WHITE & CASE

The curious ECJ case of *Eon Asset Management* and its impact on finance leasing in the United Kingdom

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Recently, the European Court of Justice (ECJ) delivered its judgment in *Eon Aset Menidjmunt OOD v Direktor na Direktsia 'Obzhalvane i upravlenie na izpalnenieto'* (C-118/11) which (save for capturing the attention of a few VAT practitioners) went largely unnoticed in the United Kingdom. This may have been due to many reasons – the value of the Bulgarian VAT at stake was modest at best, the primary issue on which the court's ruling was required related to the deductibility of VAT paid in respect of leases of cars to transport employees (which is an area of VAT littered with cases of a routine nature often of limited significance beyond the boundaries of the case in question); or perhaps it is the impenetrable English pronunciation of the Bulgarian tax authority that prevented many of us from daring to delve deeper into the case.

Nonetheless, it is worth noting the significance of this case, for hidden away somewhat innocuously in the 'preliminary considerations' section of the judgment is an important determination of the ECJ that may have a far-reaching impact on how finance leases are treated for the purposes of VAT in the European Union including the UK.

Traditionally the UK (and certain other member states of the European Union (EU)) have relied on a literal interpretation of art 14(2)(b) of the Council Directive 2006/112/EC (the Directive) (and in the case of UK, Sched 4, para 1(2) of the VAT Act 1994) – see further below – to treat only those leases which contemplate that the title to the underlying goods will pass at some point in the future (e.g., hire purchase agreements) as a supply of goods. Finance leases on the other hand which do not contemplate any such transfers of title have historically been seen in the UK as being no different from operating leases (in so far as their VAT treatment is concerned) and accordingly such leases have been treated as supplies of services. The ECJ has in this case effectively ruled that a finance lease within the meaning of IAS 17 should be seen as a supply of goods and not services. Therefore, in light of this judgment of the ECJ, the UK's traditional treatment of finance leases is probably [1] incorrect, restrictive and incompatible with the spirit and meaning of the Directive.

Background

As many readers may be aware, the European scheme of VAT imposes a charge to VAT on a supply of goods or services (provided, broadly, the supply is a taxable supply made by a taxable person in the course or furtherance of any business carried on by such person). Although VAT applies to both supplies of goods and services, the distinction between the two for VAT purposes is a fundamental one. The application of the correct rate of VAT, the time and place where the supply is treated as taking place and the valuation mechanics to be applied rely heavily on this fundamental distinction.

Under art 14(1) of the Directive, a supply of goods takes place for the purposes of VAT where there is a 'transfer of the right to dispose of tangible property as owner'.

The corresponding UK legislative provision is set out in Sched 4, para 1(1) of the VAT Act 1994 which provides that 'any transfer of whole property in goods is a supply of goods'.

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The key terms here are 'transfer', 'tangible property' and 'whole property'. 'Transfer', taking its literal meaning, presupposes the passing of something from one person to another, and 'tangible property' taking its literal meaning here, means anything that can be touched and therefore includes both movable and immovable property. The meaning of the term 'whole property' on the other hand is slightly more complex – it is generally understood as including all the rights derived from ownership of the property in question.

Article 24(1) of the Directive (and the corresponding provision in the VAT Act 1994) defines a supply of services on a residual and 'catch-all' basis as any supply (for a consideration) which is not a supply of goods.

The question whether simply the transfer of possession of goods but not legal title (e.g., leasing of goods) is a supply of goods or services is a particularly complicated one. It is logical to assume that, given the manner in which arts 14 and 24 of the Directive are crafted, where there is an operating lease of goods, the supply in question should be a supply of services and not of goods (on the basis that although there is a transfer of possession of goods, no legal title is transferred and therefore not all rights derived from the ownership of the property in question can be said to have been transferred in such circumstances). However, in the world of VAT, not everything is straightforward and every rule has at least some deviation or exception. The rules set out in arts 14 and 24 of the Directive are no exception.

Article 14(2)(b) of the Directive expressly states that, notwithstanding the definition of supplies of goods and services, the following will also be regarded as a supply of goods:

'… 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 shall pass at the latest upon payment of the final instalment…'

The corresponding UK legislation (Sched 4, para 1(2) of VAT Act 1994) replicates this principle by providing that there will be a supply of goods if the possession of goods is transferred:

'(a) under an agreement for the sale of goods; or
(b) under agreements which expressly contemplate that the property will pass at some time in the future (determined by, or ascertainable from, the agreements but in any case not later than when the goods are fully paid for).'

It is clear from the above that where there is a simple operating lease in place, the supply in question will be a supply of services and not goods for the purposes of VAT (and therefore the logical assumption expressed earlier in this connection is correct). It is equally clear from the above that where there is a hire purchase agreement or conditional sale contract in respect of goods, that is a supply of goods and not services for the purposes of VAT provided that:

(a) the title in the goods passes at the time determined by or ascertainable from the agreement; and/or

(b) the title in goods passes no later than the time when the goods are fully paid for.

As such, a conventional hire purchase agreement which expressly contemplates that title will pass from the lessor to the lessee when the goods have been paid for will constitute a supply of goods and not of services.

Treatment of finance leases

A finance lease that does not contemplate the transfer of legal title falls within the crevices of the said distinction (between supplies of goods and services) in the European scheme of VAT. Accordingly, it is not surprising that different EU member states apply differing VAT treatments to finance leases. In fact this divergence in the VAT treatment of finance leases was the highlight of *Commissioners for Her Majesty's Revenue & Customs v RBS Deutschland GmbH* (C-277/09) where the German tax authorities viewed a finance lease as supply of goods whereas HMRC viewed it as a supply of services and accordingly (given the facts of that case), VAT was charged in neither jurisdiction.

The difference in treatment of finance leases arises substantially because of the 'nature of the beast' and also because, in the author's view, of the different ways in which art 14(2) of the Directive can be interpreted.

A finance lease is defined in IAS 17 as 'a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred'.

IAS 17 further states that the question whether a lease is a finance or an operating lease depends on the substance of the transaction rather than form, and proceeds to set out a list of factors that individually or in combination would normally lead to a lease being

classified as a finance lease. These factors or indicators are as below:

'(a) the lease transfers ownership of the asset to the lessee by the end of the lease term;

(b) the lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised;

(c) the lease term is for the major part of the economic life of the asset even if title is not transferred;

(d) at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and

(e) the leased assets are of such a specialised nature that only the lessee can use them without major modifications.'

It should be noted that the indicators above notwithstanding, the fundamental test is whether the lease in question transfers substantially all risks and rewards incidental to ownership – if the answer to this question is 'yes', it is a finance lease and if not, then irrespective of whether one or more of the factors/indicators outlined above is/are present, the lease will nevertheless be a treated as an operating lease.

It is well known that finance leases (in the UK and for that matter elsewhere) do not always provide for the passing of legal title. For example where the lease term is for the useful economic life of the underlying asset in question, the lessee may not want title to the goods. Also, it is not unusual for a finance lease to sometimes require the lessee to dispose of the underlying assets as the agent of the lessor, with the consequence that the title never really passes to the lessee (but flows from the lessor to a new purchaser) – in such cases, it is usual for the proceeds of the sale to give rise to rental rebates.

The question therefore arises as to whether, notwithstanding the fact that legal title does not really pass (or is expected to pass) in such circumstances set out above, finance leases within the meaning of IAS 17 are treated nonetheless as supplies of goods within the meaning of art 14(2)(b) of the Directive (and Sched 4, para 1(2) of the VAT Act 1994)?

As both art 14(2)(b) of the Directive and Sched 4, para 1(2) of the VAT Act 1994 expressly prescribe that only leases which contemplate for the ownership of the goods to pass in the normal course of events (at the latest upon payment of the final instalment) are to be treated as supplies of goods and otherwise as supply of services, a literal reading of these legislative provisions set out above seems to indicate not.

However, if a wider meaning is given to these legislative provisions and reference to ownership is read as being more economic than legal, then it seems apparent that finance leases should be viewed as a supply of goods (irrespective of whether or not the lease contemplates the passing of legal title).

In *Staatssecretaris van Financien v Shipping and Forwarding Enterprise Safe BV* (C-320/88), the ECJ seemed to indicate as much in its judgment:

'It is clear from the wording of this provision that "supply of goods" does not refer to the transfer of ownership in accordance with the procedures prescribed by the applicable national law but covers any transfer of tangible property by one party which empowers the other party actually to dispose of it as if he were the owner of the property.

'This view is in accordance with the purpose of the [Sixth VAT Directive], which is designed inter alia to base the common system of VAT on a uniform definition of taxable transactions. This objective might be jeopardised if the preconditions for a supply of goods – which is one of the three taxable transactions – varied from one member state to another, as do the conditions governing the transfer of ownership under civil law.

'Consequently, the answer to the first question must be that "supply of goods" in art 5(1) of the Sixth Directive [the previous incarnation of art 14(1) of the Directive] must be interpreted as meaning the transfer of the right to dispose of tangible property as owner, even if there is no transfer of legal ownership of the property.'

It is also pertinent to note the opinion of the Advocate General in *Auto Lease Holland BV v Bundesamt für Finanzen* (C-185/01) where he states that:

'It should be pointed out that art 5 of the Sixth VAT Directive [the previous incarnation of art 14 of the Directive] defines supply of goods as the transfer of the right to dispose of tangible property as owner. When considering the question whether supply of goods requires the transfer of legal ownership of the goods concerned, the

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Court replied, in its judgment in *Shipping and Forwarding Enterprise Safe*, that the term covers any transfer of tangible property by one party which empowers the other party actually to dispose of it as if he were its owner. It is clear from that judgment that supply of goods has a meaning which is more economic than legal. It relates more to the opportunity for the person in receipt of the supply to make use of the goods than to the transfer of actual ownership within the meaning of the civil law of the member states.'

However, the ECJ did not in either of these cases expressly state that finance leases should (on account of their fundamental nature) be treated as a supply of goods and not services.

The ECJ decided to do so in the present case which is the subject matter of this article.

***Eon Aset Menidjmunt OOD v Direktor na Direktsia 'Obzhalvane I upravelnie na izpalnenieto'* (C-118/11)**

The facts of this case are fairly unremarkable in nature and can safely be ignored for the purposes of this article which focuses on the larger question of principle. Nevertheless for completeness, a brief summary is set out below.

Eon Aset Menidjmunt, a Bulgarian company, entered into two car leasing contracts, one an operating lease and the other, a finance lease. The leased vehicles were used to provide its managing director with transport between his home and workplace. The company claimed input tax on the VAT incurred in respect of the leases which was promptly refused by the Bulgarian tax authorities as it contended that the vehicles were not used for the purposes of the company's economic activities. The company brought the case before the Bulgarian courts which referred certain preliminary questions to the ECJ.

The ECJ, before responding to the questions referred to it by the Bulgarian courts, proceeded to set out some preliminary considerations – it opined that although as a basic premise the leasing of a motor vehicle constituted a supply of services and not goods, the lease of a motor vehicle under a financial leasing contract (as it referred to finance leases) may, nevertheless, present features which are comparable to those of the acquisition of capital goods.

The ECJ then referred to IAS 17 (noting that this has been adopted by EC Regulation No 1126/2008 of 3 November 2008) and pointed out the distinction between finance and operating leases within that accounting standard.

After making customary references to (and acknowledgment of) the two cases referred to above, the ECJ put forth the most unambiguous statement on the VAT treatment of finance leases yet:

'… where a financial leasing contract relating to a motor vehicle provides either that ownership of that vehicle is to be transferred to the lessee on the expiry of the contract or that the lessee is to possess all the essential powers attaching to ownership of that vehicle and, in particular, that all rewards and risks incidental to legal ownership of that vehicle are transferred to the lessee and that the present value of the amount of the lease payments is practically identical to the market value of the property, the transaction must be treated as the acquisition of capital goods.'

This seems to indicate that UK's emphasis on whether legal title is expected to pass in the normal course of events (in making the determination whether a lease is a supply of goods or of services) disregarding completely the economic substance of the transaction is misplaced and inconsistent with the ECJ's interpretation of art 14 of the Directive.

This also effectively means that UK's historic treatment of finance leases as supplies of services (except where title is expected to pass) may be incorrect and some taxpayers may seek for this judgment to be applied in the UK on a retrospective basis. It is doubtful however that any such retrospective application of this judgment would be tenable given that this historic treatment of finance leases as services is derived from HMRC's practice and published guidance based on its literal interpretation of the European and UK legislation.

What is more likely however is a prospective change in the treatment of finance leases in the UK – in any case taxpayers who wish to rely on this may choose to apply for a formal ruling from HMRC in respect of current finance leases to which they are party in the event that no 'clarificatory' guidance is forthcoming from HMRC in the near future.

Practical impact of this judgment in the UK

If finance leases were, in the light of this judgment, to be treated as supplies of goods and not services, this will change the manner in which VAT has historically been charged and accounted for in the UK, the amount of VAT that has otherwise been recoverable by taxpayers and the place of supply rules to be applied to determine whether any VAT in payable in the UK in so far as finance leases are concerned.

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Place of supply

Although a detailed analysis of the place of supply rules is outside the scope of this article, it is important to note that different tests are applied to determine the location of supplies of goods and services. Broadly (and quite crudely stated), the place of supply of goods is usually where the goods are located (and by extension this is where the supply is subject to VAT). The place of supply of services rules are far more elaborate – as a general rule, the place of supply of services from one business to another is usually determined by reference to the location of the recipient (subject to various exceptions to which special rules apply).

It is sufficient to note here that any change in the way finance leases are treated in the UK could potentially change the place where the supply is deemed to take place for the purposes of VAT depending on the exact location of the parties to the lease, their VAT status and the location and movement of the goods. Accordingly this could in some cases change the location where VAT is due (if any).

For example, a finance lease of goods located in the UK but between parties located outside the EU would, were it to be treated as a supply of goods, be within the scope of VAT in the UK – however if the finance lease was treated as a supply of services (as has historically been the case in the UK), the place of supply would be outside the EU (assuming here that the goods in question do not constitute a means of transport for the purposes of VAT).

Output VAT and timing

Were a finance lease (not contemplating the transfer of title) to be treated as a supply of services and not goods (as is the traditional position in the UK), the liability to account for output VAT is spread out over the term of the lease given that there will be a successive supply of services in respect of each rent payment and the value of the supply will be the value of individual lease instalments.

However, if the same finance lease is now treated as a supply of goods, there will be an obligation to account for VAT upfront (when the lease commences) on the full value of the supply of goods. This may result in considerable financing costs (in respect of VAT) for the parties to the lease.

Input VAT

The financing element of a finance lease (other than a hire purchase agreement) is currently treated as an ancillary supply to the main taxable supply of the leased item and therefore does not constitute a separate exempt supply of financing. This is in contrast to hire purchase agreements where financing services are (strictly speaking) a separate supply for the purposes of VAT (although the UK VAT legislation curiously allows for such treatment only if the separate credit element is specified in the lease).

However, were finance leases to be treated as supplies of goods and not services, it is likely that the financing proportion of the lease rental may be exempt for the purposes of VAT – this would impact on the amount of VAT that the lessor may be able to recover.

Conclusion

It is likely that the pronouncement of the ECJ in this case will push the member states to take a harmonised view in so far as the VAT treatment of finance leases is concerned. The fact that IAS 17 has been sign-posted as a reference point by the ECJ should ensure that a certain level of uniformity will apply across the EU as to what is (and is not) a finance lease for these purposes.

However, in the short term, some administrative upheaval (and uncertainty) in respect of historic leasing transactions can be predicted given that some EU member states may have to, as a result of this case, revise their long-stated position vis-à-vis the VAT treatment of finance leases in their respective jurisdictions.

Endnote

1. Hidden right below the ruling on this point is another innocuous statement by the ECJ: 'It is for the national court to determine, having regard to the circumstances of the case, whether the criteria stated in the preceding paragraph of this judgment are applicable.' This leaves open the possibility that a national court may, when faced with different facts, come to a different conclusion.

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