consider whether this is a case where it is appropriate to refer to the ECJ the question of whether the derogation was valid or not, and secondly to give some consideration to that issue ourselves in case the ECJ are interested in the view that we have formed.

82. Many of the Respondents' contentions in relation to this issue were along the lines that in arguing about neutrality and unfair competition, the Appellant was challenging the legality of the derogation on the wrong lines. The Respondents' contention was that derogations could only be granted for one of the two grounds given in Article 27, namely simplification or to prevent the avoidance or evasion of tax, and in this case, the ground on which the

derogation was sought was plainly the latter. The avoidance was the avoidance of tax at the retail stage. That result was accepted by the Commission in authorising the derogation, and effectively also accepted even by the Appellant to be a legitimate objective, and therefore the legality of the derogation should be tested by asking whether the derogation had achieved that object and also by asking "whether the means chosen [went] further than [was] necessary to achieve the objective that [was] being sought".

83. The Respondents also contended that when there was a derogation from the normal VAT rules there should be no surprise that some feature of the normal rules might cease to apply. That was plainly implicit in there being a derogation from those normal rules.

84. We accept that derogations obviously involve some departure from the normal VAT rules, but we consider it to be clearly established by the ECJ case of *EC Commissioner v. Belgium* (C-324/82) [1984] ECR 1861, that in framing a derogation to achieve some legitimate object (i.e. here, of preventing an avoidance of tax), *"the member states must employ means which, whilst enabling them effectively to obtain the objective pursued by their domestic laws, are the least detrimental to the objectives and the principles laid down by the relevant Community legislation.*

"Accordingly, whilst it is legitimate for the measure adopted by the member states to seek to preserve the rights of the treasury as effectively as possible, they must not go further than is necessary for that purpose. They may not therefore be used in such a way that they would have the effect of systematically undermining the right to deduct, which is a fundamental principle of the common system of VAT".

85. Accordingly, in sustaining the present derogation, it must be shown first that it went no further than necessary in order to achieve its legitimate object of preventing an avoidance of tax, and secondly it must be demonstrated that insofar as the derogation was in conflict with the fundamental rules of the common system of VAT, this was inevitably required in order to achieve the objective of preventing the avoidance of tax.

86. It appears to us that the present derogation has managed to breach both of those principles by the same expedient of unnecessarily ignoring costs, and the symmetrical deduction for what would have been properly deductible input tax.

87. We consider that the fallacy in the Respondents' contentions was admirably contained in the following passage that we quote from the argument advanced by the Respondents' counsel:

> *"The principle of proportionality cannot be analysed or even described unless you start with the objective. Critically, you don't start with the paradigm VAT model, you start with why did you get this derogation? The First step. The second step is the next question, "Has the member state employed means which enable effective attainment of that objective? Are the means that the member state has chosen effective to achieve the objective that is being sought? The third question is whether the means chosen go further than is necessary to achieve that objective. If that third*

question is answered affirmatively, then the principle of proportionality has been breached. If it is answered negatively then the principle of proportionality has not been breached, because the member state has employed means which enable an effective attainment of an objective which it has identified and has gone no further than that.

"So when we talk about a measure being disproportionate, what we're talking about is a measure which goes further than is necessary to achieve the objective for which the derogation under consideration was sought.

"Now this principle of proportionality is of critical importance in this case. This principle needs to be borne in mind when we're going through bundle F, because what the Appellant says is that the objective of the derogation was to ensure that taxpayers such as Avon were treated in fiscally the same way as their high street competitors. We say that's a nonsense, with the greatest respect, because if that were the objective, then it ceases to be a derogation. But in any event, that's the objective for which they contend.

"We have that principled objection to that as an objective, but forensically if you look at the correspondence between the UK and the Commission, you will find no support for the assertion that has been made that that's what the objective was. We say that the objective was to prevent the avoidance of VAT at the retail stage. That was the objective.

"The question is whether the notice of direction goes further than is necessary to achieve that. We say no, it does not, because VAT at the retail stage, the proxy for that is open market value in paragraph 2 Schedule 6. In the formula that applies to this particular taxpayer it's the brochure price, and Avon do not take issue with the proposition that the brochure price is an appropriate proxy for VAT due at the retail stage. We'll look at the notice of direction in some detail at a later stage, but I just wanted to give you a bird's eve view as to why it is that identifying the objective of the derogation is so pivotally important."

88. Testing the Respondents' case by reference to the tests laid down there by the Respondents, it seems perfectly obvious that the derogation has gone further not only than it needed to, but almost more relevantly its excessive application was not just unnecessary but fundamentally incoherent. It also managed simultaneously to infringe the other requirement of needlessly creating a structure fundamentally inconsistent with *"the fundamental principles of the common system of VAT"*.

89. We accept that the Appellant had no complaint with the feature of the derogation that calculated the Appellant's output tax liability by reference to the open market retail sales price. What the Appellant certainly did not concede, however, was that *"the brochure price [was] an appropriate proxy for VAT due at the retail stage"*. Beyond the fact that it is obvious that that is not what the Appellant conceded, in having no particular dispute with the formula calculation of the sales price, it is glaringly obvious that *"the VAT due at the retail*

stage" was illustrated by the figures that we inserted into paragraph 9 above, and was thus roughly £5.5 million and not roughly £7 million. Reverting to the wording in the fourth paragraph that we have just quoted, the fundamental statement by the Respondents' counsel is that *"We say that the objective was to prevent the avoidance of VAT at the retail stage."* At that point the critical question is "How has the avoidance come about?" and "What is the right measure of the tax avoided?" We conclude that the only conceivable answers to those questions are as follows. The avoidance has come about because the relevant Avon ladies were not VAT registered. Had they been VAT registered, how much VAT would have been charged? Answer, unquestionably "£5.5 million". How much extra VAT has been brought into charge by the derogation as framed? Answer £7 million. What has accounted for that excessive uplift in that the extra VAT charged has exceeded the VAT avoided by £1.5 million? Answer, the feature that the derogation has looked to receipts and ignored costs. Is that irrelevant or does it needlessly breach the principle of neutrality in that VAT costs incurred by traders whose receipts are to be brought into charge should correspondingly be taken into account? Does the result impose more VAT on the retail phase in the case of the supply chain to customers from the Appellant, than in the case of every other supply chain, including indeed the Appellant's own sales through its own VAT registered representatives? Yes and Yes to those two questions.

90. Our conclusion therefore is that in applying the Respondents' own formulation of the test that we should apply in considering whether the derogation has firstly gone materially further than it needed to in preventing the properly calculated avoidance of VAT, it plainly has done. In considering then whether there was some need to ignore the fundamental principle of calculating the actual tax due by looking at receipts and costs, not only was there no need to ignore that principle, but the very feature of disregarding it is precisely the feature that has caused the derogation to go materially further than required to achieve the legitimate objective. And moreover ignoring the costs has breached the principle that the member states must attain their objectives, in constructing the derogation requested, that are *"the least detrimental to the objectives and the principles laid down by the relevant Community legislation."*

91. For these reasons we consider that it is entirely appropriate to refer to the ECJ the question of whether the derogation obtained in this case was unlawful, and our opinion is that it was unlawful.

The Appellant's preference that this case be resolved by interpreting the United Kingdom statutory provision, the NoD or indeed the derogation itself to require input tax to be taken into account where the NoD applies in relation to non-registered representatives who have incurred business costs that have suffered VAT

92. We mentioned in the Introduction the entirely sensible point advanced by the Appellant that their marked preference was for this case to be resolved by including the type of wording into either the United Kingdom statute or the NoD that would enable, and where appropriate require, HMRC to allocate the relevant input tax to the Appellant when calculating the additional tax chargeable under the derogation, rather than to go to the extreme resort of

invalidating the entire directive. If, as seems inevitable, a successful claim that the derogation was invalid would undermine the entire taxation of all companies to whom NoDs had been issued, invalidating (on the example used in this Appeal) the equivalent of the £5.5 million as well as the exceptionable top £1.5 million mentioned in paragraph 9 above, that result would naturally be unfortunate, and it would undermine the perfectly correct calculation of uplift even for companies whose representatives might have incurred no, or no material, costs whatsoever. The Appellant's preference that the Appeal be allowed on the basis of adding the implied wording into the statute or the NoD is doubtless partially explained by the concern that the challenge of the derogation itself may be something that the ECJ would naturally not confirm lightly. At the same time, however, we agree with the Appellant that a successful challenge of the derogation would obviously undermine very substantial charges to tax on many companies even where they were perfectly fair (including indeed the charge of £5.5 million in 2011 in the case of the present Appellant). And that is something that the Appellant has not sought to do, and we agree that it would be highly unfortunate.

93. Whether of course the ECJ felt able to import the suggested wording into the United Kingdom statute or the NoD is something on which we have requested guidance. Having regard to the marked practical preference for achieving that more coherent result (in terms of common sense and practicality, though perhaps not necessarily strict legal analysis) we feel it just worth endorsing some of the Appellant's claims in relation to the point of interpretation. We have ourselves felt unable to decide this Appeal ourselves on this basis, but we certainly accept that the following factors render the suggested importation of wording coherent.

94. The points are that:

- the implied wording is not designed to extend or expand a derogation, but to drag it back to conform to a very obvious principle of the VAT system;
- there has been no claim by the Respondents that there was any policy motive pursued in ignoring the costs incurred by representatives when framing the derogation requested;
- it has not even been suggested that the costs were disregarded for any reason concerning simplification of administration, which might or not anyway have been a valid consideration;
- in terms of achieving what the Respondents have continually and correctly maintained, namely that the derogation was designed to preclude the avoidance of tax at the retail level (in which we observe that that objective must be to prevent the avoidance of the properly calculated tax avoided at the retail level by virtue of the representatives not being VAT-registered) the wording that the Appellant wishes to import into the statute or the NoD does have the precise effect of ensuring that the derogation ends up achieving precisely what it should achieve.

95. For these reasons, while we remain of the view that the required importation of language into the United Kingdom statute, or into the NoD, is too marked a change to the wording of the terms of either the statute or the NoD for us to sanction without appropriate guidance from the ECJ, we do agree with the Appellant that there is great force to the claim that the importation of wording is entirely coherent in terms of the proper scope of the derogation, quite apart from it being the most attractive solution to the present Appeal for practical reasons.

The terms of the reference to the ECJ

96. The Respondents repeatedly said that they considered it inappropriate for us to refer this case to the ECJ, and that were we minded to do so, they would seek to appeal to the Upper Tribunal to prevent such a reference. Whether that would indeed be a valid ground on which to seek to appeal to the Upper Tribunal we have not considered. In view however of this indication, we will defer examining the terms of the reference to the ECJ until we know whether the Respondents will or will not pursue the appeal suggested.

Our decision in summary form

97. Our decision in summary form is that:

- the Appellant's case that the terms of the derogation, strictly construed, create an incoherent result that is inconsistent with the structure of the VAT system is entirely made out;

- while we support the common sense of interpreting the statute or the NoD in the way broadly suggested by the Appellant, and we conclude that such wording would enable the derogation to achieve the objective that should certainly have been in mind when the derogation was sought, without guidance from the ECJ we feel unable to import the relevant language ourselves; and

- while we have no jurisdiction ourselves to declare the actual authorisaton of the derogation, and thus the derogation itself as well, to have been invalid, it is our view that the derogation (unless construed in the manner just addressed) exceeded its proper scope, needlessly breached fundamental principles of the VAT scheme, full compliance with which would have enabled the appropriate objective to be attained in full, and has produced an incoherent result. Our own view is accordingly that unless the derogation can be saved by the importation of the wording canvassed in this Decision, the derogation should be declared invalid by the ECJ.

The Appellant's Notice of Appeal

98. The Respondents asked us to order the Appellant to modify its Notice of Appeal, and the Appellant refused to do this, and claimed that in any event we had no power to make such an order. Our decision is not to make such an order. The Appellant is confident that the present terms of its Notice of Appeal are perfectly correct for any remaining purpose during the further progress of this Appeal, and we believe that the Appellant is right. Whether in

that respect we ourselves are correct is irrelevant. If the Appellant chooses not to amend its Notice of Appeal, which it plainly has liberty to do in the light of the statements on behalf of the Respondents, and the Appellant later regrets that course, the Appellant will be aware that it had the opportunity to amend the Notice of Appeal. At present it appears that the Appellant will not amend the Notice of Appeal.

Right of Appeal

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

HOWARD M. NOWLAN

TRIBUNAL JUDGE

RELEASE DATE: 19 February 2014