Appeal number: TC/2010/03391

VAT – zero rating – supplies of military reconnaissance equipment from second appellant to first appellant and from first appellant to United States government for onward sale to governments of Poland and Greece pursuant to US "Foreign Military Sales" programme – whether zero rated under VATA Schedule 8, Group 13, item 2 (supply to an overseas authority charged with the management of a defence project the subject of an international collaboration arrangement in the course of giving effect to that arrangement) – whether US Foreign Military Sales programme is such an arrangement – note (1) to item 2 considered – held no – appeal dismissed

FIRST-TIER TRIBUNAL
TAX CHAMBER

GOODRICH CORPORATION (1) **Appellants**
ROSEMOUNT AEROSPACE LIMITED (2)

-and-

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS **Respondents**

TRIBUNAL: **JUDGE KEVIN POOLE**
SHAMEEM AKHTAR

Sitting in public in Priory Court, Birmingham on 14 July 2014

Geoffrey Tack of DLA Piper UK LLP for the Appellant

Raymond Hill of counsel instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents

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DECISION

Introduction

1. This appeal concerns the appropriate VAT treatment of certain sales of military reconnaissance equipment to the US government (through the US Department of Defense) for onward sale to the governments of Poland and Greece under the umbrella of the "Foreign Military Sales" programme of the US government.

2. The point at issue in the appeal was whether the relevant supplies fell within the terms of a particular zero-rating provision which appears as item 2 in Part 13, Schedule 8 Value Added Tax Act 1994 ("VATA").

3. At the heart of the dispute between the parties was the question of whether the arrangements under which the sales were made amounted to an "international collaboration arrangement" for the purposes of item 2, as defined in Note (1) to item 2 of Schedule 8 VATA.

The facts

4. The parties had agreed a statement of facts, which was submitted to us together with a bundle of documents. We heard no live evidence, apart from some minor explanations of some of the material before us, which was provided informally by Mr Patrick Duffy of the first Appellant. Mr Hill helpfully agreed to this informal approach.

5. The statement of facts contained a great deal of information which is not particularly relevant to the issues in dispute between the parties, so we do not propose to set it out in full. The relevant facts can be summarised as follows.

6. The US government runs a programme called the "Foreign Military Sales Program" ("FMS"). FMS is part of the "Security Assistance" which is authorised in the US under its Arms Export Control Act. Its stated purpose is to support US foreign policy and national security objectives. It provides a structure under which the US government may enter into formal contracts with foreign governments or international organisations for the sale of military hardware and/or training and support, which the US government will source from its normal suppliers for onward sale to them. In doing so, the US government acts through the US Department of Defense (within which the Defense Security Cooperation Agency carries out the main responsible role for FMS).

7. In broad terms, if a foreign government wishes to procure hardware under the FMS, it will send a "Letter of Request" to the US government's representative. If the request is approved, a "Letter of Acceptance" will be sent in reply. The US government will then enter into contracts to acquire the relevant goods with its own suppliers (if it is not in a position to supply the goods from its own stocks) and supply them on to the foreign government.

8. Prospective purchasers also have the option of contracting direct with the manufacturers of the relevant hardware outside of FMS. The indications in the documents before us were that this would be an appropriate route to follow if the purchaser wished to acquire "non-standard" goods; the main thrust of FMS appears to be the sale to foreign governments (and international organisations) of "standard issue" goods as used by the US military.

9. The US government does not seek to make a profit out of FMS, simply charging a flat rate 3.8% fee to cover its costs of administering it. For a purchaser, it appears that the savings that might be available by effectively "piggy backing" on the buying power of the US Department of Defense and avoiding the need to negotiate its own direct contracts with the underlying suppliers can more than outweigh the administration fee.

10. Included in the bundle of documents before us was a copy of an extract from a US Department of Defense document relating to FMS. The extract was headed "Chapter 4 – Foreign Military Sales Program – General Information" and included the following text under the subheading "C4.6 General FMS Financial Policies":

> "C4.6.10 Recovery of Cost. The FMS program must be managed at no cost to the USG *[US Government]* (with certain exceptions specifically identified in the AECA *[Arms Export Control Act]*). The LOA *[Letter of Offer and Acceptance]* mandates that the purchaser pay the full program value regardless of the terms of sale specified for the individual case or the estimated values provided…"

11. No copy of the original Letter of Offer and Acceptance applicable to either of these two transactions was provided to us – perhaps unsurprisingly, as those documents would be confidential to the respective contracting governments and presumably highly sensitive. There were however some copy amendments to the original Letters which were included in our bundle (marked "Draft"), which contained the following standard form clause:

> "d. Taxes, Duties and Charges for Doing Business.
>
> The contract(s) implementing this LOA will include the clause entitled "Taxes – Foreign Fixed-Price Contracts (Jan 1991)" set forth in Federal Acquisition Section 52.229-6; therefore, price and delivery estimates within this LOA anticipate the following:
>
> (1) Property, materiel, equipment, household furniture, appliances, and supplies imported into [Poland/Greece] by contractor exclusively for use in support of the contractor and its personnel and consigned and marked as required or approved by the USG will be exempt from import and export duties, taxes, licenses, excises, imports, and any other identifiable charges. The contractor will maintain any *[sic]* inventory control and accounting system adequate to reflect the usage and disposition of all contractor-owned property which has entered [Poland/Greece] duty-free under this LOA.

> (2) The [GOP/GOG[1]], its agencies, and political subdivisions will levy no taxes or fees (including taxes on individual or corporate income or property, customs and import duties, or other taxes on employee personal household goods, supplies and personal effects imported into [Poland/Greece] for personal use) on the contractor, its employees, or the dependents of such employees.
>
> (3) If any charges under d(1) or (2) are imposed by the [GOP/GOG], costs thereby incurred by the contractor will be reimbursed to the contractor at cost, including applicable overhead and General and Administrative, but excluding profit, out of national funds to be provided by the [GOP/GOG] under this LOA."

12. Most countries around the world are included on the list of countries eligible to take advantage of FMS, including the UK.

13. The goods the subject of this appeal comprise ground stations which operate as part of the Goodrich DB-110 Reconnaissance System. The system as a whole comprises essentially two elements: an electro-optical/infrared sensor which can be mounted on either a manned or unmanned aircraft; and a ground station (which can be either fixed or mobile), to which the sensor's signals are transmitted.

14. The governments of Greece and Poland decided they wished to acquire the system. They approached the US government under the FMS. The US government agreed to commission and supply the systems under that programme. They then placed orders with the UK branch of the first Appellant (a US corporation which also operates in the UK and is VAT registered here). The first Appellant provided the airborne elements of the systems (which are not the subject of this appeal) from outside the UK, but commissioned the second Appellant (which is within the same corporate group, though separately registered for VAT) to manufacture the ground stations in the UK and supply them to it for onward supply to the US government (and, ultimately, to the Greek and Polish governments).

15. It is common ground that the second Appellant supplied the ground stations to the first Appellant in the UK, and that the first Appellant's supply of them to the US government also took place in the UK. The US government then supplied them (along with the airborne sensors, manufactured by the first Appellant elsewhere) to the governments of Poland and Greece.

16. The second Appellant did not seriously dispute that its supplies to the first Appellant were standard rated (in the amended grounds of appeal, it was stated that those supplies "may conceivably be standard rated"). The first Appellant is concerned to establish that its supplies to the US government were zero-rated, in order to avoid any liability to output tax on that supply whilst preserving its right to recover any input tax properly chargeable to it by the second Appellant.

17. The transactions in question occurred over the period July 2006 to December 2009. On 4 September 2009, the Appellants' advisers wrote to HMRC seeking

[1] Government of Poland/Government of Greece

confirmation that the supplies could be zero rated. HMRC decided they could not, and issued a decision to that effect on 9 October 2009. Following some further correspondence, a final decision was issued on 4 March 2010, confirming the decision. Assessments were subsequently issued to both Appellants in respect of the various supplies (presumably after a detailed investigation of the facts) in September and October 2010. Nothing turns on the amounts of the assessments and we do not therefore set out further details of the amounts. Suffice it to say that the amounts involved are well into seven figures in aggregate.

The law

18. The parties are agreed that the relevant provision is that contained in Item 2, Group 13, Schedule 8 VATA (headed "Imports, exports, etc"). Supplies of goods or services falling within that item are zero rated by virtue of section 30 VATA. That item (with the relevant associated Notes) reads as follows:

> "Item No….
>
> 2 The supply to or by an overseas authority, overseas body or overseas trader, charged with the management of any defence project which is the subject of an international collaboration arrangement or under direct contract with any government or government-sponsored international body participating in a defence project under such an arrangement, of goods or services in the course of giving effect to that arrangement.
>
> …
>
> Notes:
>
> (1) An "international collaboration arrangement" means any arrangement which –
>
> > (a) is made between the United Kingdom Government and the government of one or more other countries, or any government-sponsored international body for collaboration in a joint project of research, development or production; and
> >
> > (b) includes provision for participating governments to relieve the cost of the project from taxation.
>
> (2) "Overseas authority" means any country other than the United Kingdom or any part of or place in such a country or the government of any such country, part or place.
>
> (3) "Overseas body" means a body established outside the United Kingdom.
>
> (4) "Overseas trader" means a person who carries on a business and has his principal place of business outside the United Kingdom."

19. The parties are agreed that this provision is one of the longstanding derogations permitted by Article 110 of the Principal VAT Directive 2006/112/EEC. The decision whether or not this provision applies is therefore accepted by both parties as being a decision which is to be taken purely on the basis of domestic UK law (see the ECJ decision in *Talacre Beach Caravan Sales Ltd v HMRC* [2006] CMLR 31, at [22]). Mr Hill also submitted that para [23] of the same ECJ decision made it clear that such provisions, constituting exceptions to the general principle that VAT is to be levied on all goods or services supplied for consideration by taxable persons, are (as such) to be interpreted strictly. We accept this submission, as Mr Tack also appeared to (though our decision would have been the same even without applying a "strict" interpretation).

Submissions of the parties

20. Neither party sought to distinguish sharply between the positions of the two Appellants for the purposes of this appeal, in spite of the fact that the second Appellant's supplies were made to the first Appellant and the first Appellant's supplies were made to the US government (through the US Department of Defense). Mr Hill evidently took the view that there was no need to consider such matters, bearing in mind the unavailability (in his submission) of zero rating in any event. Mr Tack appears to have accepted (without formally conceding) that the second Appellant's supplies could not qualify for zero rating as they were made to the first Appellant. He therefore focused his submissions on the position of the first Appellant (which would presumably be able to recover as input VAT any VAT charged to it by the second Appellant, irrespective of the outcome of this appeal).

Appellants' submissions

21. In the Appellants' amended grounds of appeal, it was argued that the first Appellant had supplied goods to the US Department of Defense, an overseas authority; the US Department of Defense was charged with the management of FMS through the Defense Security Cooperation Agency, and that programme amounted to a defence project; and finally that the defence project in question was "subject to an international collaboration arrangement or under direct contract with any government participating in a defence project under such an arrangement", by virtue of the fact that the ultimate supply of goods under FMS was made to the Polish and Greek governments, who were both members of NATO.

22. In Mr Tack's skeleton argument, this argument was modified slightly. Instead of arguing that FMS was itself a "defence project", Mr Tack submitted that "the transactions in the present appeal are defence projects, which emanate from the FMS programme", which itself fulfilled the requirements for an international collaboration arrangement. He went on to argue that the UK government was "clearly an international collaborating party in the relevant DB110 defence projects"; he cited NATO (and "the respective countries' membership" of it) as being "exemplary of international collaboration"; he referred to the UK's "collaborative role" being shown by its "eligibility in the FMS programme to purchase from the US DoD"; he also referred to the UK's "historic involvement in DB-110" and asserted that "if the UK

had not actually been **involved** in the DB-110 project the transactions concerned would not have taken place." This was, in his submission, sufficient "involvement" of the UK government to constitute an "international collaboration agreement" to which the particular transactions were subject.

23. At the hearing, he developed this last point somewhat further, arguing that the UK government was involved in the arrangement because it also used the DB-110 system and the systems were actually manufactured in the UK.

HMRC's submissions

24. On behalf of HMRC, Mr Hill accepted that the first Appellant's supplies were made to an overseas authority (in the form of the US Department of Defense, an organ of the US government), and that the US Department of Defense was charged with the management of "the relevant defence project". As he characterised it, the dispute between the parties was as to whether 'the project in question was the subject of an "international collaboration agreement".'

25. He said there were two reasons why it was not. The first was that there was no arrangement between the UK government and any other government (or government-sponsored international body) for collaboration in a joint project of research, development or production (as required by Note 1(a) to Group 13, Schedule 8 VATA) which encompassed either or both of these FMS supplies. The second was that even if such an arrangement were found to exist, it did not include any provision for participating governments to relieve the cost of the project from taxation (as required by Note 1(b) *ibid*).

26. Mr Hill argued that any "defence projects" involved in these arrangements were between the USA and Poland/Greece. The UK had no involvement. The fact that UK, like the USA, Poland and Greece, was a member of NATO was irrelevant, because the North Atlantic Treaty was not an "international collaboration arrangement" as it was not concerned with "collaboration in a joint project of research, development or production", but was rather an arrangement for mutual defence; nor did NATO membership have anything to do with these FMS sales. The same applied to FMS itself – which was a structure unilaterally established by the US government rather than any kind of collaboration arrangement; further, FMS was concerned with simple procurement of existing defence products, not collaborative research, development or production of such items. In addition, in considering this procurement, the UK government had no involvement whatsoever.

27. By way of contrast, he referred to what he considered "true" international collaboration arrangements falling within Note (1) – those relating to the joint project for the development of the Lockheed Martin F-35 Fighter, for example (being developed by a consortium including the USA, the UK, Italy, the Netherlands, Australia, Canada, Denmark, Norway and Turkey).

28. So far as Note 1(b) was concerned, Mr Hill pointed out that there was no provision anywhere in the documents under which the UK government agreed to

relieve any costs of the transactions from taxation. The provisions referred to at [10] and [11] above did not even purport to do so. The wording at [10] above was simply a directive addressed to the US civil servants administering FMS, requiring them to ensure they did so "at no cost to the USG"; and the wording referred to at [11] above was a private matter between the US government and Poland/Greece, even if it could be said (which he doubted) to "relieve the cost of" the respective sales from taxation.

Discussion and decision

Introduction

29. The syntactical structure of Item 2 is somewhat obscure. It is set out in full at [18] above, along with the associated Notes. It is clearly intended to apply to two alternative situations. The first of these is reasonably clear:

> "The supply to or by an overseas authority, overseas body or overseas trader, charged with the management of any defence project which is the subject of an international collaboration arrangement… of goods or services in the course of giving effect to that arrangement"

30. This situation clearly envisages supplies made directly to or by the overseas entity which is managing the defence project.

31. However, the inclusion of the words "or under direct contract with any government or government-sponsored body participating in a defence project under such an arrangement" in Item 2 brings in a degree of ambiguity. The difficulty arises when attempting to decide whether these words should be read as following on simply from "The supply" at the start of Item 2, or from the words "The supply to or by an overseas authority, overseas body or overseas trader". The two possible intended meanings of these extra words, in the overall context of Item 2, are therefore:

> (1) The supply under direct contract with any government or government-sponsored international body participating in a defence project under an international collaboration arrangement, of goods or services in the course of giving effect to that arrangement; or
>
> (2) The supply *to or by an overseas authority, overseas body or overseas trader* under direct contract with any government or government-sponsored international body participating in a defence project under an international collaboration arrangement, of goods or services in the course of giving effect to that arrangement.

32. Whichever of these two formulations is correct (and the parties did not address the point in their submissions), for zero-rating to apply the relevant supply of goods or services must be made "in the course of giving effect to an international collaboration arrangement".

Is there an "international collaboration arrangement"?

33. By definition (see Note (1)), such an arrangement only exists if (i) it is made between the UK government and one or more other governments; (ii) it is an arrangement for "collaboration in a joint project of research, development or production"; and (iii) it includes provision for "participating governments to relieve the cost of the project from taxation".

34. It is important to bear in mind that Item 2 distinguishes between the "international collaboration arrangement" and the "defence project" which is "the subject of" or "under" that arrangement.

35. So what is the "arrangement" which, in this case, is said to constitute the "international collaboration arrangement" (bearing in mind that there must be a "defence project" which is "the subject of" or "under" it)?

36. The "arrangement" clearly cannot be the sales themselves, as that would be to conflate the "arrangement" and the "defence project" (if such it be). In their original grounds of appeal, the Appellants had argued that the "arrangement" was NATO. We agree with Mr Hill that this cannot be correct. NATO is concerned with mutual defence, not with any project of "research, development or production" (and in particular, not with the development or production of the DB-110 system); and in any event there is no suggestion that these sales were "the subject of" or "under" the NATO Treaty or in any other way related to the membership of NATO.

37. In Mr Tack's skeleton argument, he referred to FMS as constituting the "arrangement" (with the actual sales to the Polish and Greek governments being "defence projects" which were the subject of it).

38. Whilst we agree that the sales could be said to have been "the subject of" FMS, that they could arguably amount to "defence projects" (though we doubt it) and that FMS could be said to be an "arrangement", we do not consider FMS to be an "international cooperation arrangement". We agree with Mr Hill that the FMS is a unilateral scheme established by the US government as a framework for the sale of military equipment, etc, to friendly governments and others. The FMS itself could not in our view be said to have been "made between the UK government and one or more other governments", nor could it be said to involve "collaboration in a joint project of research, development or production"; it is simply a procurement structure offered by the US government for equipment and other supplies that have already been developed for it. Finally, we agree with Mr Hill that the provision of FMS referred to at [10] above does not amount to a "provision for participating governments to relieve the cost of the project from taxation", it is simply a directive to those administering FMS on behalf of the US government to do so at no cost to it.

39. By referring also to NATO and UK's wider involvement in the procurement of the DB-110, Mr Tack may have been attempting to argue for a much broader interpretation of what constituted a relevant "international collaboration arrangement" in this case. If he was, then we consider such arguments to be misconceived. What

he was inviting us to consider was something extremely vague (and even variable) in extent, for which we can find no warrant in the wording of Item 2 and its associated notes; however broad the concept of "arrangement" might be in principle, it seems to us that there must be clarity and certainty about its actual scope in any particular case. In passing, we would observe that any other approach would also be inconsistent with the requirement to interpret strictly the terms of this relieving provision (though, as we said at [19] above, we would reach the same conclusion even without applying a strict interpretation).

40. It can therefore be seen that we essentially agree with the submissions of Mr Hill.

41. Having reached the above conclusions, it is not necessary for us to express a view on the correct interpretation of Item 2 as set out at [31] above, as our decision would be the same whichever interpretation is correct.

Summary and decision

42. We leave open the question of which of the two possible interpretations of Item 2 is correct (see [41] above).

43. We consider that the only arguable "arrangement" relevant to this appeal would be the Foreign Military Sales programme of the US government.

44. We do not consider that the Foreign Military Sales programme of the US government constitutes an "international collaboration arrangement", because:

(1) it was not "made between the United Kingdom Government" and the US government; it is simply a unilateral scheme established by the US government, providing a framework within which it is prepared to assist approved foreign governments and others in procuring military supplies from the US government's own suppliers;

(2) it involves no "collaboration in a joint project of research, development or production"; and

(3) it contains no provision for participating governments to relieve the cost of the project from taxation.

(see [38] above).

45. The Appellants' supplies do not therefore qualify for zero rating under Item 2, Group 13, Schedule 8 VATA.

46. The appeal of both Appellants must therefore be DISMISSED.

47. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax

Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

KEVIN POOLE
TRIBUNAL JUDGE
RELEASE DATE: 11 November 2014