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Tesco Freetime: rewards, Redrow and input VAT recovery

In a decision which is now final, the Upper Tribunal (*UT*) has allowed Tesco Freetime to recover input VAT paid to third party providers of rewards to members of the Clubcard loyalty scheme, rejecting HMRC's arguments that the payments made by Tesco Freetime represented third party consideration. The UT emphasised that economic reality was not the starting point for the analysis of whether there was a supply to the taxpayer, but rather an (important) overlay to the contractual position, and endorsed the *Redrow* approach of considering things from the position of the person claiming the input tax deduction.

Loyalty schemes offering 'free' goods or services provided by a third party typically benefit multiple parties: most obviously, the loyalty scheme operator (or sponsor if different) on the one hand, and the loyalty scheme member receiving the free reward on the other. Recovery of input tax by the loyalty scheme operator paying the third party in these circumstances has been a prime target for HMRC challenge, the argument being that it is providing third party consideration for the rewards provided to members.

One might have expected that HMRC would abandon this line of argument after it was ultimately rejected by the Supreme Court in *Loyalty Management UK* (***LMUK***) [2013] UKSC 15 (although that decision was perhaps something of a shock for HMRC after experiencing success before the CJEU).

HMRC having instead persisted, the decision of the UT in *HMRC v Tesco Freetime and another* [2019] UKUT 18 allowing Tesco Freetime to recover the input tax incurred in operating the 'Partner Boost' aspect of the Tesco Clubcard scheme, and its dismissal of HMRC's arguments to the contrary, represents a further blow to HMRC's attempts to deploy these kinds of arguments in the context of loyalty schemes. In this particular case, that blow to HMRC is a fatal one, as the decision is not being appealed.

Background: Rewards

For those not familiar with how the Clubcard scheme works:

- Under the Clubcard scheme, customers purchasing 'premium' goods from Tesco Stores or 'Clubcard partners' earn Clubcard points, which are periodically converted into 'Clubcard vouchers'. These Clubcard vouchers can be used to obtain a discount against purchases of 'redemption goods' from Tesco stores or online.
- Under the 'Partner Boost' programme (operated by a separate company, Tesco Freetime under a contract with Tesco Stores Ltd), members can exchange their Clubcard vouchers with Tesco Freetime for 'reward tokens', which may be used to acquire services (and in some cases goods) ('rewards') from third party 'deal partners'. Typically the value of the reward token is a multiple of the value of the Clubcard voucher.

Broadly, the contracts between Tesco Freetime and deal partners require deal partners to provide 'fulfilment services' to Tesco Freetime to enable the latter to provide rewards to Clubcard members. Tesco Freetime pays deal partners a percentage of the face value of the reward tokens redeemed, plus VAT, and is in turn remunerated by Tesco Stores for the services provided to it.

The key issue in this case (which had already been decided in Tesco's favour by the First-tier Tribunal (***FTT***), see [2017] UKFTT 0614) was whether the input VAT paid to deal partners was deductible for Tesco Freetime.

HMRC's case: *Redrow* (and *LMUK*)

HMRC essentially ran the same case before the UT as it had done before the FTT. In many respects, HMRC's arguments also resembled those raised in the *Marriott Rewards and another* case [2018] STC 1144 concerning the Marriott hotels loyalty scheme.

The essence of HMRC's case was that, as a matter of economic reality, the provision of rewards involved final consumption of the reward by the customer. Tax on that consumption had to 'stick' and accordingly Tesco Freetime should not be entitled to recover its input VAT.

A theme running through this and other loyalty scheme cases is that, in HMRC's view, businesses making or paying for 'free' supplies to customers should either account for output tax or suffer an input tax restriction, even if the 'free' supplies are made for business purposes (e.g. to attract and retain customers, as in this case).

However, to achieve this result in cases involving the supply of services, it would be necessary to overcome both the House of Lords decision in *Redrow* [1999] STC 161 and the Supreme Court decision in *LMUK*, where the loyalty scheme provider was of course held to be entitled to input tax recovery. The points of principle argued by HMRC against Tesco Freetime were consistent with a view that *Redrow* was wrongly decided, but a decision to that effect clearly could not be reached below the level of the Supreme Court (and in any case, the Supreme Court in *LMUK* expressly endorsed *Redrow*). As to *LMUK* itself, HMRC attempted to draw a distinction between the Tesco Freetime situation and that in *LMUK* but, as discussed below, that argument also failed.

The UT's decision: recovery

The UT held that the correct approach in determining whether the amounts paid by Tesco Freetime to deal partners were consideration for a supply of services to Tesco Freetime, was:

1. (consistent with *Newey* [2013] STC 2432 and *Airtours* [2016] UKSC 21) to analyse the contractual position in order to identify the obligations imposed, in particular on the party said to be supplying services;
2. to analyse whether, in practice, the parties performed their obligations in accordance with the relevant contracts; and
3. importantly, to analyse the extent to which the performance of those obligations constituted, as a matter of economic reality, the supply of services to the taxpayer.

On this third stage, while it was open to the UT to consider whether the economic reality reflected the contractual position, it should be 'slow to interfere' with the FTT's findings. This approach may have been taken further by the CA in the recent *Praesto Consulting* decision [2019] EWCA Civ 353, where economic reality was treated as a question of fact for the FTT to determine. That made no practical difference in this case though, because the FTT's conclusion on the economic reality of the situation in point was 'unassailable': the only economically rational explanation of Tesco Freetime's behaviour was the value of the deal partners accepting reward tokens in exchange for the provision of goods or services to Clubcard members, which enabled Tesco Freetime to fulfil its obligations to Tesco Stores and the broader Clubcard programme (as well as Clubcard members).

Overall, the contractual position and economic reality pointed towards the deal partners supplying services to Tesco Freetime that would be used for the purposes of Tesco Freetime's business. That finding was not precluded by the fact that deal partners were also supplying services to Clubcard members, because of the principle established by *Redrow*.

Economic reality

The UT rejected HMRC's primary argument in relation to sticking tax on a number of grounds:

- *Redrow* tells us that the matter has to be looked at from the standpoint of the person claiming the input tax deduction (here, Tesco Freetime), not the customer.
- When considering whether the economic reality of the arrangements involved a supply by the deal partners to Freetime (per the contracts), the presence (or not) of any sticking tax in relation to the customer's consumption was 'neither here nor there'. One would only expect sticking tax if the consideration paid to deal partners was third party consideration, and so HMRC's argument assumed what it sought to prove. It was noted here that the discount treatment of in-store redemptions of Clubcard vouchers similarly did not give rise to 'sticking tax', so it was not surprising to find that redemption of points via this different route (which involved forgoing the customer's entitlement to the discount in-store) produced a similar result.
- If the fact there was no sticking tax was a reason to conclude that Tesco Freetime should not be entitled to its input tax, then the same must have been true of the arrangement in *Redrow* – but that is not the answer the House of Lords reached in that case. So, HMRC's argument was inconsistent with *Redrow*. (The UT noted that all three judges in the majority in *LMUK* before the Supreme Court approved *Redrow*.)
- In any case, if one took a broad view of the arrangements (as indeed HMRC argued for), there *was* sticking tax here because, as found by the FTT, the cost of the Partner Boost programme was factored into the prices paid by Tesco customers when they shopped in-store.

HMRC had sought to argue that the line of reasoning in this final bullet ran contrary to the decision in *Kuwait Petroleum* [1999] STC 488. But the UT rejected that argument, on the basis that *Kuwait* was concerned with a wholly different question; namely, whether – for the purposes of the business gift rules – the payment by the customers for (in that case) fuel was also consideration (for VAT purposes) for the vouchers or redemption goods. The

business gift rules were not in point in Tesco's case, and in any event only concerned goods, not services.

Compartmentalising the business gift rules in this way, as a separate regime that should not dictate the analysis in other contexts, is consistent with other (higher) authorities on the point, particularly *Associated Newspapers* [2017] STC 843 in the Court of Appeal and *Commission v Germany* in the CJEU (C-427/98).

LMUK

The UT framed HMRC's arguments in relation to the *LMUK* litigation as two-fold:

1. On a proper analysis, Clubcard was materially similar to the 'Baxi' loyalty scheme considered by the CJEU alongside *LMUK, Baxi Group* (C-55/09) [2010] STC 2651 (in relation to which the CJEU found that payments made by the sponsor to the operator of the scheme were partly third party consideration for a supply of reward goods by the operator to customers).
2. The FTT was wrong to conclude that Clubcard was materially the same as the Nectar loyalty scheme, such that the Supreme Court decision in *LMUK* regarding Nectar should be determinative of the Clubcard appeal.

The UT dismissed these arguments as well.

As to *Baxi*, HMRC had argued that the Supreme Court in *LMUK* expressly agreed with the CJEU's analysis of the Baxi reward scheme. The UT did not accept this: the Supreme Court simply stated the general principle that the CJEU's decision on matters of EU law was binding on national courts, and so it was only the principles (if any) applied by the CJEU in *Baxi* that were relevant. As the CJEU's decision in *Baxi* did not in fact contain any statements regarding how economic reality should be determined, the UT held that *Baxi* contained no binding guidance as to how to analyse the economic reality of Partner Boost – and certainly did not compel agreement with HMRC's analysis.

On the comparison with Nectar, HMRC's case ultimately involved a point about the direction of the supplies made by Tesco Freetime. HMRC argued that it was key to Lord Reed's analysis in departing from the CJEU's decision that the business of LMUK (the equivalent of Tesco Freetime in Nectar) involved making antecedent taxable supplies to Nectar members, whereas Tesco Freetime only made supplies to another Tesco entity. The UT rejected this too: in highlighting the points that the CJEU had failed to take into account, Lord Reed was not identifying the essential prerequisites to a finding that LMUK was entitled to deduct its input tax. In any event, the critical point for present purposes was that LMUK had made a prior taxable supply – the *direction* of that supply was not material. We note here that it would be very surprising indeed if Lord Reed had based his judgment on there being a supply by LMUK to Nectar members, given that Lord Reed refers in his judgment to the passage in the Court of Appeal decision which makes it very clear that was not the treatment that was being applied.

A final observation is that the UT did not make any attempt to apply (or indeed, even mention) the rather crude categorisation of different types of loyalty schemes set out by the UT in *Marriott Rewards*. Rather, the decision in this case emphasised (in our view, correctly) the limited utility of analysing how relevant principles have been applied to different fact patterns in order to draw comparisons or distinctions.

Implications for loyalty schemes

The UT's clear support for the *Redrow* approach in assessing input tax entitlement in cases where a business pays for something that directly benefits someone else - and its rejection of the proposition that the 'need' to tax final consumption somehow overrides that approach - is helpful for other businesses running loyalty schemes that give rise to similar issues. That said, the decision does not preclude the existence of third party consideration in a loyalty scheme context; each case will have to be analysed on its particular facts, by reference to the principles discussed above.

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