HMRC - VATSC81400 - The Terms Of The Contract And ‘Economic Reality’

Summary

In summary: Considering the contractual position is the starting point in most decisions, but it is particularly important in deciding single/multiple supply issues because it is necessary to consider whether one element is dependent on another in order for the supply to be made. An example is a football team requiring separate services of pitch hire and league management (see the decision in Goals Soccer Centres plc VATSC82250).

Where there are different elements which are not reliant on one another to be delivered - and are unaffected if other elements are not provided - then this is an indicator of multiple supplies because it cannot be artificial if those elements are split out and have their own identity.

You must also decide whether the contract reflects the economic reality of the arrangement which involves looking at the transaction as a whole to determine what is actually being supplied.

Background

Considering the contractual position is the starting point in most decisions, but it is particularly important in deciding single/multiple supply issues because it is necessary to consider whether one element is dependent on another in order for the supply to be made. For example, if one element of a single contract does not rely on another element in that contract in order to be delivered - and the nature of the first element is unaffected if the second element is not provided - this is an indicator of multiple supplies.

Where there are different elements which are not reliant on one another for the supply to be made - and are unaffected if other elements are not provided - this is an indicator of multiple supplies because it is not artificial for those elements to have their own identity.

It is also relevant to consider whether the different elements of the contract are separately enforceable. This takes into account whether the different elements are supplied under their own terms and conditions, and also if one element is not paid for and so not delivered whether the other elements will still be provided. In those cases, one part of the contract is not held as being conditional upon the other parts. This means if one part is breached or terminated, the other part is not automatically breached or terminated.

This aspect is relevant when considering whether two elements are so closely linked in an economic sense that there is a single supply. It may indicate that the customer has separate aims in obtaining the different elements. The result in either approach is that it is not artificial to see a multiple supply if different elements are aims of the customer in themselves.

Economic reality refers to the nature of the transaction, determining the economic substance considering all the commercial circumstances. This includes looking at factors such as the pricing structure, the optional nature of some elements and whether elements can be provided alone and have their own value. The ECJ decision in Levob (C-41/04) gave as the reasoning ‘so closely linked that they formed objectively, from an economic point of view, a whole transaction’. This means an objective assessment of the economic reality must be made - are the contractual arrangements (and the contended supplies) consistent with the economic reality?

In precedent decisions, whether single or multiple supplies, the pricing structure is always described as not being determinative, but it is often cited as an indicator and was included in the ECJ’s guidance in CPP. More importantly, the optional nature of different elements within a supply together with a separate pricing structure for them was used to determine multiple supplies where the customer has a genuine choice about which elements to receive.

Supporting cases

Examples of where this indicator was considered important include:

Durham River Trips Limited (MAN/99/876) - ‘The authorities to which we have been referred have established the need for an objective test and for the Tribunal to approach the problem by finding the “substance and reality” of the operation. It is both practical and realistic to separate the zero-rated from the standard-rated supply in the instant case’.

Courts (LON/02/312) at para 56 said ‘having set out the primary facts we analyse the transaction as it appears to have been planned’.

A.C. Tours (TC/2009/10458) at para 19 says ‘a factor that is of some relevance in considering this whole subject is the question of whether one or two charges are made’ we know from other case law that a single price is not decisive in concluding there is a single supply and conversely a multiple pricing structure does not necessarily indicate a multiple supply’.

Charterhall Marketing Ltd (19050) where there was a supply of personalised printed letters and other printed items, the Court ruled the letters were envisaged to be a separate supply by agreement and ‘can, we think, be regarded as distinct and independent from the supply of leaflets. The distinction is essentially between the particular and the general’.

Appleby Bowers ([2001] STC 185) where ‘the precise terms of the relationship between Appleby and Carol Nash changed, as various different items were from time to time specifically required or not required from Appleby’.

The Village Surgery Ltd (MAN/02/0364) where ‘the documentation unequivocally indicates that the chattels were not included’ in the sale of a building.

West Lothian College Spv Ltd (EDN/02/58) concerned ‘separate and easily distinguishable supplies albeit wrapped up in a package contained under an umbrella of a PFI project’.

Madgett & Baldwin (C-308/96 and C-94/97) - there was a single price charged, but the additional services ‘cannot be carried out without a substantial effect on the package price charged’

Appleby Bowers ([2001] STC 185) at para 191: ‘the amount charged for the supply of brochures was very large in relation to, and indeed much larger than, the contractual sum paid for the provision of promotional services the supply of brochures was invoiced or itemised separately; indeed, when compared with the allegedly principal supply—namely that of promotional services—it was paid for on a completely different basis’.

Leighton Ltd (17498) at para 65: ‘the price for dispensing services is more than one half of the price for the total supply. On that ground alone, the supply of the dispensing services should not be treated as ancillary to the supply of goods’.

Dr Beynon ([2004] UKHL 53) at para 33: ‘where ancillary goods or services are relevant to the analysis, Lightman J’s description of them as ‘add-on’ may be helpful, so long as it is borne in mind that they may be optional extras (such as in-flight catering on some but not all airlines) or goods or services which, although undoubtedly subsidiary, are for practical purposes indispensable (the ignition key of a car being a simple example)’.

CGI Group (Europe) Limited (LON/07/0374, 0430, 0978): ‘we consider that we are justified in going beyond the contractual position to consider the economic purpose.’

De Montfort University Students’ Union (18434) where customers can choose to buy three separate items, or any one or more of them, or they can buy all three at a reduced aggregate price - ‘sandwiches and crisps are no more than items some people like to eat at the same time, but neither is in any way dependent on the other for its existence or utility’ and ‘if one item is to be regarded as ancillary to another so as to adopt its tax treatment, it must be largely if not wholly dependent on it for its existence or utility.’

Pethericks & Gillard Ltd (LON 2007/0610) where professional indemnity insurance was separate from the supply of an office with associated services because it ‘seems neither ancillary to any other supply nor integral to or economically indissociable from the other supplies…’

Everything Everywhere ([2010] ECR I-12359) para 29 ‘according to the case-law of the Court, the fact that a single price is invoiced, or that separate prices were contractually stipulated, has no decisive significance for the purposes of determining whether it is necessary to find that there are two or more distinct and independent transactions or only a single economic transaction’

BGZ Leasing (C-224/11) the separate pricing and invoicing indicated the elements were not dependent on each other and ‘reflect the interests of the contracting parties’.

Goals Soccer Centres plc (TC02253) at para 95: ‘a consumer (here a team organiser on behalf of his team) may enjoy the Appellant’s facilities in a number of different ways. It is wholly unsurprising that the Appellant has separate contracts for non-league pitch hire, league pitch hire, and league management services. The various combinations of supplies make it sensible to have different contracts to cater for the different arrangements that can be made with the typical consumer’

Then at para 108: ‘The pricing structure does not lend support for the view that there is a single composite supply. The main cost to the consumer is the pitch hire. The consideration for the league management services is relatively minimal…such flexibility of arrangements does not suggest one overarching supply which could be characterised as participation in a sports competition. Rather, this suggests two discrete but linked supplies separately entered into and separately charged for. The fact that a global price is identified on the League Entry Agreement is relevant but not conclusive’.

Telewest (2005] STC 481) at para 44 said ‘in the end, it seems to us that the intention was to make Publications the supplier of the magazines. It was a lawful aim at common law, subject to the arguments on VAT law, which are yet to come. The attempt may not have been crystal clear, but it was plain enough. We should not try to defeat it for the good of the commissioners’.

Part Service (ECJ C-425/06) at para 27: ‘it must be determined whether the fact that a financing transaction - regarded in economic practice and in national case-law as an essential component of a leasing contract - is regulated by a separate contract concerning the granting of the use of the goods, can constitute an abuse’.

Tellmer (C-572/07) at para 41: ‘…to distinguish between the economic activity of letting dwellings and the activity of cleaning of the common parts does not constitute the splitting of a single, indivisible economic supply. Both activities are not so closely linked that to separate them would seem artificial, especially as, generally speaking, it is for the parties concerned, exercising their contractual freedom, to allocate that task in a particular case’.

But contrast these cases with decisions such as Weight Watchers (UK) Ltd ([2008] STC 2313) at para 46: ‘it makes no sense from an economic point of view to pay (be charged) separately for the meetings and the publications’ which was a major factor in ruling there was a single supply

Arguments against using economic reality

You should be aware that arguments may be deployed against using the concept of economic reality. In the Telewest (2005] STC 481) decision, ARDEN LJ at para 83 said

‘In my judgment, there is an objection in principle in this field of law to taxing transactions according to their economic reality. The economic reality of a transaction is antithetical to legal certainty. If VAT is payable according to economic reality, the seller will not know what VAT to account for, and the purchaser will not know what to VAT to pay. The system for the collection of VAT would no longer be straightforward. Accordingly, there seem to me strong policy reasons against the course which Mr Vajda invites us to take. The principle of legal certainty is one recognised and applied by the Court of Justice in this field (see, for example, Cantor Fitzgerald [2001] STC 1453, [2002] QB 546, para 33)’

Further, in para 87:

‘the mere fact that the court seeks to find the commercial reality of a transaction does not mean that it would seek to apply the economic reality of the transaction. The economic reality of the transaction may have nothing to do with either the essential features of what the parties agreed or the legal structure of their transaction. Moreover, as this court said in Tesco plc v Customs and Excise Comrs [2003] EWCA Civ 1367 at [159], [2003] STC 1561 at [159]: ‘Economic purpose is not the same as economic effect’.

This decision in Tesco (Court of Appeal STC 1561) explored, at para 159, the concept of ‘legal effect’ of the Clubcard scheme. This meant:

‘the entire scheme must be examined…it is necessary to go behind the strictly contractual position and to consider what is the economic purpose of the scheme, that is to say ‘the precise way in which performance satisfies the interests of the parties’ (see the Advocate General’s opinion in Mirror Group, para 27: see [41] above)’.

The judgment went on to say:

‘Economic purpose is not the same as economic effect. The fact that two transactions have the same economic effect does not necessarily mean that they are to be treated in the same way for VAT purposes (see Littlewoods especially at para 84 per Chadwick LJ: see [42] above). Equally, the economic purpose of a contract (what the Advocate General in Mirror Group called the ‘cause’ of a contract: see para 27 of his opinion: at [41] above) is not to be confused with the subjective reasons which may have led the parties to enter into it (in so far as those subjective reasons are not obviously evident from its terms) (see Mirror Group para 28: at [41] above). The Advocate General went on to observe (an observation which seems to me to be particularly apt in the context of the tribunal’s decision in the instant case):

‘… failure to distinguish between the cause of a contract and the motivation of the parties has been the source of misunderstandings, … and has complicated the task of categorising the contracts at issue.’

Although you should take into account these comments from the Telewest and Tesco decisions, HMRC’s view is that determining the economic reality is of paramount importance in deciding whether a situation is artificial. The Tesco case in particular was about whether there was a supply for consideration rather than the single/multiple topic, but taking the Tesco approach of looking at the purpose of the contract by considering the whole circumstance is consistent with the CPP guidelines.

In particular, the Levob precedent was used in the majority of judgments giving a multiple supply ruling and so determining whether economic reality indicates multiple supplies is a principal means of making a decision. This was highlighted for example in the ECJ decision in Newey (trading as Ocean Finance) (C-653/11) where the judgment stated at para 42:

‘…it is necessary to bear in mind the case law of the court according to which consideration of economic and commercial realities is a fundamental criterion for the application of the common system of VAT (see, to that effect, Revenue and Customs Comrs v Loyalty Management UK Ltd, Baxi Group Ltd v Revenue and Customs Comrs (Joined cases C-53/09 and C-55/09) [2010] STC 2651, [2010] ECR I-9187, paras 39 and 40 and the case law cited)’.

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