VAT focus

The VAT exemption for financial services: time to 'take back control'?

Speed read

It has been ten years since the European Court's judgment in *AXA Denplan*, which marked the beginning of a line of European Court judgments that have narrowed the scope of the VAT exemption for financial services. This is to be contrasted with the early 2000s when the UK courts, in cases such as *FDR* and *EDS*, favoured a broader interpretation of the exemption. After the end of the Brexit transitional period, the UK judiciary will have the opportunity to develop its own VAT jurisprudence. The taxpayer's appeal in *Target* (a case concerning loan administration services) may be the first chance for the UK courts to 'take back control' and not to apply an overly restrictive approach to the VAT exemption.

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The European Union (Withdrawal) Act 2018 states that the UK courts and tribunals are bound by 'retained case law' until the end of the transition period. Any European court judgments delivered up to 31 December 2020 will form part of the retained case law and will be accorded the status of a judgment of the UK Supreme Court. Any European Court judgments delivered after that date will not be binding on the UK courts and tribunals, although they may 'have regard' to such judgments if they are relevant to the matter under consideration.

This is especially important in the VAT world. The CJEU has had supremacy over UK courts in VAT matters as the UK's membership of the EU has required the UK to be bound by the common EU VAT system. The UK has regularly referred questions to the CJEU in VAT matters, particularly in respect of the VAT exemption for financial services. As a result, the UK courts have been bound by CJEU judgments, regardless of whether they agree with them, and have been required to decipher the CJEU's (often less than clear) reasoning.

The EU Withdrawal Act identifies the Supreme Court as not being bound by retained case law after 31 December 2020. That is to say, the Supreme Court is able to depart from the retained case law. The only condition is that the Supreme Court 'must apply the same test as it would apply in deciding whether to depart from its own case law'.

The Act also gives the UK government the power to extend the judicial option of not following specific aspects of pre-Brexit EU law to the lower courts. The government has recently confirmed, in a response to the semi-public consultation launched in August this year, that it will extend this power to the Court of Appeal. This has significant implications for pending VAT litigation – including the case of *Target Group Ltd v HMRC* [2019] UKUT 340 (TCC), which serves as a useful case study on what might happen once the UK courts start applying their new post-Brexit powers (the case itself concerns payment services, but the principles also apply more broadly to financial services generally, particularly in relation to outsourcing).

What is a payment?

As is well-known in the VAT and financial services world, matters reached their head in the CJEU in *Sparekassernes Datacenter* (Case C-2/95) (*SDC*) during something of a golden era of seminal CJEU decisions in the 1990s. In that case, the CJEU was confronted with a number of heresies surrounding the VAT exemption for payment services, and it had to distinguish truth from error with care.

SDC was an entity owned by 99% of Danish savings banks, and which provided them with electronic data handling services, used, *inter alia,* to move funds. It was paid solely by the banks and had no contract with the banks' customers, who did not know of its role (a classic outsourcing arrangement). The CJEU defined the task it was addressing (at para 16), thus:

> 'By its questions the national court is asking in effect whether points 3, 4 and 5 of Article 13B(d) of the Sixth Directive are to be interpreted as exempting from VAT supplies of services made to banks and their customers by a data-handling centre set up to serve the common interests of banks where those services *contribute to the execution of transfers* …. performed wholly or partly by electronic means' (emphasis added).

The CJEU did a good job in answering this question in the affirmative in a remarkably clear judgment which everyone thought had settled matters conclusively. It proceeded by four clear stages of analysis:

1. it dispelled any notion that the only supplies within the scope of the VAT exemption were limited to banks;
2. it made clear that the methodology, whether manual or electronic, made no difference: it was what was done, not how it was done, that made the difference;
3. it held that there was no need for a contract between the provider of payment services and the end customer (thereby allowing the VAT exemption to apply to subcontracted or outsourced services), and
4. most importantly, in one of the most quoted parts of any CJEU judgment (para 66), it held that: 'For "a transaction concerning transfers", the services provided must therefore *have the effect of transferring funds* and entail changes in the legal and financial situation. A service exempt under the Directive must be distinguished from a mere physical or technical supply, such as making a data-handling system available to a bank' (emphasis added).

'Having the effect of transferring funds' did not mean doing the whole transfer (see para 64). The exemption

'does not in principle preclude a transfer from being broken down into separate services which then constitute "transactions concerning transfers" within the meaning of that provision'. The CJEU had understood the questions being asked as applying 'where those services *contribute to the execution of transfers*' (emphasis added).

This decision defined the scope of the VAT exemption for payments and transfers (and by extension, securities transactions) for years to come. The UK courts were left to do their duty – and so they did, in such cases as *C&E Commrs v FDR Ltd* [2000] STC 672 (*FDR*) and *HMRC v Electronic Data Systems Ltd* [2003] STC 688 (*EDS*).

In *FDR*, the Court of Appeal applied the reasoning in *SDC* to the UK equivalent, FDR, a bank-owned entity that received credit and debit entry details from the banks in connection with payment card transactions, settling inter-bank, merchant-acquirer, issuer-acquirer and issuer-customer positions daily. Its function was to settle accounts between banks, who owned it, and to whom it supplied its services (as Laws LJ noted in his decision, these were 'outsourced' services, a term he described as 'the barbarous expression apparently current in the trade').

The (then) Commissioners of Customs & Excise argued that this was all mere book-keeping: FDR did not make money move, only a bank could do that. The Commissioners' argument was that 'a "transfer" is constituted by the *execution* of an instruction that the transfer should take place, and never merely by the *instruction* itself' (emphasis original).

A clear difference in interpretation has emerged between the UK courts and the CJEU

However, the court disagreed. It noted that once messages had been received, the BACS process was automatic, and no discretion was exercised in terms of the messages it sent onwards to the banks (but in the context of a carefully structured set of governing rules). The non-discretionary role of BACS was crucial, in the court's view, to concluding that FDR had caused the money to move when its tape messages were acted on. It noted that: 'BACS is in my judgment merely the agency by which FDR effects transfers ... Any other conclusion would be contrary to the good sense of the general law: *Qui facit per alium facit per se* (he who does a thing through another does it himself). And I cannot in this see the least affront to the reasoning in *SDC*: quite the contrary: it is a conclusion which conforms to the letter and spirit of article 13B(d) as it was explained in that case.'

All this makes sense if one does not lose sight of how money (or rather value) moves. In a classic passage, Laws LJ reminded us that money does not really move when debtor A tells his bank to pay £X to creditor B through his bank. What happens is that A tells his bank that it no longer owes him £X, and that the bank should tell B's bank, that it can now owe B £X. A's bank debits A, and B's bank credits B. How does £X move? It does not. It's like watching a motion picture: there are a series of freeze frames that give the impression of movement. The money disappears from one side of the account and appears on the other side. Instead of A withdrawing cash from its bank (creating a debit) and then handing it to B (who deposits it with its bank, creating a credit), A and B cut out the cash stage by having pre-arrangements with their respective banks to reproduce, by messaging, the effects of a cash transaction: in other words, a debit entry on one side, and a credit entry on the other.

But except where A and B bank at the same bank (and so the debit and credit entries can be made in a single book of account), this can only be achieved by a series of similar debits arising along a chain to a central bank (which has the single book of account) and then a cascade of credits falling to B's bank. The trick is this: A's bank and B's bank will both be clients of the Bank of England BoE) – the bankers' bank. Each evening (after the BACS messages have all been sent), clearer A will say to the BoE 'you owe me £Ym less' (somewhere in there – traceably – will be A's payment), and clearer B will say to the BoE 'you owe me £Zm more' (somewhere in there will be B's receipt). Thus, generally, the only party who can make money actually move, is the BoE, because it controls both sides of a debtor-creditor relationship between clearing banks.

Two things are clear: first, moving money involves a chain of steps by various entities, all of which have to contribute if value is actually to pass from A to B. Neither A's bank nor B's bank can do it alone. Unless the payment exemption is to be limited to the one bank that can actually do both sides of the transaction (the central bank or the bank at which both parties bank), the exemption must apply to preliminary steps which take the shape of making book entries which reflect the upcoming changes: these must be made in a co-ordinated way.

In *EDS*, the Court of Appeal followed the same approach, upholding the exemption in the case of an outsourced supply of transaction processing for mortgage lending. The Commissioners' public notices endorsed the outcome, and over ten years of certainty followed until the CJEU considered the case of *AXA Denplan* (Case C-175/09). Thereafter, a raft of further European cases ensued, culminating in *DPAS* (another dental plan provider), which have left the certainty previously provided by *SDC*, *FDR* and *EDS* far behind. How odd it is that dental plans have had such a disproportionate impact on the banking and financial services industry. This could only happen in the VAT world.

The *Target* case

This brings us to the *Target* case. Target, supplied FDR/EDS-style payment/transaction processing to a bank, which (like EDS) ran a mortgage lending business. It controlled repayments and kept the bank's books of account for it, just as FDR and EDS had done. To establish a prima facie right to exemption, it cited *FDR* and *EDS*, and the First-tier Tribunal agreed that the exemption applied in principle, although it later held that the *AXA Denplan* style 'debt collection' carve-out applied such that exemption was not available.

On appeal, the Upper Tribunal, perhaps surprisingly, concluded that Target did not even get to first base of exemption. It held that the Court of Appeal in *FDR* and in *EDS* got things fundamentally wrong: sending out BACS messages is not enough to engage the payment/transfer exemption.

It did this by reason of its interpretation of the raft of judgments delivered by the CJEU, including *AXA Denplan, Bookit* (Case C-607/14), *National Exhibition Centre* (Case C-130/15) and *DPAS* (Case C-5/17). Whilst all of these cases concerned the scope of the VAT exemption for payment services, it is notable that the taxpayers in those cases were not really providers

of financial services in any meaningful sense – they provided dental plans and the facilities to book tickets – such that they may be viewed as pushing the VAT exemption a bit too far.

In each of these cases, the UK courts found largely in the taxpayer's favour by holding that the VAT exemption should apply to the payment element of what they did (which consisted of sending payment instructions). However, when each of these cases was referred to the CJEU, they all lost. How the CJEU reached its conclusions varied in each case, but in all of these cases are signs that the CJEU does not really believe that the taxpayers were truly providers of financial services that should qualify for the VAT exemption, especially as the CJEU might have suspected an element of avoidance.

> How curious that, by taking back control, the UK courts might be able to entrench the old CJEU decision in *SDC* that has served the City well

A difference in interpretation

Therefore, a clear difference in interpretation between the UK courts and the CJEU has emerged. Is sending a payment instruction enough to be an exempt payment transaction? Until recently, the UK courts have been happy that this should be the case.

The Upper Tribunal in *Target* pointed out the differences in approach between the UK and CJEU jurisprudence (para 76):

> 'While it is true that the CJEU in *DPAS* confirms and restates the principles stated in *SDC*, it provides further elaboration of those principles which is inconsistent with the conclusion reached (expressly) in *FDR* and (tacitly) in *EDS* that a party who provides instructions to BACS to transfer funds between bank accounts can be said to be effecting the transfer of those funds … Specifically, we do not consider that the fact that BACS is pre-authorised (no doubt pursuant to the terms its participating banks have agreed with it as part of the terms and conditions of membership) to effect debits and credits from the accounts of the participating banks alters the legal conclusion that it is BACS and/or the banks themselves that effect the transfer of funds and not the entity (Target, in this case) that provides the instruction to BACS containing the necessary information upon which BACS can act.'

The difficulty is that the CJEU did not necessarily join up the dots between *SDC* and *DPAS*. However, it is questionable whether the Upper Tribunal should simply have treated *FDR* and *EDS* as overruled, rather than trying to make sense of it all in a way that left the payment processing industry where, in tax terms, it has thought itself to be for 20 years.

Therefore, many old heresies (thought buried in *SDC*) return: for example, the rejected argument of counsel for the Commissioners in *FDR*, that giving the instruction is not the same as effecting the transaction, is once again at large. There appear to be some omissions in the key reasoning of the Upper Tribunal in *Target* (at paras 74–80): it omits to deal with the fact that: (a) BACS has no discretion but to pass on the messages; and (b) it is the banks, not BACS, which act on the messages (it assumes that BACS effects the transfer of funds, the one thing it definitely does not do).

Pausing there, if this means that only banks can effect a payment, that marks a return to another pre-*SDC* heresy that the payment exemption only applies to banks. The approach also leaves no space for the CJEU's comments indicating that a chain of parties, who each contribute towards the overall transaction, can each be exempt (see *SDC* at paras 63–64). Further, it does not acknowledge that neither of the two banks in the transaction effects the transfer, each merely contributes, and that it is only those banks' banker (the BoE) that in fact can stand on both sides of the transaction and effect the transfer. This logical conclusion would restrict the VAT exemption to one player (the central bank), and effectively make the payment exemption redundant. This surely cannot be correct.

All this, plus the debt collection point from *AXA Denplan*, will no doubt be on the table in the Court of Appeal in *Target* at some point in 2021. Now we know that the Court of Appeal will be granted the ability to depart from retained EU case law, it has a decision to make: should it follow a long line of detailed reasoning by the UK courts in cases involving the core of the UK payment system, or favour the CJEU's more recent but somewhat vague reasoning in cases that are on the edge of the payment system?

Should the Court of Appeal decline to apply the more recent *DPAS* line of cases, it would, in fact, be maintaining what everyone had thought was the status quo over the last 20 years since *SDC,* and as subsequently confirmed by *FDR* and *EDS*. It could be tempting.

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