Introducing VAT liabilities: a wrong turn for supply classification

Indirect Tax



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The Court of Appeal judgment in *Gray & Farrar* on the VAT liability for its matchmaking service raises important points about the method of supply classification.

Key Points

What's the issue?

The Court of Appeal has held that a matchmaking agency was not providing services of consultants because the 'predominant element' of its supply was the making of introductions.

What does it mean for me?

As well as the impact on the consultancy profession more generally, the Court of Appeal approved the Upper Tribunal's formulation of a 'hierarchy' of tests for supply classification, identifying a 'predominant element' test as the main one.

What can I take away?

Recent CJEU case law refuting the existence of a 'predominant element' test was not brought to the court's attention, calling into question its guidance. If there is no appeal to the Supreme Court, advisers must consider carefully how best to engage with HMRC on supply classification until the position is resolved in a future case.

The Court of Appeal judgment in *HMRC v Gray & Farrar International LLP* [2023] EWCA Civ 121 may seem inconsequential – a case about a niche sector, apparently answered by clause 1 of the contract. In fact, it raises two important points: the first about the scope of consultants' services; and the second about the very method of supply classification for VAT.

The case

The case concerns Gray & Farrar's VAT liability on its matchmaking service for clients outside the UK and EU. Under Article 59(c) of Council Directive 2006/112/EC (the 'Principal VAT Directive'), the place of supply of 'the services of consultants, … consultancy firms … and other similar services, as well as data processing and the provision of information' to a non-taxable person is the place where that person is established or resides.

In essence, Gray & Farrar agreed to provide clients with a minimum of eight carefully curated 'introductions' to potential matches over a 12-month period, having discussed, verified and considered their clients' characteristics, suitability and requirements.

Clause 1 of the contract sets out Gray & Farrar's obligation to 'provide you, within 12 months of your becoming our client, with a minimum of eight introductions that we consider suitable for your requirements'. An 'introduction' was an exchange of telephone numbers.

The decisions below

The First-tier Tribunal decided that providing contact details where a person had been verified by Gray & Farrar and was considered compatible fell within paragraph (c) because it was the provision of information and advice. However, the presiding judge concluded that 'post-introduction' services of Gray & Farrar's liaison team went beyond this and involved material support in developing a relationship which fell outside the paragraph. He exercised his casting vote and dismissed the appeal.

The Upper Tribunal held that the First-tier Tribunal had erred in its approach to supply classification. It considered that the CJEU's judgment in *Mesto Zamberk v Financni reditelvsti* (Case C-18/12) ('*Mesto*') set out the primary test for characterising a supply – a 'predominant element' test.

Since the First-tier Tribunal failed to apply this test, the Upper Tribunal considered that it could remake the decision. It held that 'the qualitatively most important element to the typical consumer was the provision of the introduction to a prospective partner', which incorporated the provision of both information and advice about the potential match. The supply therefore fell within paragraph (c).

'Post-introduction' services were not reflected in Gray & Farrar's contract and were insufficient to disturb that conclusion.

The Court of Appeal's judgment

In the Court of Appeal, the parties agreed that services of consultants involved giving 'advice based on a high degree of expertise'. Since clause 1 of the contract stated that clients paid for eight 'introductions' (rather than for 'advice'), the court purported to apply *Mesto* and concluded that the 'predominant element' of Gray & Farrar's supply was the provision of introductions. The judges held that dissecting this introduction service further into its constituent elements of advice and information, as the Upper Tribunal had done, was artificial. Since an introduction service was not a service habitually supplied by consultants or consultancy firms, the Court of Appeal allowed HMRC's appeal.

What is advice based on expertise?

The court's analysis seems unduly restrictive, both in relation to paragraph (c), and to Gray & Farrar's services. It also has the potential for unexpected consequences. The most obvious is the treatment of recruitment consultants paid to match

candidates to suitable jobs which would now seem to fall outside paragraph (c).

What of consultants hired not just to advise but also to implement projects? Implementation is a common feature of 'the myriad of possible forms of modern consultancy work' (to borrow the Advocate General's language from *Maatschap M and others v Inspecteur der Belastingdienst/Ondernemingen Roermond* (Case C-167/95)).

In Gray & Farrar's case, introductions were not just names plucked from the phone book. Gray & Farrar considered a client's brief, undertook necessary research and applied their specialist expertise to make tailored recommendations. Isn't making a recommendation in these circumstances the giving of advice based on a high degree of expertise? Or on any view, the implementation of such advice? Aren't these the hallmarks of 'modern consultancy work'? Bearing in mind that Gray & Farrar's fees range from £15,000 to £140,000, it seems tolerably clear that clients are really paying for the application of Gray & Farrar's specialist expertise, as a matter of economic reality.

The 'predominant element' test: a wrong turn?

Turning to the matter of supply classification, the Court of Appeal approved a 'hierarchy of tests' to be applied in characterising a single supply for VAT purposes. This hierarchy was first identified by the Upper Tribunal in *HMRC v Metropolitan International Schools Ltd* [2017] UKUT 431 (TCC):

1. 'The *Mesto* predominance test should be the primary test to be applied in characterising a supply for VAT purposes.
2. 'The principal/ancillary test is an available, though not the primary, test. It is only capable of being applied in cases where it is possible to identify a principal element to which all the other elements are minor or ancillary. In cases where it can apply, it is likely to yield the same result as the predominance test.
3. 'The 'overarching' test is not clearly established in the ECJ jurisprudence, but as a consideration the point should at least be taken into account in deciding averments of predominance in relation to individual elements, and may well be a useful test in its own right.'

The 'overarching' test at (3) comes from *HMRC v College of Estate Management* [2005] UKHL 62, where the House of Lords held that distance learning courses were

educational services, not supplies of books. It has been neatly explained by the High Court in *Byrom, Kane & Kane (t/a Salon 24) v Revenue & Customs* [2006] EWHC 111 as meaning ‘a generic description of the supply which is distinct from the individual elements. In many cases the tax treatment of that overarching single supply according to that description will be self-evident.’

In contrast, the ‘predominance test’ at (1) is said to emanate from *Mesto*, a case about entry fees to an aquatic park which contained a variety of sporting and leisure facilities. It involves weighing up the individual elements of a supply to determine what the typical consumer would regard as qualitatively the most important one.

The Court of Appeal concluded that *Mesto* went further than the earlier cases and established a new principle of EU law that the predominant element test was mandatory and was the primary test to be applied in characterising a supply for VAT.

This is surprising, not least because the CJEU in *Mesto* proceeded to judgment without an Advocate General’s Opinion. In other words, the CJEU thought the case raised no new point of law (see Article 20(5) of the Statute of the CJEU). This is a clear indication that the CJEU was not seeking to go further than its previous case law, far less to mandate a new primary test.

With respect to the Court of Appeal, this is also a misreading of *Mesto* itself and a detailed analysis of the key paragraphs in *Mesto* appears in the longer version of this article. CJEU support for the ‘overarching’ approach is to be found in a post-Brexit judgment of the CJEU, *Frenetikexito – Unipessoal Lda* (Case C-581/19). Unfortunately, this case does not appear to have been brought to the court’s attention.

Frenetikexito: **important guidance**

Frenetikexito concerned a fitness studio that offered a fitness service and a nutrition advice service. The question was whether the studio made a single supply or multiple supplies. If the latter, was the nutrition advice service exempt medical care?

In contrast to *Mesto*, the Advocate General in *Frenetikexito* explains that the referring court (Portugal) could not identify clear criteria for assessing bundles of supplies from the CJEU’s existing case law. This case has therefore given the CJEU

the opportunity to clarify the criteria governing the VAT treatment of bundles of supplies so as to provide national courts with legal certainty. The paragraphs of central relevance to this article (AGO [22]-[33]) were expressly approved by the CJEU, underlining that the Opinion contains important clarification and analysis.

There is no substitute for reading both the Opinion and the judgment in full. Not only do they identify the different situations in which a single supply exists, but they also summarise the relevant indicia for differentiating between them. For present purposes, the salient points are:

- Every supply must normally be regarded as distinct and independent (AGO [16]).
- There are two exceptions arising from the CJEU's case law: (a) single complex supplies; and (b) dependent ancillary supplies (i.e. principal/ancillary cases) (AGO [21]).
- The Advocate General is clear that where there is a single complex supply (i.e. where the first exception applies), the multiple elements of the supply form one *sui generis* supply (AGO [22]). The individual elements merge into a new *distinct* supply such that there is only a single supply from the viewpoint of a typical consumer (AGO [25]). This is the same as the 'overarching supply' analysis: 'a generic description of the supply which is distinct from the individual elements. In many cases, the tax treatment of that over-arching single supply according to that description will be self-evident' (*Byrom* at [43]).

AGO [27] and [28] are worth setting out in full:

- '27. From the perspective of the typical consumer, where there is a single complex supply the individual elements lose their independence and become secondary to a new sui generis supply. The object to be examined is then only that single supply as a whole. Any weighting of the individual elements of the supply is rightly irrelevant. It is also to be determined solely according to the generally accepted view whether the single complex supply constitutes a supply of goods under Article 14(1) or a supply of services under Article 24(1) of the VAT Directive.
- 28. It is therefore slightly misleading when the Court sometimes states that the material factor in the assessment of a single supply is whether the elements of the supply of goods or of the supply of services "predominate". This wording suggests that the individual elements must be broken down and then weighed.

> In fact, this merely distinguishes between whether, in the generally accepted view, the complex (sui generis) supply is to be regarded as a supply of goods or a supply of services.'

Does it matter?

The Court of Appeal seems to accept that exceptions to the predominant element test might exist – but given the imprecise nature of the test itself (something that is more than merely important or essential, but not dominant enough to be a principal supply), how is one supposed to know in practice if a taxpayer's case is indeed an exception? Moreover, both *Metropolitan International Schools* and *Gray & Farrar* illustrate the difficulties in applying a primary 'predominant element' test:

- In *Metropolitan International Schools* (another distance learning case), the Upper Tribunal was unable to identify the predominant element of the supply, other than that it was not books. This was sufficient to dispose of *that case* – but had the tribunal needed to identify what the supply was (as opposed to what it was not), by its own admission it would have had to resort to the 'overarching' test to characterise the supply as that of educational services.
- In *Gray & Farrar*, notwithstanding that both the Upper Tribunal and the Court of Appeal purported to apply the same 'predominant element' test, they reached opposing conclusions because they disagreed on how far the individual elements they were trying to weigh should be broken down.

Advising taxpayers and corresponding with HMRC

If *Gray & Farrar* is not overturned on appeal, the Court of Appeal's 'hierarchy of tests' will likely be binding on taxpayers and HMRC since *Frenetikexito* is a post-Brexit CJEU judgment. Domestic case law may take another turn if and when the higher courts come to consider *Frenetikexito*. Pending any restatement, we are left with a disconnect between the approach of the UK courts on the one hand and the CJEU on the other. In dealing with HMRC and the tribunal, advisors should be careful not to be over-reliant on a 'predominant element' test to the exclusion of all other analyses and should ensure that a taxpayer's facts, evidence and legal analysis can also be presented in such a way to satisfy the guidance in *Frenetikexito.*

This article comes from a longer piece which can be found at:
www.11newsquare.com/gray-farrar-accidental-departure-from-cjeu/

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