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VAT on leasing and hire purchase: goods or services?

On 31 May 2017 Advocate General Szupnar delivered his opinion in the **Mercedes-Benz Financial Services UK Ltd** case (Case C-164/16). The case addresses the thorny question of how to distinguish between those leasing arrangements which for VAT purposes give rise to a supply of goods and those which give rise to a supply of services.

The distinction is significant and can have a real impact on the economics of a lease. With a supply of services, the VAT cost is typically spread over the term of the lease by reference to the rental payments, whereas if it is a supply of goods the VAT has to be accounted for upfront as a lump sum at the beginning of the leasing. In cross-border leasing the categorisation as goods or services can determine which of the parties has the obligation to account for VAT, or indeed whether VAT is even chargeable. Assuming the Advocate General's opinion is followed by the Court of Justice of the European Union ("CJEU"), it will provide some welcome clarification in this difficult area.

The case concerned a vehicle finance option called "Agility" that was offered to customers by Mercedes-Benz Financial Services UK Ltd ("MBFS"). Rental payments during the hire period were calculated by reference to the difference between the initial purchase price of the vehicle and its anticipated residual value at the end of the 36 month term (plus interest). At the end of the term, Agility customers had an option to purchase the vehicle by paying a substantial option price equivalent to that residual value. This was typically in excess of 40% of the original price of the vehicle. The question was whether for VAT purposes this arrangement constituted a supply of goods or a supply of services.

Under the terms of the Principal VAT Directive, a supply of goods means the transfer of the right to dispose of tangible property as owner but it is extended to also include:

"the actual handing over of goods pursuant to a contract for the hire of goods for a certain period, or for the sale of goods on deferred terms, which provides that in the normal course of events ownership is to pass at the latest upon payment of the final instalment".

A supply which is not a supply of goods is a supply of services. The paradigm example of a supply of services in this context would be a short term leasing of an asset, with no purchase option. The asset will be returned to the lessor at the end of the term and there is no mechanism for ownership to pass to the lessee. The paradigm example of a supply of goods would be a sale on deferred terms where title passes automatically once all instalments have been paid, or a hire purchase arrangement where the option price is a token amount, such that its exercise is a mere formality. The "Agility" contract in the MBFS case clearly sits somewhere in between. HMRC argued that it gave rise to a supply of goods, much like an HP contract with a final balloon payment. MBFS said it was a supply of services like a simple leasing contract.

In the UK courts there had, understandably, been much debate as to the meaning of the phrase *"in the normal course of events ownership is to pass at the latest upon payment of the final instalment"*. Was it sufficient to simply identify the existence of a purchase option in the contract? Did it make a difference whether the option price was a substantial or a nominal amount? Was it necessary to evaluate the likelihood of a customer exercising the option or to carry out an analysis of the "economic purpose" or "cause" of each contract?

The Advocate General approaches the question in a refreshingly straightforward manner which broadly reflects the rule of thumb that a purely nominal purchase option in a lease will likely result in a supply of goods, while an option to purchase for a price representing a substantial residual value will normally lead to a supply of services. The following key points can be derived from his opinion:

- (i) The accounting treatment of the lease does not determine the VAT treatment. In particular, the fact that a lease might be accounted for as a finance lease (on the basis that in economic terms it transfers substantially all of the risks and rewards of ownership of the asset to the lessee) does not mean it is a supply of goods in VAT terms. This is a welcome clarification and, if followed by the CJEU, would put to rest at least some of the uncertainty caused by the earlier CJEU decision in *Eon Aset Menidjmnt*. Comments in *EoN* had suggested that all finance leases might fall to be treated as supplies of goods and this led to HMRC confirming that they would not, at least for the time being, be following such an approach (see Revenue & Customs Brief 37/12).
- (ii) Where the leasing contract does not provide for ownership to pass automatically to the lessee at the end of the term, and does not include a purchase option, this will normally be treated as giving rise to a supply of *services*, not goods. Unfortunately, the Advocate General's opinion does not offer a definitive view on whether a finance lease with a back-end sales agency under the control of the lessee would be a supply of goods or services. Perhaps unsurprisingly given the facts of this case, the discussion focuses very much on transfer of ownership *to the lessee*, with no comment on the significance of provisions for transfer to third parties. It will be interesting to see whether, following this case, HMRC will offer any update on their views on this point.
- (iii) Where the contract includes an option for the lessee to purchase the assets at the end of the term, it should be treated as a supply of *goods* only where there is a high degree of *certainty* that the option will be exercised and that title will pass to the lessee. Otherwise, it will be a supply of *services*. In assessing whether the option is sufficiently likely to be exercised, and thus whether title will pass in the normal course of events, it is not relevant that the contract could be terminated early following a breach or by virtue of a statutory cancellation right (e.g. under the Consumer Credit Act). The question is whether ownership would transfer as a result of normal performance of the agreement.
- (iv) Where the mandatory rental payments over the term (whether structured as instalments or with a larger final balloon payment) cover the full price of the asset, and the price payable to exercise the purchase option is therefore only nominal, it can be assumed that the option will be exercised and, absent special circumstances, the arrangement will be treated as a supply of *goods*. As the Advocate General put it, the likelihood of ownership of the asset transferring to the lessee in these circumstances "*borders on certainty, as otherwise the actions of the lessee would be irrational in economic terms*".
- (v) By contrast, where the purchase option payment forms a substantial part of the full price of the asset, it cannot be assumed that the lessee will, in the normal course of events, exercise the option. Unlike the case of a nominal option fee, exercise of the option in these circumstances is not "*the only economically rational course of action*". Because the lessee has "*a genuine choice from an economic point of view*" whether to exercise, it cannot be assumed that ownership of the asset would, in the normal course of events, pass under the contract. Such arrangements would therefore normally give rise to a supply of *services* for VAT purposes, not goods.
- (vi) Finally, as noted above, an element of the Principal VAT Directive definition of a supply of goods relates to timing, in that ownership is to transfer "*at the latest upon payment of the final instalment*". The Advocate General explained that it did not matter that, in the case of an arrangement with a nominal/token option fee, ownership may technically only transfer at some point *after* the final mandatory instalment payment is made (e.g. because the option will be exercised only after making the final

mandatory payment). The transfer of ownership can be regarded as flowing from payment of the final mandatory instalment because exercise of the option is then a mere formality. In the context of arrangements like the Agility contract, however, the distinction between mandatory instalments and optional payments was important. Here it could not be said that transfer of ownership flowed from payment of the final mandatory instalment because the lessee would still have to decide whether to make a substantial optional payment and it couldn't be assumed that this would happen. The substantial optional payment couldn't be regarded as itself being the "final instalment" because otherwise all contracts with purchase options, whether substantial or nominal, would give rise to supplies of goods.

It remains to be seen whether the CJEU will follow the approach of the Advocate General. The clarification of *EoN* and the relevance (or otherwise) of the accounting treatment of leases would be welcome, albeit that it still leaves some unanswered questions in the context of finance leases with sales agency provisions. Although there will always be hard cases on the fringes, the Advocate General's focus of exercise of the purchase option having to "*border on certainty*" and be the "*only economically rational course of action*" should at least help to narrow down some of the grey areas.

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