

VAT: A NEW DAWN FOR THE PRINCIPLE OF FISCAL NEUTRALITY?

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Summary

On 10 November 2011 the EU Court of Justice handed down its eagerly anticipated judgment on two cases referred by the UK courts involving the Rank Group plc and Her Majesty's Revenue and Customs (HMRC). The disputes arose in the context of gaming activities, namely bingo and slot machines, and raised significant questions over the application of the principle of fiscal neutrality. The EU Court of Justice ruled that, where two gaming services are comparable from the point of view of the average customer and meet the same needs of that customer, under the principle of fiscal neutrality, they must be regarded as similar and receive the same treatment for VAT purposes. Whilst the decision has obvious implications for the interpretation of the gambling exemption, it will most likely also have far more reaching implications for the application of the principle of fiscal neutrality to VAT exemptions more generally, as well as to other areas of the tax such as rates' structures.

Background to the *Rank Group* case

The UK is amongst the Member States which make use of the option granted in Article 135(1)(i) of the VAT Directive by taxing only some types of gambling. Whilst that provision exempts in principle gambling from the tax, it also allows Member States some level discretion when establishing the scope of that exemption, by stating that this is "subject to the conditions and limitations laid down by each Member State". As already acknowledged by the Court in *Leo-Libera* (Case C-58/09, [2010] ECR I-5189), that level of discretion allows States to exempt from tax only certain forms of gambling, but not others. In this context, the UK excludes from the scope of the exemption essentially two types of gaming services:

- the granting of a right to take part in a game in respect of which the stake is lower than or equal to 50 pence and the prize lower than or equal to GBP £25.
- the provision of a gaming machine.

The case in *Rank* is not the first time that these UK VAT rules on gambling are under the spotlight, having given rise to significant litigation in the last decade. Indeed not only is there considerable case law at domestic level, but these rules have already been at the centre of EU Court of Justice cases. At national level, just in the last year there have been six courts' judgments on the gambling rules and the right to deduct of gaming

businesses, as follows: *Cosmo Leisure* (First-Tier Tribunal, Tax Chamber, 25 February 2011, [2011] UKFTT 143); *Deandrake* (First-Tier Tribunal, Tax Chamber, 14 April 2011, [2011] UKFTT 250); *Dransfield Novelty* (First-Tier Tribunal, Tax Chamber, 26 May 2011, [2011] UKFTT 348); *British Association of Leisure Parks, Piers and Attractions* (First-Tier Tribunal, Tax Chamber, 12 October 2011, [2011] UKFTT 662); *Rating Report* (First-Tier Tribunal, Tax Chamber, 9 November 2011, [2011] UKFTT 721); and *London Clubs Management* (Court of Appeal, 18 November 2011, [2011] EWCA Civ 1323). These levels of litigation are partly fuelled by, at the same time as reason for, significant commentary and analysis (see amongst others K. Killington, “United Kingdom: floor-based method of apportionment” (2010) *International VAT Monitor* 21(6), 469). At EU level there have also been two significant cases concerning the UK rules: *United Utilities* (Case C-85/05), on the application of the gambling exemption to outsourced activities, namely the provision of call centre services to a telephone bookmaking organiser (for comment see C. Reece, “Call Centre” (2002) *Tax Journal* 645, 23) ; and *RAL* (Case C-452/03), on the so-called aggressive VAT planning, one of the first cases concerning the application of the principle of prohibition of abuse of law to VAT (for comment see R. de la Feria, “GAME OVER’ for Aggressive VAT Planning? *RAL v. Commissioners of Customs & Excise*” (2005) *British Tax Review* 4, 394-401).

The phenomenon is not, however, exclusive to the UK: in the last decade there has been a noteworthy increase in judgments of the EU Court of Justice concerning the interpretation of the VAT gambling exemption, with the German cases in *Linneweber* in 2005 (Case C-453/02, [2005] ECR I-1131), and *Leo-Libera* in 2010 (Case C-58/09, [2010] ECR I-5189); and just recently the Belgium case in *Henfling* (C-464/10, [2011] ECR I-000). Whilst this increase can be partly explained by the overall augment of the Court’s case law on exemptions, it is also true that the level of discretion afforded to the Member States by the VAT Directive insofar as the gambling exemption is concerned is particularly prone to giving rise to a “creeping case law” phenomenon.

The decision of the EU Court of Justice in *Rank Group*

Rank is the representative member of a VAT group which operates bingo clubs and casinos in the United Kingdom in which customers have access to mechanised cash bingo and slot machines. In 2006 it brought two separate actions before the UK VAT Tribunal against HMRC for refusal to repay VAT allegedly overpaid on supplies of bingo

and slot machines gaming, respectively. At stake in both cases was the respect for the principle of fiscal neutrality and its scope of application insofar as the VAT exemption for gambling was concerned.

Insofar as the bingo case was concerned, Rank's claim was that different types of bingo were treated differently for the purposes of the VAT exemption: mechanised cash bingo was exempt only if the stake was lower than or equal to 50 pence and the prize lower than or equal to £25. It was accepted by the parties that, more both types of bingo were identical from the consumers' perspective. HMRC's defence was that the different treatment did not imply a breach of the principle of fiscal neutrality since there was no evidence that this difference in treatment had affected competition between those games. The VAT Tribunal, however, dismissed this argument, ruling in favour of Rank. Following proceedings at national level, the case was sent to the Court of Appeal, which referred the case to the EU Court of Justice.

In relation to the slot machines action, the central question was whether these machines should be regarded as "gaming machines" and as such excluded from the scope of the VAT exemption. Rank's main argument was that other type of slot machines had already been deemed not to be "gaming machines" for the purposes of VAT by HMRC, so that treating these slot machines as such was in breach of the principle of fiscal neutrality. Similarly to the bingo action, it had been accepted by the parties that both types of slot machines were identical from the customers' perspective. HMRC's defence was again that these two categories of machines were not in competition with each other.

In this context – and whilst there were other minor questions asked – the main question by the two referring courts to the EU Court of Justice was essentially whether the principle of fiscal neutrality must be interpreted as meaning that a difference in treatment for VAT purposes of two supplies of services which are identical or similar from the point of view of the consumer and which meet the same needs of the consumer is sufficient to establish an infringement, or this requires in addition that the actual existence of competition between the services in question or distortion of competition because of the difference in treatment be established.

In this regard, the Court crucially ruled that difference in treatment of two supplies of services which are identical or similar from the point of view of the consumer and which meet the same needs of the consumer is sufficient to establish an infringement of the

principle of fiscal neutrality. Consequently, the actual existence of competition between the services in question or of distortion of competition due to the differences in treatment was deemed by the Court as not to be an additional condition, and unnecessary to determine the existence of such an infringement. Similarly deemed irrelevant was the fact that two games fell into different licensing categories and were subject to different legal regimes relating to control and regulation. The Court further clarified that in order to establish whether two types of gambling machines are identical from the point of view of the consumer and fulfil the same needs, the matters to take into account are, *inter alia*, the minimum and maximum permitted stakes and prizes and the chances of winning.

The consequences and implications of the judgment in Rank Group

Following the Court's judgment in *Rank Group* HMRC issued a statement, dated 8 December 2011, where it reads:

"Bingo – In view of the EU Court of Justice, HMRC accepts that the issue is now resolved in respect of bingo and our appeal in this respect will be withdrawn. (...)

Gaming Machines – HMRC believes that the judgment of the ECJ does not provide a final determination of the domestic litigation. Further consideration of the gaming machines appeal will now have to take place with the parties and the domestic courts using the judgment of the ECJ for guidance. Accordingly our appeal will continue."

For the most part, therefore, the litigation in *Rank Group* seems to be broadly settled. That however might not be the end of the matter. Indeed, the relevance of the *Rank Group* judgment for VAT can hardly be overestimated. Whilst the decision has obvious implications for the interpretation of the gambling exemption, it will probably also have far more reaching implications for the application of the principle of fiscal neutrality to VAT exemptions more generally, as well as to other areas of the tax such as rates' structures. Consequently – and bearing in mind the creeping case-law phenomenon that characterises the EU Court of Justice's judicial interventions on VAT – this judgment has the potential to give rise in the near future to more litigation, concerning in particular the application of the principle of fiscal neutrality.

Implications of the judgment for the VAT gambling exemption

Following *Leo-Libera* (Case C-58/09, [2010] ECR I-5189), it was clear that the level of discretion granted to Member States under Article 135(1)(i) of the VAT Directive allowed those States to exempt from tax certain forms of gambling, but not others. Equally clear

from previous case law, however, was that such discretion was limited by the principle of fiscal neutrality. In *Fischer* (Case C-283/95, [1998] ECR I-3369) the Court had ruled that a Member State may not impose VAT on the unlawful operation of roulette, when the corresponding activity carried out by a licensed public casino is exempt. It stated in that case that:

“[...] the principle of fiscal neutrality precludes a generalised distinction from being drawn in the levying of VAT between unlawful and lawful transactions. It follows that Member States cannot reserve the exemption solely to lawful games of chance.”
(para. 28)

More recently, in *Linneweber* (Case C-453/02, [2005] ECR I-1131) the Court decided that a different treatment for VAT purposes between public gambling and private gambling, where the first is deemed to be exempt and the second taxable, was not acceptable either. Invoking again the principle of fiscal neutrality, the Court established that the identity of the supplier was irrelevant for the purposes of the VAT gambling exemption, stating that:

“[...] it must be observed that it is clear from Article [135(1)(i) of the VAT Directive] that gambling is in principle to be exempted from VAT but that the Member States retain the power to lay down the conditions and limitations of that exemption (*Fischer*, paragraph 25).

However, in exercising that power, the Member States must respect the principle of fiscal neutrality. According to the case-law of the Court of Justice, that principle precludes, in particular, treating similar goods and supplies of services, which are thus in competition with each other, differently for VAT purposes[...]

the identity of the manufacturer or the provider of the services and the legal form by means of which they exercise their activities are, as a rule, irrelevant in assessing whether products or services supplied are comparable. [...]

It follows that, in exercising their powers under Article [135(1)(i) of the VAT Directive], that is to say, the power to determine the conditions and limitations subject to which the operation of games of chance and gaming machines is to be exempted from the VAT provided for by that provision, the Member States cannot validly make that exemption dependent upon the identity of the operator of such games and machines.” (paras. 23, 24, 25 and 29)

The limiting role of the principle of fiscal neutrality, insofar as the gambling exemption is concerned, has therefore been clear for several years. In this regard it is worth emphasising that in *Rank Group*, HMRC never denied the applicability of the principle of fiscal neutrality to the discretionary power of the UK to determine the scope of the exemption. Instead, the main argument presented was that the distinction did not infringe that principle because there was no evidence that the difference in VAT treatment of the two types of gaming in question had affected competition between them. Thus, what had been lacking until now was the criteria for establishing whether or not there is an infringement of the principle of fiscal neutrality. We knew that a lawful / unlawful or a public / private distinction was unacceptable, the question was then what was acceptable? The answer has been implicitly given in *Rank Group*. The Court established here that a distinction was not acceptable where the services were comparable from the point of view of the customer and met the same need of the customer. *A contrario* therefore, Member States can treat different types of gambling differently for VAT purposes only where the following conditions are fulfilled:

- they are not comparable from the point of view of the customer; or
- they do not meet the same needs of the customer.

Implications of the judgment for the interpretation of VAT exemptions

When determining the scope of any of the exemptions listed in the VAT Directive consideration must always be given to the general interpretative principles developed by the Court and applicable to all those exemptions. In particular, three principles are worth noting: the principle of strict interpretation of exemptions, the principle of contextual interpretation of exemptions, and the principle of uniform interpretation of exemptions.

Of these the principle of strict interpretation is probably the one which is most often used by the Court when interpreting exemptions. In fact, the Court has consistently held that the exemptions provided for in Articles 132, 135 and 136 of the VAT Directive “are to be interpreted strictly since they constitute exceptions to the general principle that turnover tax is to be levied on all services supplied for consideration by a taxable person”(see cases 253/85, *Commission v. United Kingdom*, [1988] ECR 817; 122/87, *Commission v. Italy*, [1988] ECR 2685; C-453/93, *W. Bulthuis-Griffioen*, [1995] ECR I-2341, C-212/01, *Unterpertinger*, [2003] ERC I-13859; and C-86/09, *Future Health Technologies*, [2010] ERC I-5215, all of which regarding the interpretation of the exemption applicable to

medical services [Art. 132(1)(b)]; C-149/97, *Institute of Motor Industry*, [1998] ECR I-7053, regarding the interpretation of the exemption applicable to trade unions [Art. 132(1)(l)]; and C-150/99, *Stockholm Lindopark*, [2001] ECR I-493, on the interpretation of the exemption applicable to sport organizations [Art. 132(1)(m)]. Furthermore, it is interesting to note that – whilst the Court has at times departed from this position (see e.g. case C-2/95, *SDC*, [1997] ERC I-3017 as regards the financial services exemption – its preference for a strict interpretation of exemptions has manifested itself both as regards the services providers (subjective scope of the exemption), and the type of services which may be exempt (objective scope of the exemption).

Yet, the Court has increasingly departed from this strict interpretation, in order to ensure respect of the principle of fiscal neutrality and of its corollary, the principle of VAT uniformity, which precludes similar goods from being treated differently for VAT purposes (see amongst others, cases C-76/99, *Commission v. France*, [2001] I-249; C-307/01, *d'Ambrumenil*, [2003] ECR I-13989; and C-106/05, *L.u.p.*, [2006] ECR I-5123, all of which regarding the interpretation of the exemption applicable to medical services [Art. 132(1)(b)]; C-216/97, *Gregg*, [1999] ECR I-4947, on the interpretation of the exemptions applicable to medical services and that applicable to welfare and social work [Art. 132(1)(b) and (g)]; C-124/96, *Commission v. Spain*, [1998] ECR I-2501; C-174/00, *Krennemer Golf*, [2002] ECR I-3293, both on the interpretation of the exemption applicable to sport organizations; and C-144/00, *Hoffman*, [2003] ECR I-2921, regarding the interpretation of the exemption applicable to cultural services [Art. 132(1)(n)].

The gambling exemption is a perfect example of this recurrent struggle between the principles of strict interpretation and fiscal neutrality (a struggle first noted by C. Amand in “VAT for Public Entities and Charities – Should the Sixth Directive Be Renegotiated?” (2006) *International VAT Monitor* 6, 433-443). In *Leo-Libera* (Case C-58/09, [2010] ECR I-5189) the Court implicitly opted for strict interpretation, dismissing the fiscal neutrality argument:

“That principle cannot, if it is not to deprive Article 135(1)(i) of Directive 2006/112 and the broad discretion which that provision grants to Member States of all effectiveness, be interpreted as precluding one form of gambling from being exempt from the payment of VAT while another form of gambling is not, in so far, however, as the two forms of gambling are not in competition with one another.” (para. 35)

However, as highlighted above, in all other gambling cases the Court went the opposite way, opting for extending the scope of the gambling exemption at the expense of fiscal neutrality: in *Fischer* (Case C-283/95, [1998] ECR I-3369) the Court had ruled that a Member State may not impose VAT on the unlawful operation of roulette, when the corresponding activity carried out by a licensed public casino is exempt; in *Linneweber* (Case C-453/02, [2005] ECR I-1131) it decided that a different treatment for VAT purposes between public gambling and private gambling, where the first is deemed to be exempt and the second taxable, was not acceptable; and more recently in *Henfling* (C-464/10, [2011] ECR I-000) it ruled that outsourcing or subcontracting of gambling activities can still fall within the scope of the exemption. The judgment in *Rank Group* represents yet another signal that the Court is becoming more and more willing to depart from the general held principle of strict interpretation of exemptions, in defence of fiscal neutrality – which in itself demonstrates another point, namely the increased significance of the principle of fiscal neutrality within the EU VAT system.

Implications of the judgment for the application of the principle of fiscal neutrality

In *Rank Group* the Court was dealing with VAT exempt – or not exempt – services, but as it has stated before, and reiterated again now (see para. 34 of the *Rank Group* decision), the principle of VAT uniformity, or equal treatment, as a corollary of the general principle of fiscal neutrality also applies to goods, in particular in the context of the application of reduced rates of VAT. Until now, however, the criterion used to determine the application of the principle of fiscal neutrality seemed to have been whether the goods were or not in competition with each other. As opposed to what the Court seems to be indicating in *Rank Group*, in *Commission v France* (Case C-481/98, [2001] ECR I-3369), whilst acknowledging the relevance of fiscal neutrality and its corollaries, the Court went on to say:

“It is clear that, in introducing and maintaining in force a VAT rate of 2.1% solely for reimbursable medical products, the French legislation did not, and does not infringe the principle of fiscal neutrality. Reimbursable and non-reimbursable medical products are not similar products in competition with each other [...] Once included in the list of reimbursable products, a medical product will, vis-à-vis a non-reimbursable medical product, have a decisive advantage for the final consumer [...] Consequently it is not the lower rate of VAT which provides the reason for his decision to purchase.” (paras 25 and 27)

More recently in *Commission v Netherlands* (Case C-41/09, [2011] ECR I-000) the Court put again the emphasis on the non-competing nature of the products:

“Taking their respective uses into account, a horse destined for slaughter is not similar to a racehorse or a pet horse where the animal is sold as such [...] those categories of horses are not in competition, meaning that they can be subject to different rates of VAT” (para. 66)

It is clear that in *Rank Group* the Court adopted a new approach to fiscal neutrality, so the question is then whether the new criteria set out in that ruling will have implications for the Court approach to VAT rates structures. Some have already been defending that it will, stating that it is “highly likely” that the criteria laid down in *Rank Group* will affect the application of VAT rates particularly to food, and that “the entire fabric of the manner in which VAT is applied to food will have to be re-examined” (see V. Sloane, “VAT Focus – Rank and Fiscal Neutrality” (2011) *Tax Journal* 1101, 20, 18 November 2011).

In truth, there are indeed indications that the Court might be soon looking more closely into VAT rates applicable to food. In the recent decision in *Bog* (Case C-497/09, [2011] ECR I-000) the Court was asked to interpret the term “foodstuff” in Category 1 of Annex III to the VAT Directive. Without ever referring to fiscal neutrality, the Court clearly departed from the preferred method of strict interpretation of exceptions to the general rule, by adopting a broad meaning of the term, stating that “the provision in question refers to foodstuffs in general and makes no distinction or restriction” (para. 85). Also significant is the fact that in *Rank Group* the Court relied upon an old judgment concerning excise duties, *Roders and Others* (Joint cases C-367/93 to C-377/93, [1995] ECR I-2229). The Court had been asked in that case to consider the similarity of fruit wines and grape wines for the purposes of excises. Although the final decision was left to the national court, the following guidance was given:

“According to the settled case-law of the Court, which has interpreted the concept of similarity widely, in order to determine whether products are similar it is necessary to consider whether they have similar characteristics and meet the same needs from the point of view of consumers, the test being not whether they are strictly identical but whether their use is similar and comparable.” (para 27)

Should this approach to fiscal neutrality in fact spread to rates in such a fashion, the *Rank Group* case could go down in VAT history as the ruling that initiated a true

revolutionary process in domestic VAT systems. For the first time since the Approximation of VAT Rates Directive in 1992, and despite the Court's previously timid approach to these matters, Member States' freedom to establish their own rates' structures might be on the verge of being significantly curtailed. What could not be achieved at legislative and political levels for the last twenty years might be about to happen via the judicial route.