

VAT focus

Characterising supplies for VAT following *Mesto Zamberk*

Speed read

The characterisation test for a single supply is fundamental to VAT. Perhaps surprisingly, the relevant test has recently received important clarification from the Court of Appeal. It is now clear that the primary test to be applied when characterising a single supply for VAT purposes is to determine the predominant element from the point of view of the typical consumer with regard to the qualitative and not merely the quantitative importance of the constituent elements. This has significant practical consequences for the presentation of evidence in characterisation disputes.



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The fundamental issue in VAT is to determine the nature of the supply. The rules to establish whether the supply is taxable, zero-rated or exempt as well as the place of supply all fall to be applied in light of that.

A significant amount of recent case law has focused on distinguishing single and multiple supplies. In *Card Protection Plan Ltd v HMRC* (Case C-349/96) (CPP), the CJEU made clear that there is a single supply where one or more elements are to be regarded as constituting the principal service, whilst other elements are to be regarded as ancillary services which share the tax treatment of the principal service. In *Levob Verzekeringen BV and another v Staatssecretaris van Financiën* (Case C-41/04), the CJEU confirmed that a single supply also exists where two or more elements supplied by the taxable person to the customer are so closely linked that they form, objectively, a single, indivisible economic supply. However, once it has been determined how many supplies are being made, the question of how any single supply should be characterised has received very much less judicial attention.

***Mesto*: the most important VAT case you might not have heard of**

The leading authority on how supplies should be characterised for VAT purposes is *Mesto Zamberk v Finanční reditelství v Hradci Králové* (Case C-18/12) (*Mesto*). In *Mesto*, the CJEU addressed whether access to a municipal aquatic park which offered visitors not only sporting facilities but also facilities for other types of leisure constituted a supply of services closely related to sport. The CJEU identified a single supply and then explained how that supply should be characterised. First, 'all the circumstances in which the transaction takes place must be taken into account in order to ascertain its characteristic elements and its predominant elements must be identified.' Secondly, 'the predominant element must be determined from the point of view of the typical consumer', 'who must be determined on the basis

of a group of objective factors.' Thirdly, regard must be had 'in an overall assessment, to the qualitative and not merely quantitative importance of the elements'.

Recognition of the importance of *Mesto* in the UK has been slow in coming. At the time of writing, it receives just one mention in HMRC's manuals – in the context of the sporting exemption. Until very recently, such cases as have mentioned *Mesto* have generally failed to refer to it as the leading authority on characterising single supplies. The notable exception to this is *HMRC v Metropolitan International Schools Ltd* [2017] UKUT 431 (MIS) where the Upper Tribunal (UT) (Mann J and Judge Greenbank) had to decide whether a distance learning course was zero-rated as a supply of books. The *Mesto* test was applied and the UT found (at para 109) 'that the typical student, viewing the course as presented in the marketing and contractual material, would not consider that he or she was predominantly buying books ... with some other bits and pieces, but was buying a package in which books were important, and indeed central, but in which the books [did] not predominate... [t]hey were part of an overall package, with real additional benefits, and the package was sold as such'. Accordingly, the supply was not a zero-rated supply of books.

The significance of *Mesto* has now been fully recognised by the Court of Appeal in *Gray & Farrar International LLP v HMRC* [2023] EWCA Civ 121 (*G&F*) where the taxpayer provided exclusive matchmaking services to individual clients. The particular dispute concerned the place of supply rules and their application followed from the characterisation of the supply. Despite HMRC arguing to the contrary, Simler LJ (with whom Newey and Lewison LJ agreed), expressly concluded (at para 47) that: '*Mesto* goes further than the earlier cases referred to, and has established a principle of EU law that the predominant element test is the primary test to be applied in characterising a supply for VAT purposes... In *Mesto* the CJEU gave authoritative guidance on the test for deciding how a single complex supply must be categorised for VAT purposes. The language used by the CJEU in setting out this test is mandatory. Where it is possible to do so, the predominant element must be determined. This is the primary test to be applied for this purpose.' The Court of Appeal made clear that this is retained EU law which continues to apply post Brexit.

Simler LJ summarised the *Mesto* test as follows (at para 42): 'The exercise is an objective one. The view of the typical consumer, determined by reference to objective factors, is critical. The question is what is the predominant element in what the typical consumer thinks he or she is acquiring. An overall assessment must be made of all elements of the supply to determine their importance to the typical consumer, both qualitatively and quantitatively, to decide which predominates.'

Clarity from the Court of Appeal in *G&F*

In *G&F* itself, the Court of Appeal had 'no doubt that the typical consumer would regard the provisions of introductions to prospective long-term partners as the qualitatively most important element of the service' (para 61). It followed from both this and the contract that the provision of the introductions was the predominant element of the supply. That meant the service was neither of a kind habitually supplied by consultants nor data processing nor the supply of information, with the result that services supplied to clients outside the UK and EU were within the scope of VAT.

The upshot is that it is now clear that the key test in characterising a supply is to establish the predominant element in what the typical customer perceives themselves

to be receiving. This brings clarity and indeed the Court of Appeal accepted HMRC's submission that the previous case law showed different tests being adopted at different times and in different circumstances to answer the characterisation question. Readers can decide for themselves whether this amounts to a new approach or whether from an EU perspective *Mesto* merely clarified the existing jurisprudence.

It is important to note some points of detail and qualifications to what is said above. In *Mesto*, the CJEU expressly stated that 'the fact that the intention of some visitors does not relate to the predominant element of the supply at issue determined [according to the proper test] cannot call that determination into question.' It is therefore essential to identify one or more objectively typical consumers. The CJEU also stressed that to ensure uniform application of VAT 'regard must be had, save in exceptional cases, to the objective character of the transaction.' In *Mesto* itself, this meant looking closely at the physical characteristics of the aquatic park.

Following *Mesto* and now *G&F*, it is clear that the primary, and arguably only, test to be applied when characterising a single supply for VAT purposes is to determine the predominant element from the point of view of the typical consumer with regard to the qualitative and not merely the quantitative importance of the constituent elements

The contractual framework also remains of paramount importance in characterising supplies. As the CJEU stated in *HMRC v Newey (trading as Ocean Finance)* (Case C-653/11) 'the contractual position normally reflects the economic and commercial reality of the transactions and in order to satisfy the requirements of legal certainty, the relevant contractual terms constitute a factor to be taken into consideration when [characterising supplies]'. In *G&F*, Simler LJ took the contract as her starting point in characterising the supply. The typical consumer's experience of the supply is determined in light of what the contract provides for.

A hierarchy of three tests?

In *G&F*, the Court of Appeal also expressly approved the conclusion of the UT in *MIS* that there is a hierarchy of three tests to be applied in characterising a supply (para 49).

1. First is the '*Mesto* predominance test', as discussed above, which takes clear priority.
2. Secondly, 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. Finally, an "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.'

In the author's view the *Mesto* test is by the far the most important and the other two tests are open to criticism. *Mesto* is clear that the predominant element must be identified

from the point of view of the typical consumer, so when *CPP* operates to tell us that there is a principal element to a supply to which other elements are merely ancillary then *Mesto* applies to determine the characterisation of that principal, or predominant, element. The UK courts are clear that this should yield the same result as *Mesto*: that is because it is really the same test. As regards the 'overarching' test, as the UT in *MIS* acknowledged, this has no basis in EU law. Simler LJ correctly identified that the cases relied upon in support of it, notably *Byrom (trading as Salon 24) v HMRC* [2006] STC 992, where a supply was characterised (as a supply of massage parlour services) differently from its main element (the supply of a room), pre-date *Mesto*. In the author's view *Byrom* is better explained as simply the *Mesto* principle being applied before the CJEU had clarified the position. The essence of Warren J's judgment is that the masseuse as the relevant consumer was receiving a package of services rather than a supply of land to which the other elements were ancillary.

What of HMRC's approach to all of this?

HMRC has not been keen on applying *Mesto* as the test of characterisation. In *G&F*, HMRC argued unsuccessfully that it was 'purely interpretative guidance' and inconsistent with domestic authority. From the author's own experience and what is *not* said in recent case law HMRC has generally not sought to invoke *Mesto* as a characterisation test, although *MIS* is a partial exception.

HMRC's reluctance to adopt *Mesto* may perhaps partly be explained by the practical impact which it has on VAT disputes where, as it often is, the characterisation of a single supply is in dispute. As should be apparent, it should generally be expected that evidence from a typical consumer is required. In some disputes the contracts and other objective evidence may be sufficient to determine characterisation. However, in borderline cases how a typical customer experiences the supply is likely to be critical. Where appeals reach the First-tier Tribunal then suitable witness evidence will need to be gathered.

The author has first-hand experience of the application of *Mesto* in this way. A place of supply dispute involving a large corporate was due to come to trial. The dispute turned on characterisation. A very large amount of documentary evidence was exhibited together with the statements of several witnesses including a customer who was speaking to his experience of the supply on behalf of the taxpayer. HMRC had gathered no equivalent witness evidence and, following receipt of the author's skeleton argument for the taxpayer with *Mesto* duly cited, conceded the appeal.

Where does this leave us?

In conclusion, following *Mesto* and now *G&F*, it is clear that the primary, and arguably only, test to be applied when characterising a single supply for VAT purposes is to determine the predominant element from the point of view of the typical consumer with regard to the qualitative and not merely the quantitative importance of the constituent elements. This has significant consequences, including as regards the composition of witness evidence in characterisation disputes. Nevertheless, all of the facts continue to be relevant to characterisation, especially the contractual framework. ■

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► Cases: *Gray & Farrar International LLP v HMRC* (21.2.23)

► Cases: *HMRC v Metropolitan International Schools* (14.11.17)