[2012] UKUT 90 (TCC)
Appeal number FTC/29/2009

VALUE ADDED TAX — margin scheme for second-hand goods — arrangement by which motor dealer raised finance and became able to sell demonstrator cars within margin scheme — whether abusive — yes — appeal allowed

UPPER TRIBUNAL
TAX AND CHANCERY CHAMBER

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS

Appellants

- and -

1) PENDRAGON PLC
2) STRIPESTAR LIMITED
3) PENDRAGON COMPANY CAR FINANCE LTD
4) PENDRAGON DEMONSTRATOR FINANCE LTD
5) PENDRAGON DEMONSTRATOR FINANCE NOVEMBER LTD
6) PENDRAGON DEMONSTRATOR SALES LTD

Respondents

TRIBUNAL:
MR JUSTICE MORGAN and JUDGE BISHOPP

Sitting in public at Royal Courts of Justice, London on 10th, 11th, 12th and 13th May and 28th & 29th November 2011

Mr Nigel Pleming QC and Mr Owain Thomas (instructed by the General Counsel and Solicitor to HM Revenue and Customs) for the Appellants

Mr Roderick Cordara QC and Ms Valentina Sloane (instructed by KPMG) for the Respondents

DECISION

TRIBUNAL JUDGES: Mr JUSTICE MORGAN and JUDGE BISHOPP
RELEASE DATE:

Introduction

1. This is an appeal to the Upper Tribunal (Tax and Chancery Chamber) by the Commissioners for Her Majesty's Revenue and Customs ("HMRC") against the decision of the First-tier Tribunal ("the FTT"), released on 31st July 2009. The FTT had allowed appeals by various taxpayers in the Pendragon group of companies against assessments and other determinations made by HMRC. It will be necessary in due course to refer to the roles played by the various companies in the Pendragon group but for most of the time we will be able to refer to the taxpayers collectively as "Pendragon".

2. The appeal is brought under section 11 of the Tribunals, Courts and Enforcement Act 2007. Such an appeal can only be brought on a point of law arising from the decision of the FTT. The appeal is brought with the permission of Judge Bishopp granted on 12th October 2009.

3. The tax which is in issue in this case is VAT. The events which are relevant took place in late 2000 and early 2001 and, accordingly, we will refer to the provisions of the Sixth Council Directive 77/388/EEC ("the Sixth Directive"), then in force, rather than its replacement, Council Directive 2006/112/EC ("the VAT Directive"). It will also be necessary to refer to the relevant national legislation which was in force at the relevant time, principally the Value Added Tax Act 1994, the Value Added Tax (Cars) Order 1992 and the Value Added Tax (Special Provisions) Order 1995.

4. On this appeal to the Upper Tribunal, Mr Nigel Pleming QC and Mr Owain Thomas, instructed by the General Counsel and Solicitor to HMRC appeared for HMRC and Mr Roderick Cordara QC and Ms Valentina Sloane, instructed by KPMG, appeared for Pendragon. We are grateful to counsel for the considerable assistance which they gave us.

The legislation

5. Article 2, as amended, of the First Council Directive (67/227/EEC) on the harmonisation of legislation of Member States concerning turnover taxes provided:

> "The principle of the common system of value added tax involves the application to goods and services of a general tax on consumption exactly proportional to the price of the goods and services, whatever the number of transactions which take place in the production and distribution process before the stage at which tax is charged.

On each transaction, value added tax, calculated on the price of the goods or services at the rate applicable to such goods or services, shall be chargeable after deduction of the amount of value added tax borne directly by the various cost components.

The common system of value added tax shall be applied up to and including the retail trade stage."

6. Pursuant to article 11A of the Sixth Directive, the general rule as to the taxable amount, in respect of which a taxable person was liable to account for VAT on a supply of goods, was:

> " … everything which constitutes the consideration which has been or is to be obtained by the supplier from the purchaser, the customer or a third party for such supplies …"

7. Article 26a of the Sixth Directive (as introduced by Council Directive 94/5/EC) provided for special arrangements which were applicable to second-hand goods, works of art, collectors' items and antiques and was in these terms:

"**A. Definitions**

For the purposes of this Article, and without prejudice to other Community provisions

...

(d) second-hand goods shall mean tangible movable property that is suitable for further use as it is or after repair, other than works of art, collectors' items or antiques and other than precious metals or precious stones as defined by the Member States;

(e) taxable dealer shall mean a taxable person who, in the course of his economic activity, purchases or acquires for the purposes of his undertaking, or imports with a view to resale, second-hand goods and/or works of art, collectors' items or antiques, whether that taxable person is acting for himself or on behalf of another person pursuant to a contract under which commission is payable on purchase or sale

...

B. Special arrangements for taxable dealers

1. In respect of supplies of second-hand goods, works of art, collectors' items and antiques effected by taxable dealers, Member States shall apply special arrangements for taxing the profit margin made by the taxable dealer, in accordance with the following provisions.

2. The supplies of goods referred to in paragraph 1 shall be supplies, by a taxable dealer, of second-hand goods, works of art, collectors' items or antiques supplied to him within the Community:

-- by a non-taxable person,

or

-- by another taxable person, in so far as the supply of goods by that other taxable person is exempt in accordance with Article 13 (B) (c),

or

-- by another taxable person in so far as the supply of goods by that other taxable person qualifies for the exemption provided for in Article 24 and involves capital assets,

or

-- by another taxable dealer, in so far as the supply of goods by that other taxable dealer was subject to value added tax in accordance with these special arrangements.

3. The taxable amount of the supplies of goods referred to in paragraph 2 shall be the profit margin made by the taxable dealer, less the amount of value added tax relating to the profit margin. That profit margin shall be equal to the difference between the selling price charged by the taxable dealer for the goods and the purchase price.

For the purposes of this paragraph, the following definitions shall apply:

-- selling price shall mean everything which constitutes the consideration, which has been, or is to be, obtained by the taxable dealer from the purchaser or a third party, including subsidies directly linked to that transaction, taxes, duties, levies and charges and incidental expenses such as commission, packaging, transport and insurance costs charged by the taxable dealer to the purchaser but excluding the amounts referred to in Article 11(A)(3),

-- purchase price shall mean everything which constitutes the consideration defined in the first indent, obtained, or to be obtained, from the taxable dealer by his supplier

...

> 5. Where they are effected in the conditions laid down in Article 15, the supplies of second-hand goods, works of art, collectors' item or antiques subject to the special arrangements for taxing the margin shall be exempt.
>
> 6. Taxable persons shall not be entitled to deduct from the tax for which they are liable the value added tax due or paid in respect of goods which have been, or are to be, supplied to them by a taxable dealer, in so far as the supply of those goods by the taxable dealer is subject to the special arrangements for taxing the margin
>
> ...
>
> 8. Where he is led to apply both the normal arrangements for value added tax and the special arrangements for taxing the margin, the taxable dealer must follow separately in his accounts the transactions falling under each of these arrangements, according to rules laid down by the Member States,
>
> 9. The taxable dealer may not indicate separately on the invoices which he issues, or on any other document serving as an invoice, tax relating to supplies of goods which he makes subject to the special arrangements for taxing the margin.…
>
> 11. The taxable dealer may apply the normal value added tax arrangements to any supply covered by the special arrangements pursuant to paragraph 2 or 4
>
> ..."

8. Article 26a refers to "normal value added tax arrangements" (see Article 26a B 11) and also to "special arrangements for taxing the profit margin" (see Article 26a B 1). This terminology makes it clear that the margin scheme permitted by Article 26a is a derogation from the normal position whereby VAT is charged by reference to the total consideration for the relevant supply.

9. Article 28o of the Sixth Directive permitted Member States to make transitional provisions as to the application of Article 26a in relation to second-hand means of transport.

10. Articles 26a and 28o of the Sixth Directive were introduced by EC Council Directive 94/5/EC. It is relevant to refer to the recitals to this Directive which stated, as follows:

> "…

> Whereas, in accordance with Article 32 of the Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes - Common system of value added tax: uniform basis of assessment, the Council is to adopt a Community taxation system to be applied to used goods, works of art, antiques and collectors' items;
>
> Whereas the present situation, in the absence of Community legislation, continues to be marked by the application of very different systems which cause distortion of competition and deflection of trade both internally and between Member States; whereas these differences also include a lack of harmonization in the levying of the own resources of the Community; whereas consequently it is necessary to bring this situation to an end as soon as possible;
>
> Whereas the Court of Justice has, in a number of judgments, noted the need to attain a degree of harmonization which allows double taxation in intra-Community trade to be avoided;
>
> Whereas it is essential to provide, in specific areas, for transitional measures enabling legislation to be gradually adapted;
>
> Whereas, within the internal market, the satisfactory operation of the value added tax mechanisms means that Community rules with the purpose of avoiding double taxation and distortion of competition between taxable persons must be adopted;
>
> Whereas it is accordingly necessary to amend Directive 77/388/EEC,
>
> ..."

11. By section 4(1) of the Value Added Tax Act 1994 ("VATA 1994"), VAT is to be charged on any supply of goods or services made in the United Kingdom, where it is a taxable supply made by a taxable person in the course or furtherance of any business carried on by him. By section 5(3) of VATA 1994, the Treasury may by order provide with respect to any description of transaction that it is to be treated as neither a supply of goods nor a supply of services: see, in particular, section 5(3)(c). By section 19 of VATA 1994, the value of any supply of goods or services is to be determined in accordance with section 19 and schedule 6 to VATA 1994.

12. The Value Added Tax (Cars) Order 1992 ("the 1992 Order") was made pursuant to the enabling powers in the Value Added Tax Act 1983 and amended pursuant to such powers in VATA 1994. The 1992 Order was the subject of a number of amendments prior to the date of the relevant transactions in this case and, indeed, was further amended after the date of those transactions.

13. Article 8 of the 1992 Order, in the form current at the time of the relevant transactions in this case, provided as follows:

> "(1) Subject to complying with such conditions (including the keeping of such records and accounts) as the Commissioners may direct in a notice published by them for the purposes of this Order or may otherwise direct, and subject to paragraph (3) below, where a person supplies a used motor car which he took possession of in any of the circumstances set out in paragraph (2) below, he may opt to account for the VAT chargeable on the supply on the profit margin on the supply instead of by reference to its value.
>
> (2) The circumstances referred to in paragraph (1) above are that the taxable person took possession of the motor car pursuant to--
>
> (a) a supply in respect of which no VAT was chargeable under the Act or under Part I of the Manx Act;
>
> (b) a supply on which VAT was chargeable on the profit margin in accordance with paragraph (1) above, or a corresponding provision made under the Manx Act or a corresponding provision of the law of another member State;
>
> (bb) a supply received before 1st March 2000 to which the provisions of article 7(4) of the Value Added Tax (Input Tax) Order 1992 applied;
>
> (c) a transaction except one relating to the transfer of the assets of a business or part of a business as a going concern which was treated by virtue of any Order made or having effect as if made under section 5(3) of the Act or under the corresponding provisions of the Manx Act as being neither a supply of goods nor a supply of services,
>
> (d) a transaction relating to the transfer of the assets of a business or part of a business as a going concern which was treated as neither a supply of goods nor a supply of services if the transferor took possession of the goods in any of the circumstances described in this paragraph.…"

14. Article 8 of the 1992 Order as set out above contains the amendments made to the 1992 Order by the Value Added Tax (Cars) (Amendment) Order 1995 (SI1995/1269). The Explanatory Note to this Order made it clear that the United Kingdom was thereby implementing Directive 94/5/EC. That Note stated:

> "The directive enables the United Kingdom to allow taxable persons to continue to calculate VAT by reference to the profit margin on certain goods and also to extend this facility to other goods, all of which become subject to the conditions contained in the directives"

Article 7 of this Order amended Article 8 of the 1992 Order. The Explanatory Note to Article 7 stated:

> "It allows taxable persons to opt to use the margin scheme in the circumstances provided for in the above directives for supplies of second-hand motor cars."

15. The Value Added Tax (Special Provisions) Order 1995 ("the 1995 Order") was made pursuant to the enabling powers in VATA 1994.

16. Article 5 of the 1995 Order in the form current at the time of the relevant transactions in this case provided, as follows:

> "(1) Subject to paragraph (2) below, there shall be treated as neither a supply of goods nor a supply of services the following supplies by a person of assets of his business--
>
> (a) their supply to a person to whom he transfers his business as a going concern where--
>
> (i) the assets are to be used by the transferee in carrying on the same kind of business, whether or not as part of any existing business, as that carried on by the transferor, and
>
> (ii) in a case where the transferor is a taxable person, the transferee is already, or immediately becomes as a result of the transfer, a taxable person or a person defined as such in section 3(1) of the Manx Act;
>
> (b) their supply to a person to whom he transfers part of his business as a going concern where--
>
> (i) that part is capable of separate operation,
>
> (ii) the assets are to be used by the transferee in carrying on the same kind of business, whether or not as part of any existing business, as that carried on by the transferor in relation to that part, and

> (iii) in a case where the transferor is a taxable person, the transferee is already, or immediately becomes as a result of the transfer, a taxable person or a person defined as such in section 3(1) of the Manx Act.…
>
> (4) There shall be treated as neither a supply of goods nor a supply of services the assignment by an owner of goods comprised in a hire-purchase or conditional sale agreement of his rights and interest thereunder, and the goods comprised therein, to a bank or other financial institution.”

17. Before considering the transactions in the present case, it is useful to describe the most obvious ways in which paragraph 8(2) of the 1992 Order was intended to operate, in conjunction with the general provisions as to VAT. We will take first the case of a car dealer buying a car wholesale from a manufacturer and selling it, unused, to a consumer. In such a case, the normal provisions as to VAT apply and the provisions as to the margin scheme do not apply. The dealer pays the manufacturer input tax, charges the consumer output tax and is able to reclaim the input tax. We take next the case of a car dealer buying a car wholesale from a manufacturer, using it for a time as a demonstrator car and then selling it to a consumer. Although the car is a used car at the point of sale to the consumer, the case does not come within the margin scheme. Accordingly, the general provisions as to VAT apply. The dealer pays the manufacturer input tax, charges the consumer output tax and is able to reclaim the input tax.

18. We take next a case where the margin scheme was plainly intended to apply. This is the case where: (1) a car dealer buys a car wholesale from a manufacturer and sells it to a consumer (“the first consumer”); the first consumer uses the car for a time and sells it back to a car dealer (who may or may not be the original dealer); and (3) the car dealer sells the used car to another consumer (“the second consumer”). The first stage in this sequence is dealt with as described earlier. The general provisions as to VAT apply and the special provisions as to assessing tax by reference to the profit margin have no part to play. The dealer pays the manufacturer input tax, charges the first consumer output tax and is able to reclaim the input tax. At the second stage, the first consumer does not charge the car dealer any VAT and so the dealer does not incur any input tax. At the third stage, in the absence of the special provisions in question, the dealer would have

to charge VAT under the general provisions by reference to the price charged on that sale. This would produce the result that, in relation to the same car, VAT would be payable on the sale to the first consumer and on the sale to the second consumer, on both occasions by reference to the prices charged on those two sales. However, by reason of the special provisions, the dealer who sells the used car to the second consumer is able to charge VAT not by reference to the full price payable on that sale but by reference to the dealer's profit on that sale.

19. We recognise that the above examples are uncomplicated and that the special provisions were intended to operate in a number of further circumstances where the underlying transaction could be much more complex. After all, paragraph 8(2) of the 1992 Order contains 5 different sub-paragraphs (though most are irrelevant to this case) and, further, it is to operate in conjunction with the de-supply provisions of the 1995 Order. Nonetheless, the above discussion illustrates how the margin scheme was intended to operate in one case which was no doubt expected to be of common occurrence.

The transactions in question

20. We can now begin to describe the transactions which were entered into in this case. Before the relevant transactions were entered into, the proposed arrangements were described in a letter dated 8th November 2000 sent to Pendragon plc by KPMG acting as its tax advisers. It is convenient to refer to the description of the proposed arrangements and the terminology used in that letter. The letter stated that the arrangements required "five captive companies under the control of Pendragon plc and a non UK resident licensed bank". The captive companies were referred to as Captive Cos 1, 2, 3, 4 and 5. The intended sequence was to comprise 5 steps:

> <u>Step 1</u>: Pendragon plc was to sell new cars, destined for use as demonstrators before sale to a consumer, but at this stage still unused) to Captive Cos 1, 2, 3 and 4 (" the Captive Leasing Companies").

Step 2: On the same day as Step 1, the Captive Leasing Companies were to lease the cars pursuant to hybrid HP/lease agreements to Pendragon plc's dealerships ("the Dealerships").

Step 3: On the day following Step 1, the Captive Leasing Companies were to begin assigning the hybrid HP/lease agreements and title in the cars to the non-UK resident bank.

Step 4: On a date 30-45 days later, the non-UK resident bank was to transfer as a going concern the lease agreements and title in the cars to Captive Co 5.

Step 5: The cars could then be sold to customers, title passing from Captive Co 5 to customers via the agency of the Dealerships.

21. The relevant parties entered into contractual documents designed to give effect to this scheme. The scheme was implemented twice. The first implementation occurred between 16th November 2000 and 22nd December 2000 (a 37 day period), and involved the following documents:

Step 1: There was no specific evidence of any documents used for the purposes of Step 1, but HMRC accepted that the cars in question were purchased by the Captive Leasing Companies from Pendragon plc.

Step 2: On 16th November 2000, each of three Captive Leasing Companies entered into a "Vehicle Demonstrator Hire Agreement" (referred to as a hybrid lease) in favour of the Dealerships. Clause 8(c) of the hire agreements conferred on the hirer an option to purchase the hired vehicles. The option was only exercisable 7 days after the end of the hire agreement and, in the event of the exercise of the option, title to the vehicles was to pass 14 days after such exercise.

Step 3: On 17th November 2000, each of the three Captive Leasing Companies entered into a "Deed of Assignment" with SG Hambros & Trust (Jersey) Limited ("Soc Gen Jersey"). Soc Gen Jersey paid the three Captive Leasing Companies the sum of £20 million (approximately). Soc Gen Jersey had on the same date entered into a facility agreement with its parent company in the UK, Soc Gen London, in relation to the facility of £20 million to finance the assignments. Soc Gen Jersey granted Soc Gen London an assignment of the assets to be assigned to it as security.

Step 4: On 22nd December 2000, another captive company of Pendragon plc (performing the role of Captive Co 5 as per the letter of 8th November 2000) resolved to purchase the "hire business" carried on by Soc Gen Jersey. (Although this company was only the fourth captive company used in the implementation of the scheme, we will continue to call it Captive Co 5 for the sake of consistency.) On the same date, Soc Gen Jersey contracted with Captive Co 5 to sell to it the business of the hire of motor cars said to have been carried on by Soc Gen Jersey. The consideration was in excess of £18 million and was apportioned as to £100,000 for the sale of goodwill and as to the balance (save for £2) for the sale of the motor vehicles. That agreement was completed on the same date and Captive Co 5 paid the agreed price to Soc Gen Jersey.

Step 5: On various dates thereafter the cars were sold to customers, by the Dealerships acting as undisclosed agent for Captive Co 5, in which title was vested. VAT was charged to the purchasers on the seller's profit margin on the sale, rather than on the total sale price.

22. The scheme was implemented a second time in the period from 22nd February to 5th March 2001 (an 11 day period). The documents used for this second implementation were in similar format to those used for the first implementation of the scheme.

The VAT analysis of the steps in the transactions

23. The VAT consequences, absent any application of the principle of abuse of law, are as follows.

Step 1

24. Pendragon plc's sale was a taxable supply of goods for VAT purposes and Pendragon plc accounted for output tax on the sale of cars and reclaimed input tax. The Captive Leasing Companies therefore incurred VAT on the purchase.

Step 2

25. The services provided by the Captive Leasing Companies under the Vehicle Demonstrator Hire Agreement to the Dealerships were taxable supplies at the standard rate. Input tax incurred by the Captive Leasing Companies on the purchase of the vehicles from Pendragon plc at Step 1 was therefore fully recoverable being attributable to the making of those taxable supplies of leasing to the Dealerships.

26. The Dealerships incurred VAT on the rental payments but recovered that VAT in full being attributable to their taxable sale activities.

27. Further, by virtue of the particular characteristics of the hire purchase agreements in this case, rather than amounting to a supply of goods for VAT purposes, those agreements gave rise to a supply of services. That was because of clause 8(c) of the agreements which provided that title in the goods subject to the agreement was not to pass when the final payment had been made, but rather passed afterwards; see VATA 1994, schedule 4 para. 1.

Step 3

28. The assignment by the Captive Leasing Companies to Soc Gen Jersey was not a supply for VAT purposes by virtue of Article 5(4) of the 1995 Order which "de-supplies" it. The 1995 Order was made under VATA 1994, section 5(3).

29. We have already set out Article 5(4) of the 1995 Order but it is convenient to quote it again. It provided: "[t]here shall be treated as neither a supply of goods nor a supply of services <u>the assignment</u> by an owner of goods comprised in a <u>hire-purchase</u> or conditional sale agreement of his rights and interest thereunder, and the goods comprised therein, <u>to a bank</u> or other financial institution" (emphasis added).

30. There was no VAT due on this transaction.

31. It was this transaction which is, in particular, critical to the success of the scheme. It depended on a lease written by a captive leasing company to a Pendragon dealership being assigned to an offshore bank. For present purposes it is enough to note that it was a transaction which was de-supplied under section 5(3) VATA 1994.

Step 4

32. The sale by Soc Gen Jersey to Captive Co 5 of its "hire business" was the transfer of a business as a going concern ("TOGC") and was neither a supply of goods nor a supply of services pursuant to section 5(3)(c) VATA 1994 and Article 5(1) of the 1995 Order which "de-supplied" that transaction. Accordingly there was no VAT due on this transaction.

Step 5

33. When Captive Co 5 sold the vehicles to the consumer, the 1992 Order applied. Article 8 provided relief for the sale of second-hand cars. The relief only applied where the taxable person making the sale had come into possession of the car in the circumstances set out in Article 8(2). Where those requirements were met, VAT was due only on the profit margin on the supply, rather than on the whole value received for the supply. In the present circumstances, that meant that Captive Co 5 accounted for VAT on the difference between the cost of the car on purchase from Soc Gen Jersey and the price at which it sold the car to the consumer. By means of the de-supplied assignment of the leases to Soc Gen Jersey at Step 3 and the TOGC from Soc Gen Jersey at Step 4 the scheme was designed to and did fulfil the requirements of the 1992 Order.

34. The precise manner in which the requirements were met was a combination of Articles 8(2)(c) and (d) of the 1992 Order. They provided (in material part) that among the circumstances which qualified were circumstances where the taxable person (i.e. Captive Co 5) took possession of the motor car pursuant to:

> “(c) a transaction [except a TOGC], which was treated by virtue of any order made under Section 5(3) of [VATA 1994]…as being neither a supply of goods or a supply of services
> (d) a transaction relating to the transfer of the assets of a business or part of a business as a going concern which was treated as neither a supply of goods nor a supply of services if the transferor took possession of the goods in any of the circumstances described in this paragraph”

35. Soc Gen Jersey, the transferor, transfered the “hire business” to Captive Co 5 at Step 4. That was neither a supply of goods nor a supply of services but it was a TOGC. On its own, that would not suffice for a sale made by Captive Co 5 to qualify for the margin scheme under Article 8(2)(c) because while Captive Co 5 would have taken possession of the car pursuant to a transaction which was “de-supplied” under section 5(3) VATA, it was a TOGC and so was excluded by Article 8(2)(c).

36. However, by reference to Article 8(2)(d), certain acquisitions via a TOGC benefited. The requirements of 8(2)(d) were met because:

    1. Captive Co 5 took possession pursuant to a “transaction relating to the transfer of the assets of a business or part of a business as a going concern which was treated as neither a supply of goods nor a supply of services”; and
    2. the transferor (Soc Gen Jersey) itself took possession of the goods “in [one] of the ‘circumstances described in [that] paragraph’” because the assignment at Step 3 fell within Article 8(2)(c). That assignment was de-supplied by virtue of Article 5(4) of the 1995 Order made pursuant to section 5(3) VATA 1994 and was not a TOGC.

The principle of abuse of law

37. There is a principle of law, which has operated for some time in the European Community legal order, which has been referred to as the principle of abuse of law or abuse of rights. Speaking broadly, an application of the principle can result in the refusal or withdrawal of an advantage, which would otherwise be available, in a case where the required conditions for the obtaining of that advantage have

been artificially created. The circumstances in which such a principle falls to be applied were considered in some detail by the ECJ in Emsland-Stärke GMBH v Hauptzollamt Hamburg-Jonas [2000] ECR I-11569. This case did not concern VAT.

38. The principle of abuse of law was first considered by the ECJ in the context of VAT in Halifax Plc v Customs & Excise Commissioners [2006] STC 919. Although the decision in Halifax has been applied, and to some extent clarified, in a number of later decisions, that decision is still the leading statement of the principle of abuse of law, certainly in the context of VAT. The basic principle is set out at paragraph 69 of the judgment:

> "The application of Community legislation cannot be extended to cover abusive practices by economic operators, that is to say transactions carried out not in the context of normal commercial operations, but solely for the purpose of wrongfully obtaining advantages provided for by Community law (see, to that effect, Case 125/76 Cremer [1977] ECR 1593, paragraph 21; Case C-8/92 General Milk Products [1993] ECR I-779, paragraph 21; and Emsland-Stärke, paragraph 51)".

39. The two limbs of the test for abuse are set out at paragraphs 74 – 76 and expanded upon at paragraphs 80 – 81 of the court's judgment:

> "74. In view of the foregoing considerations, it would appear that, in the sphere of VAT, an abusive practice can be found to exist only if, first, the transactions concerned, notwithstanding formal application of the conditions laid down by the relevant provisions of the Sixth Directive and the national legislation transposing it, result in the accrual of a tax advantage the grant of which would be contrary to the purpose of those provisions.

> 75. Second, it must also be apparent from a number of objective factors that the essential aim of the transactions concerned is to obtain a tax advantage. As the Advocate General observed in point 89 of his Opinion, the prohibition of abuse is not relevant where the economic activity carried out may have some explanation other than the mere attainment of tax advantages.

> 76. It is for the national court to verify in accordance with the rules of evidence of national law, provided that the effectiveness of Community law is not undermined, whether action constituting such an abusive practice has taken place in the case before it (see Case C-515/03 Eichsfelder Schalchtbetrieb [2005] ECR I-0000, paragraph 40).
>
> …
>
> 80. To allow taxable persons to deduct all input VAT even though, in the context of their normal commercial operations, no transactions conforming with the deduction rules of the Sixth Directive or of the national legislation transposing it would have enabled them to deduct such VAT, or would have allowed them to deduct only a part, would be contrary to the principle of fiscal neutrality and, therefore, contrary to the purpose of those rules.
>
> 81. As regards the second element, whereby the transactions concerned must essentially seek to obtain a tax advantage, it must be borne in mind that it is the responsibility of the national court to determine the real substance and significance of the transactions concerned. In so doing, it may take account of the purely artificial nature of those transactions and the links of a legal, economic and/or personal nature between the operators involved in the scheme for reduction of the tax burden (see, to that effect, Emsland Stärke, paragraph 58)."

40. One of "the foregoing considerations" (as referred to in paragraph 74 of the court's judgment) was the consideration stated in paragraph 73 of the judgment in these terms:

> "… it is clear from the case law that a trader's choice between exempt transactions and taxable transactions may be based on a range of factors, including tax considerations relating to the VAT system (see, in particular, BLP Group [1995] STC 424, para 26 and Customs and Excise Comrs v Cantor Fitzgerald International [20001] STC 1453, para 33). Where the taxable person chooses one of two transactions, the Sixth Directive does not require him to choose the one which involves paying the highest amount of VAT. On the contrary, as the Advocate

> General observed in para 85 of his opinion, taxpayers may choose to structure their business so as to limit their tax liability."

41. It is also worth quoting what was said by the Advocate General in Halifax at paragraph 89 of his Opinion, a paragraph which was specifically approved by the court as stated in paragraph 75 of its judgment:

> "The prohibition of abuse, as a principle of interpretation, is no longer relevant where the economic activity carried out may have some explanation other than the mere attainment of tax advantages against tax authorities. In such circumstances, to interpret a legal provision as not conferring such an advantage on the basis of an unwritten general principle would grant an excessively broad discretion to tax authorities in deciding which of the purposes of a given transaction ought to be considered predominant. It would introduce a high degree of uncertainty regarding legitimate choices made by economic operators and would affect economic activities which clearly deserve protection, provided that they are, at least to some extent, accounted for by ordinary business aims."

42. In Halifax, the court held (at paragraph 94) that:

> "the transactions involved in an abusive practice must be redefined so as to re-establish the situation that would have prevailed in the absence of the transactions constituting that abusive practice".

43. The Respondents invited us to have regard to the findings of fact made by the VAT and Duties Tribunal in its decision (following remission by the High Court) in Halifax (released on 27th June 2002). Whilst we have considered those findings, we do not think that it is necessary to set them out in this decision. What matters is the legal principle laid down in Halifax which is to be applied to the facts of the case before us.

44. The legal principles in Halifax were considered by the Court of Appeal in WHA Ltd v Revenue & Customs Commissioners [2007] STC 1695. At paragraph 12 of his judgment, Lord Neuberger stated that it was useful, in this context, to consider

the following four questions (although he recognised that the answers to these questions might overlap to some extent):

> "First, does the Scheme, or an aspect of the Scheme, result in the accrual of a tax advantage which, as HMRC assert, is 'contrary to the purpose of' the provisions of the Sixth Directive? Secondly, if so, was it, as HMRC contend, the 'essential aim' of the Scheme, or of the relevant aspect, that a tax advantage be obtained? Thirdly, if so, are there any special features of the Scheme itself, or of the law relating to it, which should nonetheless prevent the abuse argument succeeding? Fourthly, if not, can (and must) the Scheme, or the relevant part, be 'redefined'?"

45. When deciding whether the result of a scheme was contrary to the purpose of the legislation, it was the effect of the scheme as a whole which must be examined rather than each individual step independently. Lord Neuberger made this clear, at paragraph 22, when considering a submission that questions relating to VAT were to be determined by looking at individual steps:

> "… While I accept the soundness of the approach in classic VAT cases (indeed, we adopted it when considering whether the Scheme worked when considered at face value), I do not consider that it can possibly be appropriate when considering whether a scheme infringes the purpose of the Sixth Directive. Otherwise, a scheme would never be liable to attack on the basis of the principle established in Halifax. Effectively by definition, each step of such a scheme would be unassailable (as it would otherwise be unnecessary to invoke the abuse principle). Accordingly, on this argument, the scheme itself would be unassailable. Indeed, if this argument were correct, the European Court would have decided Halifax differently. The whole point of the principle is that, although each step of the scheme in question works, the overall effect of the scheme is unacceptable."

46. The ECJ has provided an important clarification of the legal principles in Halifax in its judgment in Ministerio dell'Economia e delle Finanze v Part Service Srl, [2008] STC 3132. In particular, the ECJ considered whether the aim of obtaining a tax advantage had to be the "principal" aim or the "sole" aim of the transaction. It was held that it was sufficient if that was the principal aim of the transaction. The references to the "sole" aim in Halifax were references to the facts of that case and

did not impose a requirement that the aim of obtaining a tax advantage had to be the sole or only aim of the transaction. The court added at [62]:

> "As regards the second criterion, the national court, in the assessment which it must carry out, may take account of the purely artificial nature of the transactions and the links of a legal, economic and/or personal nature between the operators involved (Halifax (para 81)), those aspects being such as to demonstrate that the accrual of a tax advantage constitutes the principal aim pursued, notwithstanding the possible existence, in addition, of economic objectives arising from, for example, marketing, organisation or guarantee considerations."

47. In Ampliscientifica v Ministerio dell'Economia e delle Finanze [2011] STC 566, the ECJ had to consider whether Italian national legislation was contrary to certain principles of European law. In that context, the court referred to the principle of abuse of law and gave a brief description of the relevant principle, referring to Halifax and to Cadbury Schweppes v Revenue and Customs Commissioners [2006] STC 1908. The court referred to transactions which had "the sole aim" of obtaining a tax advantage. Part Service was not referred to and the Chamber of the ECJ which decided Ampliscientifica was different from that which decided Part Service.

48. The three cases of Lower Mill Estate v Revenue and Customs Commissioners [2011] STC 636, Revenue and Customs Commissioners v RBS Deutschland Holdings GmbH [2011] STC 345 and Commissioners for Her Majesty's Revenue and Customs v Weald Leasing Ltd [2011] STC 596 were all decided on the same day (22nd December 2010). The first of these was decided by the Upper Tribunal (Tax and Chancery Chamber) (Warren J (P) and Judge Wallace) but without having available to it the two other decisions, which were decisions of the ECJ (although the Upper Tribunal did refer to the Opinion of the Advocate General in Weald Leasing).

49. In Lower Mill, the Upper Tribunal considered the earlier cases in detail and drew attention to the apparent difference between the test of "principal aim" in Part Service and the reference to "sole aim" in Ampliscientifica but held that it did not have to choose between these different formulations. At [60], the Upper Tribunal

commented on the fact that the test as to the aim of the transaction was an objective one and stated:

> "Next it can be seen, following Halifax, that the purpose of the transaction has to be judged objectively not subjectively. That is to say, it has to be judged by reference to the terms of the scheme and the commercial realities not by reference to what the parties concerned say their intentions were (or what their subjective intention is found to have been). Whether evidence of subjective intention is therefore altogether inadmissible is not, however, entirely clear."

50. The Upper Tribunal in Lower Mill also noted the point that where a tax payer could structure a desired transaction in more than one way, he was free to choose the course of action which minimised his tax liability. The Upper Tribunal added at [68]:

> "But what is of significance is that this escape from a finding of abuse is circumscribed. No doubt in a case where there are different options which can both be seen as grounded in commercial reality or, to put the point in different words, where 'normal commercial operations' can be carried out in different ways to achieve the same result, it is open to a trader to adopt the option which is the more beneficial to him in terms of VAT. But this is not a licence to adopt any transactions which the trader might choose when they involve artificiality, being contrived to bring a VAT benefit."

51. The decision of the Upper Tribunal in Lower Mill is helpful to us as an illustration of a court or tribunal (above the level of the First-tier Tribunal) applying the Halifax principle to the facts of the particular case. This came about because the Upper Tribunal reversed the First-tier Tribunal on the question of abuse of law and went on to make its own decision.

52. In Revenue and Customs Commissioners v RBS Deutschland GmbH [2011] STC 345, the ECJ held that the transactions in that case did not infringe the principle of abuse of law. At [49], the ECJ took the test for the relevant principle from paragraphs 74 and 75 of Halifax where the court had referred to "the essential aim" of the transaction. At [50], it was stated that the transactions took place between two parties which were legally unconnected, the transactions were not

artificial in nature and they were carried out in the context of normal commercial operations. At [51], it was considered that the characteristics of the transactions and the nature of the parties' relations contained nothing to suggest an artificial arrangement which did not reflect economic reality or that "the sole aim" was to obtain a tax advantage. At [54], the court re-stated the point made in Halifax (at paragraph 73) that where it was possible for a taxable person to choose from among a number of transactions, he may choose to structure his business in such a way as to limit his tax liability. The court did not discuss any possible difference between "the essential aim" and "the sole aim" and did not refer to Part Service, although that case was referred to in a footnote in the Opinion of the Advocate General in RBS Deutschland.

53. In Revenue and Customs Commissioners v. Weald Leasing Ltd [2011] STC 596, the ECJ summarised the Halifax principles as follows (referring also to Part Service):

> "26. It should be recalled that the application of EU legislation cannot be extended to cover abusive practices by economic operators, that is to say, transactions carried out, not in the context of normal commercial operations, but solely for the purpose of wrongfully obtaining advantages provided for under EU law and that the principle of prohibiting abusive practices also applies to the sphere of VAT (see Halifax (paras 69 and 70) and Ampliscientifica (para 27).
>
> 27. On the other hand, a trader's choice between exempt transactions and taxable transactions may be based on a range of factors, including tax considerations relating to the VAT system. Where the taxable person chooses one of two transactions, the Sixth Directive does not require him to choose the one which involves paying the higher amount of VAT. On the contrary, taxpayers may choose to structure their business so as to limit their tax liability (see Halifax (para 74), and Part Service (para 47).
>
> 28. In that context, the court has held that in the sphere of VAT, finding that an abusive practice exists requires that two conditions be met.
>
> 29. First, notwithstanding formal application of the conditions laid down in the relevant provisions of the Sixth Directive and in the national legislation transposing it, the transactions concerned must result in the accrual of a tax

> advantage the grant of which would be contrary to the purpose of those provisions (see Halifax (para 74), and Part Service (para 42).
>
> 30. Second, it must also be apparent from a number of objective factors that the essential aim of the transactions concerned is to obtain a tax advantage. The prohibition of abuse is not relevant where the economic activity carried out may have some explanation other than the mere attainment of tax advantages (see Halifax (para 75), and Part Service (para 42)."

The decision of the FTT

54. The FTT consisted of Judge Shipwright and Ms Wong Chong. The FTT heard the various appeals in this case in September 2008 and released its decision on 31st July 2009. The decision is lengthy. It sets out a large amount of non-contentious fact to which it is not necessary for us to refer in our decision. What follows is necessarily an abbreviated summary of the findings and the reasoning of the FTT.

55. The FTT identified the extent of the common ground between the parties: paragraph 13. This included the fact that the cars in question, which were conveniently called "demonstrator cars" were used cars for the purposes of the relevant legislation. Subject to the possible application of the principle of abuse of law, HMRC accepted before the FTT that the taxpayers were entitled to rely upon the margin scheme for used cars. Accordingly, the FTT directed itself that the sole issue before it was whether the transactions in question were abusive in that sense: paragraph 7. That gave rise to two questions: (1) was the accrual of the tax advantage contrary to the purpose of the legislative provisions and (2) judging the matter objectively, was the obtaining of a tax advantage the essential aim of the transactions (paragraph 8).

56. The FTT referred to and set out substantial parts of the relevant legislation. It referred to Article 26a of the Sixth Directive and the preamble to Council Directive 94/5/EC (which introduced Art 26a into the Sixth Directive). In relation to this preamble, the FTT stated at paragraph 19:

> “**[19]** The preamble notes the lack of harmonisation in the area and various other matters such as distortion of competition, deflection of trade and double taxation. It does not reveal a clear underlying policy but does want gradual adaptation of the legislation in specific areas. It does not refer to ‘trapped VAT’ nor require ‘Input VAT’ to have been paid. It does make it clear that a uniform basis (presumably a margin scheme) should apply to used goods works of art, antiques and collectors’ items. We are inclined to agree with Mr Cordara QC that this is a set of ad hoc arrangements to ameliorate matters until something better was agreed. No clear policy agreement had been reached between the member states.”

57. The FTT recorded that it had received evidence from 3 witnesses: (1) Mr Forsyth, the finance director of Pendragon plc; (2) Mr de Rousset-Hall, formerly managing director of Ford Credit; and (3) Mr Ingram, a partner in Clifford Chance LLP. Mr de Rousset-Hall was not cross-examined; the other two witnesses were.

58. The FTT then proceeded to make what it described as findings of fact. At paragraph 42, it said that the steps in the transactions were bound together and were pre-planned and would inevitably take place in accordance with that plan in the sense that there was contractual interdependency between the steps. The FTT thought that these matters were indicative of the aim of the transactions being financing rather than abuse of law.

59. The FTT referred in some detail to the evidence given by Mr Forsyth as to the financing requirements of the Pendragon group. At paragraphs 51 – 53, the FTT stated:

> “**[51]** We have carefully considered the position here in the light of these objective factors and all the circumstances of the case from an objective perspective. We consider that the obtaining of finance in all the circumstances of the case was the predominant, principal, or a central, aim of the transactions and we so find as a primary fact on the basis of objective factors.
>
> **[52]** This was clearly the case for the first tranche and we consider it also to be the case, though less certainly, for the second tranche. This is not to suggest that we are wavering as to the finding concerning the second tranche. We are not because the shortening was because of budget uncertainty and

> not because finance was not needed. Again we find this on the basis of objective factors.
>
> **[53]** We find, having considered all the evidence and circumstances, that it is not '... apparent from a number of objective factors that the essential aim of the transactions concerned is to obtain a tax advantage.' The essential aim was finance."

60. At paragraphs 57 – 59, the FTT made these further findings:

> "**[57]** Mr Forsyth said in his witness statement (para 69) 'tax efficiency was a consideration, but not the main factor in my decision. The primary objective is to ensure the continued funding needs were met at a time when trading conditions were extremely difficult'. This was the period of the 'Rip Off Britain' campaign and changes in the block exemption orders etc.
>
> **[58]** We accept that this is Mr Forsyth's personal view and so subjective. However, we consider that it reflects what an outsider looking in at Pendragon objectively would have thought and we so find.
>
> **[59]** We find that this is part of the setting for the transaction which is necessary to consider to give an objective view to the transactions and are objective factors to consider. Whether something is not commercial needs to be considered in the light of the objective commercial context in which transactions take place."

61. In paragraphs 63 – 80, the FTT described the transactions in question. At paragraphs 81 – 82, it stated:

> "**[81]** These transactions should be compared with those of a normal sale and leaseback transaction or finance from the manufacturer's finance arm … . The essential elements of finance and security of the same person as was the commercial need to the manufacturer to be able to record sales were included and we so find.
>
> **[82]** We find the transactions were not self-cancelling or evidently uncommercial not-for-profit contracts. The £20m facility is particularly significant here as an objective factor. It is not to be categorised as a non-commercial operation and HMRC have not sought to do so."

62. At paragraphs 83 – 99, the FTT referred to the evidence as to the involvement of KPMG in the transactions in question and then stated at paragraphs 94 and 99:

> "**[94]** This is all very interesting but suffers from the same potential difficulty as that Mr Pleming objected to concerning Mr Forsyth's evidence. This sets out the subjective view of what KPMG thought it was selling. KPMG seemed to think it was selling a means of reducing VAT on demonstrator cars which also involved the provision of third-party finance.
>
> …
>
> **[99]** KPMG's belief as to what it was doing would be a subjective and not an objective matter."

63. Having set out a summary of the submissions made by the parties to the FTT, it then addressed the question whether the transactions in question were "contrary to the purposes of the Sixth Directive" and it concluded at paragraphs 168 – 170:

> "**[168]** We have discussed art 26a and its policy and rationale (see [19] above) (*this cross-reference is as corrected*). We concluded it does not reveal a clear underlying policy but does want gradual adaptation of the legislation in specific areas. It does not refer to 'trapped VAT' nor require 'input VAT' to have been paid. It does make it clear that a uniform basis (presumably a margin scheme) should apply to used goods, works of art, antiques and collectors' items.
>
> **[169]** In the light of the requirement of certainty that the ECJ has emphasised it would require in our view a clearer policy, rationale or purpose to be able to say that in this context the Sixth Directive was being abused by virtue of the transactions. Bearing in mind those second-hand goods, ie used cars, are being sold it is not obvious that this is against its purpose.
>
> **[170]** We conclude that the transactions are not against the purposes of the Sixth Directive. If we are wrong on this then as we consider the essential aim to be finance and not the obtaining of a tax advantage it should not make a difference to the outcome."

64. The FTT next considered the question whether the essential aim of the scheme was to obtain a tax advantage. At paragraphs 172 – 184, it reached the following conclusions. Although the passage is a lengthy one, we think that we ought to set it out in full:

“[172] We have been careful in considering Mr Forsyth’s evidence to look to the commercial realities objectively as to the position of Pendragon and to consider the terms of the transactions.

[173] We consider (even ignoring Mr Forsyth’s evidence) that the obtaining of finance provided some autonomous basis which if tax considerations are left endows some economic justification in the circumstances of this case and we so find.

[174] This is so not because Mr Forsyth said that the company needed finance but from the position of the officious bystander it was clear that the company in this business would need considerable finance available to it. A company in Pendragon’s position as regards headroom and gearing in particular would clearly need finance and on the finest terms available.

[175] It is permitted to arrange affairs to take advantage of the relevant tax provisions provided it is not abusive. Here we find that the financing was necessary but was done in a tax-efficient but non-abusive way. The ECJ has not prevented this. It specifically says that one may choose the more tax-efficient way of carrying out a transaction. We consider that this was what Pendragon did and we find this as a primary fact. The obtaining of finance provided a sufficient autonomous basis and economic justification.

[176] This case is distinguishable from *Part Service* where economic interdependence meant that the business splitting could not be regarded as genuine. Consequently, it was abusive even though it fulfilled the technical requirements of such treatment. It did not represent ‘normal commercial operations’ but was entered into ‘solely for the purpose of wrongfully obtaining advantages provided for by Community law.’

[177] We find that Pendragon was fully aware of the VAT position. It would be surprising if they were not. They had a significant in-house tax team and had taken advice from leading accountants and practitioners on the matter. The fact that they took advice does not make the transactions abusive.

[178] In reaching this conclusion we have borne in mind what Lord Neuberger said (at [29]) in *WHA*:

‘[29] Of course, in one sense at any rate, the purpose of the Scheme was to enable NIG’s liabilities under the MBIs to be performed and to be reinsured. So, it may be contended, tax avoidance cannot be said to be the sole, even arguably the main, purpose of the Scheme, viewed as a whole. However, as I see it, when considering the purpose of the Scheme for present purposes, one must primarily address the aspects of the Scheme which are artificial ...’

He also reminded us that the national court/ tribunal must ‘determine the real substance and significance of the transactions concerned.’ This plainly seems to envisage that a scheme may be abusive while having a genuine underlying commercial purpose. The transfer of the business as a going concern from outside the Pendragon group does not in our view amount to an abusive artificial transaction. Any lender would be likely to require security and where chattels were concerned would be highly likely to want ownership of the goods as well as a right to the income stream. Given the need for finance from a third party who would require such security we find this to be part of the normal commercial operations in these particular circumstances and not transactions ‘solely for the purpose of wrongfully obtaining advantages provided for by Community law.’

[179] We also note that His Lordship says that a scheme may be abusive while having a genuine underlying commercial purpose. We have already found that there is a genuine commercial purpose here. We do not consider that the use of the hybrid hire purchase agreements and/or the transfer of the business as a going concern are themselves abusive. They have a commercial purpose in connection with the financing--the sale and leaseback could not otherwise have been obtained. Pendragon on advice chose ‘... to structure their business so as to limit their tax liability’ (see *Halifax* para 73). This was not abusive.

[180] Mr Forsyth’s position, although similar to that of Mr Ross-Roberts [a witness in *WHA*] as regards his own personal views as to the subjective reasons for the transactions are not the basis on which we have reached our conclusions. We have adopted an objective approach and so Lord Neuberger’s warning does not apply.

[181] As regards the point that a taxpayer who has alternative courses open to him is entitled to choose that which minimises his liability to VAT Lord Neuberger does not consider that there was anything in that point in *WHA*. He said:

‘there may be cases where it is difficult to decide whether a particular arrangement is one which includes a step or steps which amount to an abuse or whether it is a course which is properly open to the taxpayer as a way of minimising his liability to VAT. However, this is not such a case.’

He considered the insertion of the company was an ingenious, but wholly artificial, step included purely to enable the input tax paid by *WHA* to be reclaimed.

[182] This is factually not the case here. Given that outside financiers would require security over both the vehicles and the income flow it is not an artificial step to carry out a transfer of

> the business as a going concern. Given that there was to be a hire of the vehicles drafting an HP contract in such a way as to give the taxpayer the choice of carrying out the normal commercial operation in a tax-efficient way cannot be said to be abusive in the current circumstances. It was not something inserted as a purely artificial step which could be disregarded. The cars were to be sold and leased back such that title to the goods, ie the cars and the income (ie the rentals), would be in a third-party bank. The vehicles had to be got back and the short-term finance repaid. In the circumstances of this case there was no artificial insertion of steps or the creation of a wholly artificial set of transactions rather the necessary financing was carried out in a tax-efficient way. This seems to be contemplated by the ECJ when discussing how a taxpayer can structure his or her business.
>
> **[183]** We note that the Court of Appeal rejected contentions that the abuse principle can only be invoked in relation to EU legislation and not domestic law and if different that the doctrine of abuse should not be invoked to put right an oversight in the drafting of national legislature. We do not consider those arguments further.
>
> **[184]** From the evidence which we have seen and heard we find as a fact considering matters objectively and not subjectively that in the particular circumstances of this case the essential aim of the transactions was to obtain finance and not to obtain a tax advantage. The real substance and significance of the transactions was the obtaining of finance. This puts it in Mr Pleming's non-abusive box and we so find."

65. The FTT finally considered how the scheme should be redefined. It presumably considered this matter in the alternative to its actual finding that the scheme did not involve any abuse of law and so there could be no question of the scheme being redefined for VAT purposes. The FTT said that the question of redefinition was very difficult to answer. It thought that the obvious re-characterisation was as a loan transaction but it thought that would be difficult to achieve given the involvement of a bank and the transfer of vehicles. The FTT concluded that if the transactions had to be re-characterised, they should be regarded as "short-term leasing transactions" but the FTT expected that the VAT treatment should be similar to that claimed by Pendragon.

66. In the event, the FTT allowed the taxpayers' appeals against HMRC's assessments. On 12th October 2009, Judge Bishopp granted permission to HMRC to appeal to the Upper Tribunal against the decision of the FTT.

The parties' submissions

67. The parties provided us with detailed written submissions and made oral submissions at a hearing which, in the end, lasted 6 days. It is not necessary for the purposes of our decision to set out all of the many points which were made in the course of those submissions. We will however attempt to identify the principal points which were made so that we can deal with those principal matters in our later discussion.

68. Both parties took us to the relevant legislation and to the many cases dealing with the principle of abuse of law. At the end of the argument, the parties were perhaps not very far apart as to the legal principles which we should apply. There may have been some difference of emphasis as to the second question in Halifax, as a result of the many decided cases using two different descriptions of the question, sometimes referring to "the essential aim" and sometimes referring to "the sole aim". We will refer to this matter again when we discuss our approach to the second question in Halifax. There was also a difference in approach as to the relevance of (and perhaps the admissibility of) evidence as to the objective aim of the transaction. Both parties agreed that the question required the examination of objective factors and not subjective motives. However, this basic rule was applied differently by the parties. HMRC said that the communications with KPMG went to objective matters which were highly relevant and did not deal with the subjective motives of KPMG or their clients. Pendragon submitted that the communications with KPMG were mostly, if not wholly, subjective and inadmissible. There was also disagreement about the evidence of Mr Forsyth, the finance director of Pendragon. Pendragon submitted that his evidence was highly relevant when describing the particular circumstances of Pendragon and its need for finance and its readiness to engage in the transactions in question. Conversely, HMRC submitted that much of Mr Forsyth's evidence related to his subjective

motivations and was to be left out of account. We will return to this question also when we explain our approach to the second question in Halifax.

HMRC's submissions

69. The first question raised by the decision in Halifax relates to whether the accrual of a tax advantage pursuant to the transactions in question would be contrary to the purpose of the legislative provisions. On that question, HMRC submitted that it was necessary to identify the tax advantage obtained as a result of the scheme, to identify the relevant parts of the legislation, to analyse the purpose of the particular provisions of that legislation and so to determine whether the tax advantage which has accrued is contrary to that purpose. HMRC then proceeded to identify the tax advantage which had accrued in this case. They submitted that Article 26a had two purposes, namely, to avoid double taxation and distortion of competition between taxable persons. HMRC cited the decisions of the ECJ in Jyske Finans [2006] STC 1744, Forvltnings AB Stenholm v Riksskatteverket [2004] STC 1041 and Auto Nikolovi [2011] STC 1294. It was submitted that the margin scheme for cars was an exception to the general principle of taxation on the full amount of consideration received for a supply. The exception was for the limited purpose of avoiding double taxation where a vehicle having previously left the supply chain, when sold to a consumer, was again acquired and sold on by a VAT registered dealer. The margin scheme was not intended as a means of avoiding tax altogether. It was not a measure to relieve businesses from VAT on the full value of ex-demonstrator cars sold to a consumer where VAT on the full value of those cars had never come into account at an earlier stage of a sale to a consumer. The common theme in relation to all second-hand goods to which the margin scheme applied was that they were goods which had gone into consumption and subsequently re-entered the supply chain. The FTT was simply wrong in paragraphs 19 and 168 of its decision when it said that the relevant provisions did not reveal a clear underlying policy. If HMRC were right as to the purpose of the margin scheme provisions, then the accrual of a tax advantage in this case was contrary to that purpose because there was no risk of doubt taxation in the present case and the scheme in question involved a distortion of competition

in that Pendragon would obtain an advantage over other car dealers selling ex-demonstrator cars.

70. The second question raised by Halifax is whether the essential aim of the transactions in question was to obtain a tax advantage. On this question, HMRC submitted that the relevant inquiry was as to the aim of the transactions and not the aim of the individuals who effected the transactions. The inquiry was a wholly objective one involving an assessment of objective factors as to the character of the transactions, whether they were artificial, whether the transactions involved "normal commercial operations", as to the links between the various participants, and as to the real substance and significance of the transactions. It was further submitted that the FTT appeared to think that it had to decide whether the aim of the transaction was the obtaining of a tax advantage or the obtaining of finance. This was said to be a false dichotomy. It was not necessary to go so far as to hold that the transactions had no commercial purpose or benefit. One had to focus on the elements of the transaction which were artificial. It was perfectly possible to have transactions which had the essential aim of obtaining a tax advantage but which had beneficial commercial consequences. This was illustrated by a number of the decided cases and, in particular, by Halifax itself.

71. HMRC then put forward five matters which were said to be objective factors which would enable us to determine the essential aim of the transactions in question. These were grouped under the headings: (1) the creation of the scheme by KPMG; (2) the timing of the scheme; (3) the features of the scheme which were inserted for VAT reasons; (4) the marketing and pricing of the scheme; and (5) the implementation of the scheme. These matters were elaborated in some detail and it is not necessary for the purposes of our decision to recount the many points which were made by HMRC. It will suffice to refer briefly to some of the more important matters which were relied upon.

72. In relation to the creation of the scheme by KPMG, HMRC pointed to the many references in the communications involving KPMG to the scheme being a VAT saving scheme, or similar references. In relation to the timing of the scheme, HMRC referred to the fact that the scheme was devised following the enactment

of earlier anti-avoidance legislation on 3rd July 1997 and the scheme was conceived as a new VAT avoidance scheme. In relation to the features of the scheme which were inserted for VAT reasons, HMRC pointed to the use of the Captive Leasing Companies. It was said that there was no commercial purpose for the use of Captive Leasing Companies apart from the desire to take advantage of the provisions which referred to leases being assigned to a Bank. Further, HMRC pointed to the provisions of the hybrid leases whereby title to the cars was not to pass pursuant to the option to purchase until after the end of the lease. Additionally, HMRC relied on the use of an off-shore Bank even though the money advanced by the Jersey bank was provided to it by its London associated company and as between these two entities it was the London associate which took all the risk and reward involved in the transaction. In relation to the marketing and pricing of the scheme, HMRC relied on the fact that KPMG asserted that it had a valuable intellectual property in the scheme and that the fees payable by Pendragon to KPMG were framed by reference to the intended VAT savings. In relation to the implementation of the scheme, HMRC referred to a large number of documents which, they said, showed that the scheme was essentially tax driven.

73. HMRC submitted that the FTT made a number of errors of law in relation to the second Halifax question and in particular: (1) failed to identify the nature of the tax advantage; (2) wrongly dismissed the evidence of KPMG’s involvement; (3) regarded the existence of an underlying commercial benefit as precluding a finding of abuse; and (4) failed to analyse the features of the transactions relied upon by HMRC and, in particular, the use of Captive Leasing Companies, the use of an off shore bank and the terms of the hybrid leases.

74. HMRC made detailed submissions on the redefinition which would be appropriate following a finding that the scheme involved an abuse of law. It was said that redefinition was mandatory and was not a separate hurdle for HMRC to surmount. The particular redefinition contended for was that set out in HMRC’s decision letter of 22nd October 2001. That entailed a redefinition so that the sales of demonstrator cars to consumers were effected by the Dealership Companies and so that Steps 1 to 5 had not taken place. On that basis, the Dealership Companies

should not have accounted for output VAT on selling the cars to the Captive Leasing Companies (Step 1), should not have deducted any VAT on the lease transactions (Steps 2 and 3), should have accounted for output VAT on the full value of the sales they made as agent of PDS (Step 5) and should have accounted for output VAT on any private use of the "stock in trade" cars on which input VAT had been recovered. Further, the Captive Leasing Companies should not have deducted any VAT on the purchase of the cars from the Dealership Companies (Step 1) and should not have charged any VAT on the lease transactions (Step 2). As to Pendragon Demonstrator Sales Ltd (which took the part of Captive Co 5), it should not have accounted for any VAT on the sales at Step 5.

75. HMRC submitted that the abuse in question was that the Dealership Companies sold the cars to consumers without accounting for VAT on the total sale consideration for such sales. Accordingly, the redefinition which was appropriate to re-establish the situation that would have prevailed in the absence of the transactions constituting the abuse (see Halifax at paragraph 94) was simply to provide for a cancellation of all of the steps between the initial sale by the Dealership Companies to the Captive Leasing Companies and the final sale to consumers. The Dealership Companies simply use the cars as demonstrators and then sell them to consumers. The arrangements with Soc Gen London or Soc Gen Jersey simply involved a loan with no VAT consequences. HMRC accepted that there might be other possible redefinitions. Any redefinition should be one which corrects the abuse but does not go further and does not prejudice persons who were not a party to the scheme (see WHA at paragraph 57).

Pendragon's submissions

76. In relation to the first question, raised by the decision in Halifax, as to whether the accrual of a tax advantage pursuant to the transactions in question would be contrary to the purpose of the legislative provisions, Pendragon accepted that the policy behind Article 26a of the Sixth Directive *included* the purpose of preventing double taxation and the distortion of competition. However, Pendragon went on to submit that HMRC had failed to demonstrate that the policy of the

legislation was confined to those purposes. Rather, Article 26a created a set of *ad hoc* arrangements put in place as an interim measure to address the highly fragmented, unharmonised treatment of second-hand goods in the Community. There was a singular lack of agreement between Member States as to its nature and scope. The case put forward for HMRC was grossly over-simplified and one-sided. The United Kingdom was entitled to enact the relevant versions of the statutory instruments in question which treated used goods which had been through the TOGC/de-supply stages (and so not taxed) as fitting in with the margin scheme left optional by the European Directives. In the present case, the key triggers in the scheme (the de-supply provisions in play at Stages 3 and 4) did not derive from Article 26a but predated it and were not implementations of it. It was only the interaction between those provisions and the United Kingdom's subsequent detailed implementation of the margin scheme that brought the two together. There could be no suggestion that such discretionary implementation as it stood at the time of the transactions in question was not within the powers of the United Kingdom or was not fully compliant with the Directives. Equally, it was not possible to suggest that those who operated the provisions, as they stood, were in breach of EU VAT law. HMRC was unable to identify any class of car dealer who could legitimately use the combination of provisions in question. HMRC's suggestion that there had to be a departure from the supply chain and a re-entry did not explain the absence of such a requirement to this day in the statutory instruments nor was it consistent with the de-supply/TOGC gateways continuing to be available as part of the machinery of the margin scheme. Nor does that suggestion explain the application of the scheme to antiques and new works of art. Finally, there was nothing in HMRC's point about possible distortion of competition. HMRC led no evidence on this point and made no headway in cross-examining Pendragon's witnesses. It was open to anyone in the car industry to do what Pendragon had done.

77. In relation to the second question in Halifax, Pendragon submitted that the FTT had held as a matter of primary fact that the essential aim of the transactions was to obtain finance. That finding involved a multi-factorial assessment based on further findings of primary fact. Those primary facts related to the transactions themselves and to their commercial context. The context included: (1) the

importance to motor dealerships of obtaining finance; (2) the need of Pendragon to obtain further sources of funding; (3) the hybrid character of the leases was not unusual or uncommercial; (4) the option to purchase in the leases was not unusual or uncommercial; (5) the benefit of a £20 million facility for 45 days or so was significant; (6) the essential elements of finance and security were the same as with a normal sale and leaseback transaction or finance from a car manufacturer's finance arm; and (7) the introduction of Soc Gen Jersey fitted well with Pendragon's desire to do business with more bankers to serve its need for finance. The appeal in this case is limited to an appeal on law. An appellate court should not interfere with a multi-factorial value judgment, particularly one made by a specialist tribunal. Reliance was placed on Proctor & Gamble UK v Revenue and Customs Comrs [2009] STC 1990. The FTT was right to regard the evidence of the involvement of KPMG as subjective and not objective. The FTT was right in its reaction to the terms of the hybrid lease and the off shore bank. In any case, the success of the scheme did not depend upon the particular terms of the hybrid lease.

78. Pendragon developed these submissions with detailed references to the evidence before the FTT. It submitted that the FTT had evidence from two experts who could speak as to the objective commerciality and normality of each stage of the transactions. Each stage had a commercial purpose and was comparable to the building blocks in other cases of securitisation or structured debt funding. It was submitted that HMRC had not really challenged this expert evidence that the transactions involved normal commercial operations. At the relevant time, Pendragon had a critical need for a new source of finance. Pendragon would have continued to implement the scheme on a rolling basis but for the fact that HMRC had wrongly withheld input tax reclaimed by Pendragon on cars which were the subject of hybrid leases even when these leases were not part of the transactions now in question. Mr Forsyth, the finance director of Pendragon, gave evidence to the effect that the main objective of the transactions was the obtaining of finance, that tax efficiency was not the main factor and tax planning was subservient to the issue of funding for Pendragon. The FTT rightly regarded much of the documentation involving KPMG as irrelevant. Pendragon accepted that a transaction could involve an abuse of law even where the transaction had an

underlying commercial purpose. The FTT had not made the mistake of thinking otherwise. As to the specific matters relied upon by HMRC: (1) the creation of the scheme by KPMG was irrelevant and/or inadmissible subjective material; (2) the timing of the scheme was immaterial and was in any event some three years after the amendments of 3rd July 1997 referred to by HMRC; (3) as to the alleged artificial steps in the scheme, HMRC ignored the expert evidence as to the normality and commerciality of these steps; further, Pendragon had used captive finance companies since the mid-1980s; the specific terms of the hybrid leases were not necessary to obtain the tax advantage; it was true that a supply of goods by the Captive Leasing Companies to the Dealerships would have given rise to an output tax liability on the full value of the goods but that would have been matched by a corresponding right to reclaim input tax in the same amount so that the result would have been VAT and cash neutral; as to the use of an off shore bank, the evidence was that this was for proper commercial reasons but, in any event, the de-supply by reason of Article 5(4) of the 1995 Order did not depend upon the bank being off shore; (4) the fact that KPMG had intellectual property in the scheme and the further fact that its fee was to be determined by reference to the amount of VAT saved was commonplace and not indicative of abuse of law; (5) the scheme was intended to be tax efficient and hence it was appropriate for Pendragon to take tax advice; it could not be said that every set of arrangements which were designed to be tax efficient involved an abuse of law; the short term nature of the finance provided was normal and commercially rational; on a detailed examination of the evidence, there was nothing in the suggestions that the detailed implementation of the scheme helped HMRC's case.

79. On the question of redefinition, Pendragon referred to the findings of the FTT. AS to the particular form of redefinition contended for by HMRC, Pendragon made three points. The first was that the suggested redefinition did not provide Soc Gen London or Jersey with security for repayment of the monies made available. Pendragon submitted that that fact alone was fatal to the suggested redefinition. Secondly, Pendragon submitted that there was no evidence that it could have borrowed the sums involved without providing security. Thirdly, if security had been required, there was no evidence as to Pendragon's ability to provide that security. Finally, Pendragon explained that the point as to the correct VAT

The first question in Halifax

80. We will now consider the first question raised by the decision in Halifax which is whether the accrual of a tax advantage pursuant to the transactions in question would be contrary to the purpose of the legislative provisions. There is no real doubt as to the tax advantage which would accrue in this case if the transactions had effect in accordance with their terms. We have set out above the steps in the scheme and the VAT treatment of those steps, considered individually. The scheme enabled the Pendragon companies to sell demonstrator cars in circumstances where it did not charge VAT on the full amount of the consideration for the supply of the demonstrator cars to consumers and so that VAT was charged on the much smaller sum which represented the profit margin on such sale. This result would apply where there had not been an earlier sale to a consumer where VAT on the full sale price had been charged and where there was no risk of double taxation.

81. Article 26a of the Sixth Directive was introduced by Council Directive 94/5/EC. The second, third and fifth recitals in the preamble to that Council Directive disclose that the policy behind the new Article 26a was the avoidance of double taxation and the distortion of competition. These recitals were treated as stating the policy of Article 26a in Forvaltnings AB Stenholmen v Riksskatteverket [2004] STC 1041 (see the Opinion of the Advocate General at paragraphs 34, 35 and 60 – 61 and the judgment of the Court at paragraphs 8 and 25) and Jyske Finans A/S v Skatteministeriert [2006] STC 1744 (see the Opinion of the Advocate General at paragraphs 60 – 67 and the judgment of the Court at paragraphs 32 - 41).

82. The same approach to the purpose of the relevant provisions was adopted in Direktsia – Varna v Auto Nikolovi OOD [2011] STC 1294. This case involved the provisions of the VAT Directive, in particular Article 314, rather than Article 26a

of the Sixth Directive. Recital 51 of the VAT Directive identified the same policy for the provisions dealing with second-hand goods as was identified in the recitals to Council Directive 94/5/EC, namely, the prevention of double taxation and the distortion of competition. The provisions dealing with second-hand goods are contained in Title XII (Articles 311 to 343) of the VAT Directive. This case involved goods which were second-hand goods but which had been imported into the EU by the trader himself and subject to the normal VAT rules relating to deduction of input tax (i.e. there was no trapped VAT). The Court decided that the provisions of the VAT Directive (principally Article 314) were premised on granting margin scheme treatment to goods which had been supplied to a person in the Community by one of the persons listed in Article 314 (a) and (d). It decided that importation by the second-hand goods dealer himself did not qualify for the margin scheme even though the definition of taxable dealer included taxable person who "imports … second-hand goods". The purpose of the provision as being to avoid double taxation was central to the reasoning of the Court, as appears from the following passages:

> "46. Next, it should be noted that the arrangements for the taxation of the profit margin made by the taxable dealer on the supply of second-hand goods, works of art, collectors' items and antiques constitute a special arrangement for VAT – derogating from the general scheme of Directive 2006/112 – which, like the other special arrangements provided for in that directive, must be applied only to the extent necessary to achieve their objective (see Jyske Finans, paragraph 35).
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> 47. As is apparent from recital 51 in the preamble to Directive 2006/112, the objective of the margin scheme is to avoid double taxation and distortions of competition between taxable persons in the area of second-hand goods (see, to that effect, Case C-320/02 Stenholmen [2004] ECR I-3509, paragraph 25; and Jyske Finans, paragraphs 37 and 41).
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> 48. To tax, on its overall price, the supply by a taxable dealer of second-hand goods, where the price at which that dealer purchased those goods includes a sum of input VAT which was paid by a person falling within one of the categories identified in Article 314(a) to (d) of that directive and which neither that person nor the taxable dealer was able to deduct, would lead to such double taxation (see, to that effect, Stenholmen, paragraph 25 and Jyske Finans, paragraph 38).

> 49. However, where a taxable person resells, for the purposes of his taxed transactions, goods, such as those at issue in the main proceedings, which he imported himself, subject to the normal VAT scheme, into the Member State in which he carries out those transactions, and where he is therefore entitled, under Article 168(d) of Directive 2006/112, to deduct the VAT payable or paid for those imported goods, there is, as the Commission points out, no likelihood of double taxation which could justify the application of the derogating margin scheme.
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> 50. In that regard, it should be noted that the Explanatory Memorandum to the Proposal, presented by the Commission to the Council of the European Union on 11 January 1989, for a Directive supplementing the common system of value added tax and amending Articles 32 and 28 of Directive 77/388/EEC – special arrangements for second-hand goods, works of art, antiques and collector's items (OJ 1989 C 76, p. 10), expressly states that, where goods have been imported by the taxable dealer subject to the normal VAT scheme at the time of their importation, the existence of the right to deduct precludes the likelihood of double taxation, so that there is no justification for excluding the application of that normal scheme in favour of the special margin scheme".

83. The case is clear authority for the proposition that the mere fact that goods are second-hand goods (as defined) does not entail that the margin scheme should be applied to them, as appears from paragraph 52 of the judgment of the Court:

> "It follows that, irrespective of whether the goods at issue in the main proceedings are covered, or not, by the definition of 'second-hand goods', in Article 311(1)(1) of Directive 2006/112, the margin scheme is, in any event, not applicable to supplies of goods such as those concerned by the present case, which the taxable dealer himself imported into the European Union under the normal VAT scheme".

84. The recitals to the Directive which introduced Article 26a, and the approach of the ECJ to the identification of the policy behind the margin scheme provisions for the supply of second-hand goods, are consistent in stating that the policy behind the provisions is the avoidance of double taxation and of distortion of competition. No other purpose for the provisions has been identified in those recitals or in any decided case to which our attention was drawn. Indeed, the argument for Pendragon does not attempt to identify any further purpose behind the provisions.

That argument involves an assertion that there are or may be additional purposes but yet Pendragon does not seek to identify them. Pendragon's argument is that the provisions were the result of a compromise where it is not possible to discern any clear policy behind the approach adopted so that it becomes impossible to apply the relevant principle of law which requires one to ask whether a particular result is contrary to the purpose of the provision. We are not persuaded by that approach. In our judgment, we can rely upon the recitals to the relevant Directive and the consistent statements in the decided cases to identify the relevant purpose and this should enable us to answer the first question posed by Halifax rather than to conclude that the exercise cannot be attempted.

85. So far we have considered the conclusion of the FTT that Article 26a of the Sixth Directive did not disclose a clear underlying policy. At the hearing before us, it seemed that Pendragon's submissions went beyond supporting the reasoning of the FTT on this question. We therefore need to deal with these further submissions.

86. It is accepted that the principle of abuse of law which undoubtedly applies to the legal rules of the Community also applies to national legislation which implements, for example, a European Directive. It also appears to be accepted that the United Kingdom legislation which provides for a margin scheme for second-hand goods etc is compliant with the European Directives as to VAT. As the Explanatory Note to SI 1995/1269 makes clear, the amendments to Article 8 of the 1992 Order which were made in 1995 (and which were in force at the time of the transactions in this case) were made to give effect to Council Directive 94/5/EC. Accordingly, the purpose of the United Kingdom margin scheme for second-hand goods etc was the same as the purpose of Article 26a.

87. The accrual of the tax advantage claimed by Pendragon in the present case would, in our judgment, be contrary to the purpose of Article 26a (and as implemented by the 1992 Order as amended). The accrual of the tax advantage is not needed to prevent double taxation. Further, the accrual of the tax advantage would tend to distort competition. It seems obvious to us that if Pendragon were able to benefit from the tax advantage which it claims that would tend to distort competition by

placing Pendragon in a position where it reduced the amount of VAT which it had to charge and to account for, as compared with other car dealers who charged and accounted for VAT on the full amount of the consideration for the sale of a demonstrator car. It does not seem to us that any specific evidence of this tendency is needed. The position is obvious. In any case, a witness called by Pendragon agreed that if Pendragon obtained a tax advantage as a result of the scheme, then it would give Pendragon a competitive advantage as compared with a dealer who was not implementing such a scheme; we refer to this evidence at paragraph 100 below. Further, it is no answer to suggest that other car dealers could do as Pendragon had sought to do and operate a scheme which would allow the car dealer to benefit from the margin scheme in relation to such sales.

88. This conclusion does not mean that the national provisions were *ultra vires*. It is merely that the application of the national provisions in the circumstances of this case is abusive. The national provisions are being used for the essential aim of obtaining a tax advantage which is contrary to the purpose of the European and (compatible) national provisions.

89. We do not accept Pendragon's submission that a finding for HMRC would produce the result that no person could ever properly rely on Article 8(2)(c) and/or (d) of the 1992 Order. Article 8(2)(c) applies in the case of a trader who supplied goods to a consumer pursuant to a hire purchase agreement and subsequently assigned the benefit of the agreement to a bank or a financial institution which then took possession of the goods and made a further sale. Article 8(2)(d) allows margin scheme treatment, for example, where a dealer in second-hand cars transferred all or part of his business to a purchaser trading or intending to trade as a second-hand car dealer and where the transferor bought the relevant car from a member of the public.

90. It follows that we do not agree with the conclusion of the FTT on this question. We consider that the FTT's answer to this question involved an error of law on its part.

The second question in <u>Halifax</u>

91. We can now move to consider the second question in Halifax. The decided cases contain different formulations of this question and refer to the "essential aim" but some also refer to "the sole aim" of the transaction. In our judgment, the question involves the court or tribunal determining what is "the essential aim" of the transaction in question. This is the formulation which is used in Halifax itself and which is repeated in the later cases, without any suggestion that it is not the appropriate test. When the decided cases refer to "the sole aim", we do not regard them as substituting a new test for the test of "essential aim". It is clearly established that a transaction can give rise to an abuse of law even where the transaction has real commercial consequences. Normally, those consequences will be intended, although perhaps only as a collateral consequence. It would not be right to hold that because the taxpayer intended to benefit from those commercial consequences, he did not have the "sole aim" of obtaining the relevant tax advantage. It may be that this conclusion can also be reached by focussing on the word "aim" rather than the words "essential" or "sole". We consider that the decided cases are consistent with the view that the "aim" of a transaction may be something different from its collateral consequences, even where those consequences are foreseen and even desired. Matters which are collateral in that way are not part of the "aim" of the transaction.

92. The decided cases make it clear that the essential aim of the transaction is to be assessed by considering objective factors relating to the transaction, by asking what is the real substance and significance of the transaction, by having regard to commercial reality, by asking whether the transaction involves a normal commercial operation, by taking account of any artificiality in the scheme or in its steps, by considering any links between the participants in the transaction and by not being distracted by the fact that, in addition to the tax advantage apparently obtained, the transaction produces collateral commercial benefits.

93. In our judgment, the correct way to go about that task in this case is to begin with a consideration of the terms of the transactions and both their tax consequences and their commercial consequences. Speaking generally, expert evidence could assist in considering how normal or how commercial the scheme or a particular

step in the scheme is. Thus, we will need to consider any expert evidence directed to those matters. We also consider that the particular circumstances of Pendragon and its attitude to obtaining finance will potentially be relevant when considering the essential aim of the transactions. However, evidence from the finance director of Pendragon which attempts to answer the question as to why Pendragon entered into the transactions would appear to be on the wrong side of the line as to admissibility, as it would appear to deal with the subjective motives of Pendragon and not the objective character of the transactions. In addition, evidence of that kind, even if admissible, would be likely to be self serving. In any case where the transaction involved collateral commercial benefits, the temptation for the taxpayer to emphasise those benefits as the essential aim of the transaction and to play down the tax advantages as merely a permissible choice as to tax efficiency would be considerable. In a case where a scheme has been devised with the assistance of tax advisers (such as KPMG in this case) care will have to be taken as to the relevance of evidence as to the nature of that assistance. If the evidence shows what the particular taxpayer's motives were, then that evidence will be subjective material which does not help to determine the objective essential aim of the transactions. Further, care will have to be taken to distinguish between assistance given to make a transaction tax efficient in a way which involves no abuse of law and assistance given to obtain a tax advantage by contrived steps which are not normal and commercial. In the same way as expert evidence may help to answer the question whether the scheme or steps in it were normal and commercial, we consider that evidence of the communications with the tax adviser may also help with the answer to that question.

94. We have already described in detail the documents which were entered into to give effect to the scheme and the VAT treatment of the steps in the scheme, absent any possible effect of the principles as to abuse of law.

95. We consider that it is important to assess both the tax and the commercial consequences of the transactions. The transactions concerned motor vehicles with a value of approximately £20 million. The rate of VAT at the relevant times was 17.5%. If the motor vehicles were sold in circumstances where VAT at 17.5% was chargeable on the total consideration for the supply of the vehicles, the resulting

VAT would be £3.5 million. If the margin scheme applied to the sale of £20 million worth of vehicles, then the amount of VAT chargeable would depend on the profit margin on the vehicles.

96. Some indication of the difference in the amount of VAT chargeable is shown by the three sales invoices which were in evidence, relating to later sales to consumers of some of the vehicles which were involved in these transactions. An invoice dated 17th January 2001 refers to a car being sold for £18,500 together with accessories being sold for £107.11 with the total bearing VAT of £18.7x (the last figure is cut off in the photocopying). VAT at 17.5% on £107.11 is £18.74 and this suggests that no VAT was charged on any part of the sale price of £18,500. The same position is revealed by an invoice dated 24th January 2001 referring to a car being sold for £21,213.30 together with accessories for £818.26 and with VAT of £143.11. This is the amount of VAT at 17.5% on the accessories so that no VAT was charged on any part of the sale price of £21,213.30. The same position applied in the case of the third invoice which was dated 31st January 2001. The car was sold for £19,361.9x (the last figure is again cut off) with accessories of £542.98 and VAT of £95.0x. VAT at 17.5% on £542.98 is £95.02. Thus the implementation of the scheme might have been expected to produce a tax advantage worth all, or nearly all, of £3.5 million to Pendragon. We recognise that these three invoices refer to sales after Pendragon entered into the first transactions in November 2000 although they are before the second transactions in February 2001. The tax advantage of £3.5 million to which we have referred assumes that the value of the relevant vehicles was £20 million exclusive of VAT. If those vehicles had a value of £20 million inclusive of VAT, then the tax advantage would be £2.978 million.

97. It may also be relevant to refer to the report dated 25th October 2000 from Mr Forsyth, Pendragon's finance director, to his fellow directors where he stated that the first transactions would provide the opportunity for Pendragon to make an additional £3 million of profit as a result of the first transactions involving £20 million worth of vehicles. Similarly, it may be relevant to refer to the letter dated 8th November 2000 from KPMG to Pendragon where KPMG's assessment was if the scheme was implemented in relation to cars worth £20 million the tax

advantage would be “approximately £3.5 million”. There is room for argument as to whether an objective assessment (in advance of the transaction) of the likely tax advantage would have been the same as the assessment of Mr Forsyth or that of KPMG. However, it does not seem to us that in the end it matters very much whether the tax advantage was worth £3 million or nearer to £3.5 million.

98. The terms on which £20 million was to be made available to Pendragon pursuant to a facility which was to exist between 15th November 2000 and 29th December 2000 and again between 1st February 2001 and 15th March 2001 were set out in a term sheet provided by Soc Gen London to Pendragon plc on 31st October 2000. In relation to the first facility, Pendragon was to pay an arrangement fee of £100,000 plus interest at 6.75% (i.e. 0.75% above 1 month LIBOR); in addition, Pendragon was liable to pay earn out fees of £125,000 and £75,000, but so that the earn out fees were contingent on Pendragon receiving from HMRC satisfactory confirmation as to the VAT treatment of the steps in the scheme. In relation to the second facility, the terms were an arrangement fee of £80,000 plus interest as before plus a contingent earn out fee of £125,000. Soc Gen calculated the return which it would receive as being a return of 73.33% if one left out of account the earn out fees and 183.17% if one took into account the earn out fees.

99. The FTT had evidence from Mr de Rousset-Hall who was called by Pendragon. He had been the managing director of Ford Credit which he described as the captive finance house which covered the lending activities of Ford and others. He described the workings of the UK motor finance industry, the UK retail motor industry, matters specific to the motor industry in 1999 to 2002 and matters specific to Pendragon. He commented on the transactions in this case. There was no real challenge to this evidence. It is not necessary to set out the detail of his evidence. From that evidence we take the principal points to be: (1) the United Kingdom motor finance industry is large, complex and highly competitive; (2) lending to dealers often involves the dealer providing security for the loan and the security arrangements are often complex and sophisticated; (3) dealers operate a cash intensive business which requires dealers to have available funding facilities; (4) the industry was cyclical and at the time of the transactions in this case (i.e. pre 1st September 2001) involved peaks in new car sales in August so that it was

important to have good cash management to cover these peaks; (5) the period from 1999 to 2002 was a particularly difficult period for the cash flows of dealers; (6) in that period UK banks and other lenders were particularly nervous about the car industry; (7) there were established arrangements whereby manufacturers provided finance to dealers but these arrangements involved disadvantages from the dealer's point of view; (8) there were parallels between the typical financing arrangement provided by manufacturers to dealers and the arrangements entered into in this case. This evidence forms relevant background when considering what was, objectively considered, the essential aim of the transactions in this case.

100. When Mr de Rousset-Hall was cross-examined, he agreed that for a dealer to make additional profit of £3 million on the sale of cars worth some £20 million, by reason of the implementation of the scheme in question, would place that dealer at a competitive advantage, as compared with a dealer who was not implementing such a scheme. As we have already commented, we would in any event have regarded that matter as obvious.

101. The FTT had evidence from Mr Ingram of Clifford Chance LLP. Mr Ingram is a solicitor experienced in dealing with what he described as securitisation transactions and structured financing. We do not think that his evidence about securitisation is of particular relevance in this case. As to structured financing, for present purposes it is sufficient to focus on financing where repayment of the loans is secured against assets made available as security to the lender. Mr Ingram's evidence was not the subject of any real challenge. It is not necessary to set out the detail of his evidence. Mr Ingram explained that sale and leaseback transactions are a common financing tool in structured debt finance with application to a variety of asset classes. He also referred to the steps in the transactions in this case and indicated the nature of the security obtained by the lender. He then drew analogies with securitisation and other structured debt financings. He referred to the ways in which the lender had security for repayment of the loan and to the extent to which the lender relied on the credit worthiness of the those on the borrower's side of the transaction. He was cross-examined about the reasons for the involvement of Soc Gen Jersey and he did not resist the suggestion that none of the normal commercial reasons (apart from tax

considerations) which might lead to the involvement of an off shore bank appeared to apply on the facts of this case.

102. The FTT had evidence from Mr Forsyth, the finance director of Pendragon. There was a lengthy witness statement from Mr Forsyth, supported by a selection of documents on which he relied. He was also examined in chief and was cross-examined. Some of his evidence concerned factual matters as to the background against which the transactions were entered into. We consider that such evidence was admissible. However, much of his evidence sought to explain what he said had been his thinking, his intentions and his wishes in relation to the transactions. As a matter of principle, the question as to the essential aim and intent of the transactions is different from the aim of the participants and, more particularly, does not involve an assessement of the state of mind of the participants. Furthermore, in a case where the transactions in question appear to secure a tax advantage and also to have real commercial consequences, and the question is whether the essential aim of the transaction was to secure the tax advantage, if evidence as to subjective motive were admissible, it would always be open to a participant in the transaction to present evidence in a way which emphasised that he was principally motivated by the commercial consequences of the transactions. Such evidence would therefore be likely to be self serving but nonetheless might appear plausible. In our view, much of the evidence of Mr Forsyth was cast in a way which focussed on what he said were his motives and his reasons. Cast in that way, the evidence went directly to inadmissible subjective matters. On the other hand, we can see that if the evidence had been drafted in a different way, Mr Forsyth could have drawn on his own involvement in the transactions to identify the considerations which would have influenced reasonable commercial people, acting in the circumstances in which Pendragon actually found itself at the relevant time. That would have been material to the objective assessment which was required to determine the essential aim of the transaction.

103. In the event, the FTT received all of Mr Forsyth's evidence. It seems to us that this placed the FTT in a most difficult position. It had to guard against being directly influenced by the considerable amount of evidence given by Mr Forsyth as to subjective matters but, perhaps, it could try to distil from that evidence the

different evidence which could have been given as to the type of considerations which, objectively assessed, would have been in the minds of reasonable commercial people in the actual circumstances. The decision of the FTT contains passages (notably at paragraphs 58 -59, 172 – 174 and 180) where they state that they would leave out of account Mr Forsyth's subjective views and look instead at what an outsider, knowing the relevant facts, would have objectively thought. However, the difficulty of the exercise, given the unhelpful way in which the evidence was presented, should not be under-estimated.

104. We have considered the evidence which Mr Forsyth gave. As that evidence was lengthy, we will not set out a summary of it in this decision but we will refer to the main topics which were addressed. He described: (1) the background relating to the position of car manufacturers and car dealers and the relationship between them; (2) the position of the Pendragon group of companies; (3) economic and financing issues in the car industry and in the Pendragon group; (4) typical financing arrangements in the car industry; (5) his own approach to obtaining funding for Pendragon; (6) the four principles which he applied as to funding; (7) examples of the application of his four principles; and (8) his detailed reasons for entering into the transactions in question.

105. In the course of his evidence, Mr Forsyth described the credit facilities available to Pendragon at the time of the relevant transactions. He provided detailed information, as at November 2000, of all the providers of facilities and the rates of interest chargeable, which varied from LIBOR plus 0.45% to LIBOR plus 1.75%, or possibly in one case to as much as LIBOR plus 2.0%. That evidence also distinguished between committed and uncommitted facilities and identified the extent to which the facilities had been taken up. Mr Forsyth explained in his evidence his assessment of the amount of headroom in the committed facilities to deal with cash flow pressures which might present themselves.

106. Alongside Mr Forsyth's comments on the extent of the headroom represented by the committed facilities we also note that by 16th October 2000 (as recorded in an internal Soc Gen email of that date) Pendragon had told Soc Gen that the funds being advanced to Pendragon were by way of a temporary reduction of current

borrowings without cancellation of pre-existing credit facilities. Further, by 16th November 2000 (as recorded in an internal Soc Gen email of that date), Pendragon had told Soc Gen that as at 30th September 2000, Pendragon had £70 million of undrawn committed facilities. In addition, on 17th October 2000, prior to Pendragon entering into the first transaction, Pendragon plc was required by Soc Gen London to confirm that it was unaware of any circumstances which could lead to the withdrawal of committed funding facilities which Pendragon plc had in place and it was required to represent that the given level of these committed facilities and forecast cashflows would be in excess of £20 million up to and including 29th December 2000.

107. Before the FTT, HMRC relied upon certain correspondence between KPMG and Pendragon. It is clear from this correspondence that KPMG developed the scheme with the aim of securing a VAT advantage. KPMG claimed the intellectual property in the scheme believing it to have a considerable value. In its letter to Pendragon of 8th November 2000, when describing the operation of the scheme, KPMG referred only to the tax advantages to be gained. On the other hand, in its letter to Pendragon of 16th November 2000, under the heading "Commercial rationale", KPMG stated that it was "important to recognise that there was a funding benefit to the transaction in addition to the indirect tax advantage". The FTT put some, if not all, of the evidence about the communications between Pendragon and KPMG on one side on the ground that these communications set out "the subjective view of what KPMG thought it was selling" and were therefore not relevant to an objective assessment of the essential aim of the transactions.

108. In our judgment, some of the contents of the communications between Pendragon and KPMG are admissible and relevant to the question which needs to be decided as to essential aim. We consider that it is an objective characteristic of the scheme which was implemented that it had been devised by tax advisers to obtain a tax advantage, without regard to any other commercial benefits which might result. However, that characteristic is not of itself conclusive. It is legally possible for a scheme of such a kind to be implemented in a range of different circumstances and so that, in some circumstances, the essential aim of the

particular transaction would not be to obtain the tax advantage. One would expect a tax adviser to concentrate on the tax treatment of the arrangements and to leave it to its client to assess the commercial circumstances in which the arrangements might be implemented. Furthermore, the mere fact that a taxpayer takes tax advice as to how to structure an intended transaction does not of itself establish that the essential aim of the transaction is to obtain a tax advantage. The decided cases make it clear that a taxpayer can engage in tax planning and select a permissible method of proceeding which is more tax efficient than alternative methods. Further, we do not consider that the opinions expressed by KPMG as to the likely success of the scheme and whether it was an "aggressive" scheme and whether HMRC would be likely to challenge it are admissible when objectively assessing the essential aim of the transaction. Further, even if such opinions were admissible, we would not regard them as of any real help in assessing the essential aim of the transaction.

109. We can now try to draw the strands together and consider whether, objectively assessed, the essential aim of the transactions was to obtain a tax advantage. We have already explained what we understand is involved in the concept of "essential aim". It was undoubtedly the case that the transactions, absent any abuse of law, would have secured a substantial tax advantage for Pendragon. It is also the case that the transactions did have real commercial consequences and that Pendragon obtained short term funding as a result. The decided cases make it clear that the fact that a transaction carries with it collateral commercial benefits does not preclude a finding that the essential aim of the transaction was to obtain a tax advantage. In the present case, if one contrasts the scale of the tax advantage and the nature of the other commercial consequences, it seems to us *prima facie* that the obtaining of the tax advantage was overwhelmingly the real reason why Pendragon entered into the transactions. Putting it another way, *prima facie* there is an overwhelming case for saying that, objectively assessed, the essential aim of the transaction was to gain a considerable tax advantage, even though that involved entering into a transaction which provided short term finance to Pendragon on relatively expensive terms and at a time when it had undrawn committed facilities for sums comfortably above the amount advanced.

110. So far we have only described the *prima facie* result. It remains to check that result against the admissible evidence from Mr de Rousset-Hall, Mr Ingram and Mr Forsyth. The evidence of the first two witnesses was necessarily general and related to the general commercial background. Pendragon submitted that this evidence showed that the structure of the transactions in this case was normal and commercial. We can readily accept the evidence that financing arrangements can be elaborate, complex and sophisticated and even more so than the structure used in the present case. Equally, we are sure that it would be possible to obtain secured finance from a lender with a less elaborate structure. It is also right that from the lender's point of view, the lender was providing finance and obtaining security for repayment and the structure used was legally effective to provide such security.

111. We should also consider at this point the arguments as to whether certain steps in the transactions were artificial. The use of the Captive Leasing Companies was wholly artificial and served no commercial purpose. The provisions of clause 8(c) of the hybrid lease do appear uncommercial. As against that, those provisions were not necessary to the efficacy of the scheme. The assignment by Soc Gen Jersey to Pendragon being treated as a TOGC appears somewhat artificial but whether the assignment should be so treated turns on the technical legal meaning of a TOGC and the parties accept that the assignment was a TOGC. The involvement of an off shore bank appears to have served no independent commercial purpose. The parties did not agree whether the fact that the bank was off shore was essential to the operation of the scheme. Pendragon submitted that this was not essential as that fact was not relevant to the operation of the de-supply provisions in article 5(4) of the 1995 Order. HMRC submitted that the use of an off shore bank was essential otherwise the assignment to the bank would be a TOGC and then the combined operation of Article 8(2)(c) and (d) (on which the scheme depended) would not work. Alternatively, HMRC submitted that the use of an off shore bank, even if not essential, was "belt and braces" to avoid the argument which would otherwise have arisen as to whether the assignment to the bank was a TOGC. We consider that the use of an offshore bank in this case (moreover, a bank whose UK parent conducted the negotiations for the loan and

provided all the funds) was artificial and driven by the perceived need to achieve the desired VAT result and no other reason.

112. As to the evidence of Mr Forsyth, we have already commented on the extent to which that evidence was admissible and, in relation to the large part of it which was inadmissible, whether Mr Forsyth's evidence can easily or safely be used in order to help with an assessment of the objective matters which would be considered by a reasonable observer. Mr Forsyth explained the desirability, objectively assessed, of Pendragon having sources of finance, even short term finance, and commercial relationships with a number of potential lenders. He also described the particular borrowing requirements of Pendragon at the time when the transactions were entered into.

113. Having reflected on the evidence of the three witnesses, in our judgment, that evidence does not come anywhere near displacing the overwhelming case for saying that the essential aim of the transactions in this case was to obtain a tax advantage.

114. The FTT decided otherwise. We are not legally able to reverse the decision of the FTT and give effect to our own conclusion unless the FTT committed an error of law in reaching its conclusion. We consider that the decision of the FTT on this question was wrong. We also consider that the issue as to the essential aim of the transaction was not an issue as to the primary facts but one which was, at least in part, an issue of law. Accordingly, we consider the FTT's decision was wrong in law. If it were necessary for us to do so, we would hold that the FTT's decision was plainly wrong and was only consistent with its having committed an error of law in its approach. We consider that we can see how and why the FTT reached a conclusion which we have held was plainly wrong. The FTT do not refer to matters which we regard as of central importance, namely, the scale of the tax advantage and the fact that the finance was relatively expensive at a time when Pendragon had unused committed facilities. It is conspicuous that the FTT did not provide in its decision a comprehensive description of the arrangements, nor a detailed analysis of them, and in consequence focussed on the fact that finance was obtained, rather than on the fact that the obtaining of finance was subordinate

to the essential aim of obtaining a tax advantage. Further, the FTT must have under-estimated the difficulty of leaving out of account much of what Mr Forsyth had said and of confining themselves to objective factors which would have occurred to a reasonable observer. The fact that the FTT said that it was determining the essential aim of the transaction "as a primary fact" does not prevent the Upper Tribunal reversing that finding but rather serves to emphasise that the FTT did not understand the task before it as involving an objective assessment of essential aim. The background facts may have been primary facts but an assessment of aim by reference to objective factors is not a primary fact. A finding as to Mr Forsyth's state of mind may have been a primary fact but that was not a directly relevant matter. The FTT appears also not to have appreciated that the essential aim of the lender might have been different from the essential aim of the transaction. No doubt, the lender did intend to lend money and obtain security by entering into documents which were effective to provide such security but we do not regard that as the essential aim of the transaction. Finally, it is likely that the FTT lost sight of the fact that it was not enough for Pendragon to show that the transactions produced real commercial consequences where those were collateral matters which did not detract from the essential aim of obtaining a tax advantage; the reference in paragraph 173 of its decision to "some autonomous justification" suggests that this is so. It is not necessary for us to determine whether these explanations as to how and why FTT reached a conclusion which was plainly wrong themselves disclose further separate errors of law, although we incline to the view that at least some of them do. In our judgment, the ultimate decision of the FTT was plainly wrong and therefore the FTT committed an error of law in reaching that conclusion. Even if the decision of the FTT involved a multi-factorial valuation judgment, we are satisfied that its decision ought to be reversed.

Redefinition for VAT purposes

115. If one finds that the transactions in this case involved an abuse of law, then the consequence is that the transactions must be redefined. The redefinition is to produce the situation that would have prevailed in the absence of the transactions constituting the abuse: see <u>Halifax</u> at paragraph 94. The purpose of redefining the

transactions is to “achiev[e] an appropriate outcome for VAT purposes in the light of the principles which inform the Sixth Directive”: see WHA at paragraph 59. It was said in Revenue and Customs Commissioners v The Atrium Club Ltd [2010] STC 1493 (at paragraph 44) that there was not necessarily only one possible way of redefining a transaction. Further, in the same case, at paragraph 45, it was said:

> “The redefinition under the Halifax principle is not designed to create a situation which can be sustained in practice. It is a purely notional device, for the purpose of assessment to tax, that may inevitably involve ignoring the terms of existing contracts.”

116. The only challenge to the redefinition suggested by HMRC was based on the points made by Pendragon as to the absence of the provision of security from the redefined transaction. It may be that Pendragon would wish to support the redefinition suggested by the FTT to the effect that the transactions were short-term leasing transactions.

117. We do not accept the suggestion that the transactions were to be characterised as short-term leasing transactions. The essential aim of the transactions was not to engage in the activity of short-term leasing. Short term leases were part of the structure which involved an abuse of law. Further, we do not accept an approach which produces the conclusion that redefinition simply cannot be done. Halifax makes it clear that redefinition is mandatory.

118. In our judgment, the transactions are to be redefined in the way contended for by HMRC. The only challenge to that redefinition is that it does not provide for security for repayment of the monies advanced. However, redefinition does not require the court or tribunal to provide for all of the features of the actual abusive transactions, if those features concern collateral matters. A redefinition which does not deal with the question of security, whether by including it or excluding it, is sufficient for the purpose for which redefinition is needed, i.e. to remove the element of abuse of law and to identify the VAT consequences once the abuse is removed. In our judgment, if one had to include a provision for security into the redefined transaction, one could simply introduce security provisions in a VAT neutral way, for example by including a floating charge. We do not think that

there is any difficulty in the present case as a result of the fact that the ease or difficulty of providing security was not explored in the evidence. That matter did not have to be explored because redefinition can take place with or without a provision dealing with security. Further, even if this matter were relevant and could have been explored in the evidence, that would not produce the result that HMRC would fail in its case that there was an abuse of law in the present case. Once that matter was established, the court or tribunal would have to do the best it could, on such evidence as it had, to redefine the scheme. We are also not convinced that Soc Gen London or Jersey would have insisted on security other than a guarantee from Pendragon plc (which was actually provided). The return for Soc Gen was extremely good, the time period was very short and Pendragon plc guaranteed payment. Further, if security had to be provided there was no basis for holding that security of a conventional kind could not have been provided. The only evidence to which our attention was called as to the extent to which Pendragon plc had provided security to other lenders was that it had *not* provided such security (see the credit opinion dated 30th October 2000 referring to the annual report of Pendragon plc) and so it could not be suggested that Pendragon plc had already charged all its assets to the maximum extent.

The result

119. Our conclusion is that the transactions in this case were an attempt to obtain a tax advantage contrary to the purpose of the relevant provisions and in circumstances where the essential aim of the transactions was to secure that tax advantage. The transactions therefore involved an abuse of law. The transactions must therefore be redefined in the way contended for by HMRC in its decision letter of 22nd October 2001 and be taxed accordingly. We conclude that the FTT committed an error of law in coming to its contrary conclusion and in the result HMRC's appeal against the decision of the FTT must be allowed.

MR JUSTICE MORGAN **JUDGE BISHOPP**