



Mercedes-Benz Financial Services (C-164/16) – AGO – Risk or Opportunity

The Advocate General [Opinion](#) (AGO) was recently released in a case involving the VAT treatment of a common type of hire purchase (HP) contract. Readers will probably be aware that HP contracts are a common method of financing the purchase of new and used cars in the UK. Therefore, this case potentially has significant ramifications for the automotive retail and finance sectors.

Background

Traditional HP contracts have been used to finance the purchase of expensive consumer goods in the UK since the 19th century. Under a HP arrangement the customer takes possession of the goods and pays for them in regular/equal instalments (i.e. weekly or monthly) over an agreed period. On payment of the final instalment, ownership of the goods is transferred to the customer. Typically, each instalment will include an amount of capital and finance.

Since the introduction of VAT in the UK in 1973, these contracts have been treated as a taxable supply of goods and an exempt supply of finance. During the mid-1990s, Personal Contract Plans (PCP) which are a form of HP, evolved in the automotive retail sector. Under these contracts, a customer pays lower monthly instalments resulting in a higher final payment (often referred to as a 'balloon payment'). These have also been treated as a taxable supply of goods and an exempt supply of finance for UK VAT purposes. As a supply of goods VAT is due on the full capital value of the goods at the inception of the contract.

The relevant EU legislation is Article 14(2)(b), Principle VAT Directive which deems there to be a supply of goods in the event of *"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."* (emphasis added).

The emphasis is added because under the UK Consumer Credit Act 1974, a consumer has the right to voluntarily terminate a HP type contract and hand possession of the goods back to the finance company once he/she has paid instalments equal to 50 percent of the total amount payable under the contract. Consequently, in a significant proportion of PCP contracts involving car sales, ownership of the vehicle will never pass to the customer.

In recent years, it is these PCP arrangements which have largely fuelled the high level of UK new car sales. As a result, the FCA is considering more stringent regulations which would usher in strict affordability checks which the media has suggested is in a bid to avoid a PCP-prompted financial crisis.

MBFS 'Agility' Contract

The MBFS Agility finance arrangement was aimed at customers who did not know at the outset of the arrangements whether they would ultimately want to purchase the vehicle or hand it back. Thus the HP contract entered into by the customer largely reflected the form of a PCP contract; specifically the final balloon payment was marketed as being entirely optional for the customer (which was then reflected in the form of the contract).

MBFS therefore maintained that its Agility PCP contract should be treated as supplies of services, rather than goods on the basis that ownership of the vehicle would not necessarily pass in the normal course of events. The effect of treating the PCP contract as one of taxable services is that the VAT is payable based on each monthly instalment rather than on the full vehicle value at the inception of the contract. Such treatment gives rise to a significant working capital improvement for the finance company.

MBFS AGO

In referring to Article 14(2)(b), the Advocate General described 'in the normal course of events' as a series of events envisaged by the contract. This can include agreements where the option to purchase fee is not mandatory but is only symbolic in value (e.g. £95) such that in practice transfer of ownership is the only economically rational course of action. This concept however cannot include the situation, as in the case of the Agility contract, where the customer has a genuine economic choice based on a non-mandatory balloon payment. In this situation, 'in the normal course of events', ultimate transfer of ownership to the customer is just as likely to occur as not.

The Advocate General has therefore found that the Agility PCP contract should be treated as services for VAT purposes on the basis that the final balloon payment is both contractually optional (i.e. not a mandatory instalment contractually due under the agreement) for the customer and significant (i.e. akin to a lease). However, the AGO also confirmed that where the sum of the mandatory instalments under a HP/PCP contract (including any balloon payment) is virtually equivalent to the purchase price of the car, the contract includes an ownership transfer clause and any option to purchase fee is only symbolic in value, the required tests are met and these contracts fall to be treated as a supply of taxable goods.

KPMG's view

In the event that the CJEU confirms this AGO, it is KPMG's view that the VAT treatment of PCP contracts will be determined on the basis of whether the balloon payment is either contractually mandatory and, where it is not, whether it is significant.

However, businesses wishing to utilise or adopt such a position and gain access to the resulting working capital improvement should consider whether the VAT liability of the finance charges could also be affected. As noted by the Advocate General *"...a leasing agreement is normally a substitute for the acquisition of the ownership of the subject matter of the leasing agreement – it allows him to use it as if he were the owner without having to pay the full purchase price immediately; on the other hand, the instalments paid by the lessee...during the lease term must, as a rule, cover the cost of acquisition, depreciation and financing of the subject matter of the leasing agreement by the lessor."*

In the above circumstances, it is generally accepted that the finance element included in the lease payments are part of a series of single taxable supplies of services. Therefore, where a PCP contract results in a supply of services (akin to a lease) which gives rise to the working capital improvement there is a risk that the UK tax authorities will treat the finance element as part of the taxable supply of services.

Consequently, the impact of treating certain PCP contracts as supplies of services for VAT purposes will need to be fully evaluated on a business-by-business basis. KPMG's automotive indirect tax team can assist businesses to understand the potential wider implications of this AGO in order that a fully informed strategy can be developed ahead of the release of the full CJEU (which is typically handed down within three months of the AGO) decision in this matter.

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