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Centralan Property Ltd v C & E Comrs (Case C-63/04)

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Capital goods scheme – adjustments to deductions under Article 20 (3) following disposal of land – regulation 115(3) Value Added Regulations 1995 – disposal by means of two linked transaction – apportionment

Centralan Property Ltc v C & E Comrs (Case C-63/04) (Judgment released on 15 December 2005) concerned the proper application of the system of deductions envisaged by Article 20(3) of the Sixth Directive, following the disposal of a single parcel of land through two linked transactions: an exempt supply of a 999-year lease, and a taxable supply of the reversionary interest in the land.

It would appear from the history of the case that the University of Central Lancashire Higher Education Corporation wished to procure the construction of a new building, known as the Harrington Building, to be used for the purpose of its mainly exempt activities. In an attempt to minimise its VAT liability the University put in place a structure involving a number of subsidiary companies and a series of transactions involving the Harrington Building.

In September 1994, following completion of the Harrington Building, the University sold the same to Centralan Property Ltd (Centralan), the appellant in the national proceedings, for £6.5m plus VAT. Centralan was a wholly owned subsidiary of Centralan Holdings Ltd, itself wholly owned by the University.

At the same time, Centralan, having opted to tax, leased the Harrington Building back to the University for a term of 20 years at a yearly rent of £300,000 plus VAT. From the perspective of the University, these two transactions had the effect of replacing the (otherwise) non-deductible VAT which had been paid during construction with the non-deductible VAT on the rents to be paid during the 20-year term.

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The Harrington Building amounted to capital goods in the hands of Centralan and adjustments therefore had to be made pursuant to Article 20 and the national provisions implementing that regime. During the third interval for the purpose of that regime, Centralan disposed of its whole interest in the building so that a final adjustment was required pursuant to Article 20(3) of the Sixth Directive, implemented through regulation 115(3) of the VAT Regulations 1995.

That disposal was effected by means of two separate transactions: a 999-year lease to Inhoco 546 Ltd (another wholly owned subsidiary of Centralan Holdings Ltd) for £6.37m and a transfer of the freehold reversion to the University for £1,000. By reason of VATA 1994 Sch 10 para 2(3A) (repealed soon after the transaction was completed), the grant of the lease to Inhoco was an exempt supply, as the two companies were connected within the meaning of that subparagraph. The transfer of the freehold reversion, on the other hand, was a taxable transaction as the supply of the freehold in a new non-residential building was excluded from exemption by reason of VATA 1994 Sch 9 Group 1 Item 1(a)(ii).

A question arose as to the correct application of the rules about final adjustment under Article 20(3). The VAT and Duties Tribunal, following HMRC's alternative argument, concluded that an apportionment should be made, by reference to the respective values of the 999-year lease and the reversionary interest should be made, resulting in a liability on the part of the appellant of some £796,000. This was on the basis that, in the Tribunal's view, the appellant company had disposed of its interest in the building by means of two supplies, one exempt and one taxable, which were ineluctably linked and preordained.

In reaching its conclusion, the Tribunal had rejected Centralan's argument that final disposal of the interest in the Harrington Building had only taken place and could only have taken place by means of transfer of the reversionary freehold interest and that, accordingly, only that latter transaction, fully taxable, ought to be taken into account when applying Article 20(3).

On appeal by the taxpayer, the High Court referred the matter to the ECJ for a preliminary ruling and effectively asked for guidance on the method by which the initial deduction of VAT by Centralan was to be adjusted, pursuant to Article 20(3), following disposal in the circumstances of the case. Essentially three possibilities were envisaged by the question referred:

(1) that the capital good should be regarded as having been used for business activities which are presumed to be fully taxed, by only taking into account the taxable supply of the reversionary freehold interest;

(2) that they be presumed to be fully exempt, by only taking into account the exempt supply of a 999-year lease; or

(3) that they be presumed to be partly taxable and partly exempt, in the proportion of the values of the two transactions.

Centralan, supported by the Commission, argued that Article 20(3) provided no discernible basis for permitting several transactions to be taken into consideration in proportion to their respective values. Accordingly, as the transfer of ownership was not finally effected until the reversionary freehold interest was transferred to the University, only this taxable transfer could form the basis of calculations of any adjustments under Article 20(3).

The Commission, though agreeing with Centralan as set out above, then went on to suggest that the principle of abuse of right might be utilised in order to disregard transactions with no economic justification which produce artificial situation, such as that in the present case, the sole purpose of which was to create the conditions necessary for the recovery of input VAT. No argument on the possible application of the principle of abuse had been advanced before the national courts.

The United Kingdom, on the other hand, argued that the purpose of the rules governing deduction, including Article 20(3), is to determine the proportion of VAT deductible so as to correspond as precisely as possible to the use to which the inputs are put by the taxpayer. In a case such as the present one, where capital goods are supplied by means of two preordained transactions, an apportionment by reference to the value of each transaction would be appropriate and would reflect the purpose of the relevant provisions.

Despite the clear wording of Article 20(3), which does not expressly envisage any apportionment of the sort suggested by the United Kingdom, the ECJ, largely following in this respect Advocate-General Kokott, had little difficulty in disposing of much of the taxpayer's arguments, subject to some caveats considered further below.

After setting out well-known principles in relation to deduction of input tax pursuant to Article 17, it went on to hold that the rules relating to capital goods found at Article 20 were intended to enhance the precision of deductions and to establish a close and direct relationship between the right to deduct input VAT and the use of the goods for taxable transactions. That Article did not dictate that, where the supply of the building was carried out by means of two closely and inextricably linked transactions, only one of those transactions should be taken into consideration for the purpose of the adjustment envisaged by that Article. On the contrary, taking into account each of the two transactions in proportion to their respective values was likely to better attain the objective of the system of deductions established by the Sixth Directive. That interpretation could not be rejected simply because no apportionment mechanism was expressly provided for in Article 20(3), as that Article has to be interpreted in the light of the objective of the adjustment rules relating to capital goods, which was to ensure that deductions of input VAT closely reflected the use of durable inputs for the purpose of taxable transactions.

This conclusion is subject to two important caveats, which might well lead to further litigation before the High Court.

Firstly, the ECJ, at paragraph 38 of its judgment, makes it abundantly clear that its consideration of the questions referred is limited solely to a situation whereby "two inextricably linked transactions have been concluded". Clearly it is now open to the taxpayer to seek to overturn that particular finding of fact by the Tribunal on usual limited grounds, though this might prove a difficult task on appeal.

Secondly, the ECJ based its conclusions on the assumption that, as a matter of English law, the transactions gave both the University and Inhoco the right to dispose as owner of the Harrington Building. At the same time, at paragraph 64 of its judgment, the ECJ made it clear that it was solely for the national court to assess whether, in the specific circumstances of the case, that was, in fact, the case. Accordingly, it might just be possible for the taxpayer to persuade the national court that only Inhoco obtained the right to dispose of the building as owner, to the exclusion of the University, though comments made by the ECJ at paragraph 66 would probably render such an argument difficult to support.

It is perhaps noticeable that, by applying a purposive approach to what appears to be the otherwise clear wording of Article 20(3), the ECJ has deftly side-stepped the need to consider the potential application of the principle of abuse of rights in a case such as this. Indeed, such side-stepping is expressly acknowledged by the comments found at paragraphs 60 and 61 of the Opinion of Advocate-General Kokott. We will have to await the judgment in the Halifax group of cases for further guidance on the application of that principle.

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