PLACE OF SUPPLY - Fixed establishment - Gaming supplies in UK by Channel Islands subsidiary of UK parent - Machines leased to CICo by another UK subsidiary and situated in arcades of further UK subsidiary - Services provided by further UK subsidiary - Contracts between CICo and other three subsidiaries of common parent - Whether arcades fixed establishment of CICo in UK - Whether place of supply in UK - Yes - Sixth Directive Art 9.1 - 13th Dir, Art 2.1 - VATA 1994, s.7(10), 9(2), 39 - Appeals dismissed

AVOIDANCE - Scheme to make place of supply abroad - Purpose to avoid VAT - Whether Halifax principle applies to make supply by UK company - No - Whether abuse of rights - No- Result of place of supply rules not contrary to purpose of Directive

LONDON TRIBUNAL CENTRE

(1) R A L (CHANNEL ISLANDS) LIMITED
(2) RAL LIMITED
(3) RAL SERVICES LIMITED
(4) RAL MACHINES LIMITED - Appellants
- and -
THE COMMISSIONERS OF CUSTOMS AND EXCISE - Respondents

Tribunal: THEODORE WALLACE (Chairman)

K S GODDARD MBE

Sitting in public in London on 17, 18, 19, 20, 23, 24, 25, 26, 27, 30 September and 1-3 October 2002

Dr Paul Lasok QC and Valentina Sloane, counsel, instructed by KPMG, for the Appellant

Christopher Vajda QC and Mario Angiolini, counsel, instructed by the Solicitor for the Customs and Excise, for the Respondents

DECISION

1. These appeals arise from an avoidance scheme prepared by KPMG in relation to gaming machines operated in the UK by companies in the RAL Holdings Ltd group. Under the scheme gaming machines in 127 amusement arcades in the UK were leased to a newly formed Channel Islands subsidiary company, which was granted licences by a group company in the UK to use the arcades. Another UK subsidiary contracted with the Channel Islands company to provide the staff at the arcades. The basis of the scheme was that the place of supply of gaming machine services to customers would be in Guernsey and that the Channel Islands company would be entitled to repayment of input tax on supplies made to

it without being liable to any output tax. Before the scheme, a single UK subsidiary made the supplies and output tax was paid.

2. The appeals are against a series of decisions contained in a letter dated 28 August 2001, some of which were in the alternative. All four Appellants are subsidiaries of RAL Holdings Ltd ("Holdings") which is the representative member of a VAT group (registration number 684 0037 43) of which RAL Ltd ("RAL") is the only other member. RAL Machines Ltd ("Machines") and RAL Services Ltd ("Services"), both being UK companies, applied for VAT registration on 5 October 2000 soon after their formation and were separately registered. RAL Channel Islands Ltd ("CI") was formed in Alderney on 8 November 2000 but did not register for VAT; following the decision letter it was compulsorily registered on 3 October 2001 with effect from 1 December 2000; its office is in Guernsey.

3. The decisions were (a) the refusal of repayment claims by CI made under regulation 186 of the VAT Regulations 1995 giving effect to the Thirteenth VAT Directive, (b) that CI was liable to output tax on the gaming machine supplies and (c) that CI was therefore liable to register for VAT, (d) that RAL made the gaming machine supplies and (e) that neither Machines or Services should be registered. Decisions (d) and (e) were alternative to (b) and (c).

4. At the time of the decision letter, CI had made three repayment claims : £355,541 in January 2001, £1,034,721 in April 2001 and £1,033,614 in July 2001. Later claims were also refused and appeals were lodged; in a letter dated 19 March 2002 the Commissioners agreed to treat all the claims for refund in accordance with the decision in this appeal. The later claims up to the period ending 31 March 2002 totalled a further £4,166,007 making some £6.6 million to that date.

5. The appeal against the refund refusals falls under section 83(c) of the VAT Act 1994 by reason of regulation 195 of the VAT Regulations 1995. The decisions in respect of output tax, which are alternative to each other since CI and RAL cannot both be liable for tax on the same supplies, have not yet given rise to assessments and the appeals are under section 83(b). The decisions on registration fall under section 83(a). The decisions that Machines and Services should not be registered have not yet been implemented and it is not clear from what date cancellation would take effect; as stated above, they are alternative to the decision that CI should be registered. The takings from gaming machines are chargeable to VAT under section 23, which is a derogation from the exemption for gambling under Article 13B(f) of the Sixth Directive, see *H J Glawe Spiel-und Unterhaltungsgeräte Aufstellungsgesellschaft GmbH & Co KG v Finanzamt Hamburg-Barmbek-Ulhenhorst* (Case C-38/93) [1994] STC 543, per Jacobs A-G at paragraphs 8-10.

6. The basic issue concerns CI and the place of supply rules. It is common ground that CI has a business establishment in Guernsey within section 9 of the 1994 Act and has established its business there within Article 9.1 of the Sixth Directive. The dispute is whether or not it has in the UK a "fixed establishment from which the service is supplied" within Article 9.1 of the Directive to which section 9 is intended to give effect. More specifically, the issue is whether CI has fixed establishments at the 127 arcades where the machines are situated and if so whether those establishments rather than the Guernsey office are the places of supply within Article 9.1. If the Commissioners are correct in contending that there are fixed establishments at the arcades which constitute the place of supply, then CI is liable to register and to account for output tax with input tax

credit on supplies to it and the repayment claims under regulation 186 do not arise.

7. If the Commissioners are incorrect in contending that CI has fixed establishments in the UK and is liable to tax here, they raise two separate alternative contentions. The first alternative is that, although the contractual arrangements between CI and the other Holdings subsidiaries were real and had consequences otherwise than for VAT, nevertheless, on a correct analysis of VAT law the gaming machine supplies continued to be made by RAL because the sole purpose of the transactions was to avoid VAT and in substance even after the restructuring RAL continued to make the supplies. This analysis relies on the Tribunal decision in *Halifax Plc and Others v Commissioners of Customs and Excise* [2001] V&DR 73. On this basis CI is not liable to register but cannot make claims under regulation 186 and RAL is accountable for VAT on the gaming machine supplies.

8. The other alternative contention is that, although not a sham, the restructuring constituted to an Abuse of Rights with the result that the repayment claims by CI were properly rejected and that in economic reality RAL made the supplies. This involved the doctrine of Abuse of Rights which was referred to the Court of Justice by the Tribunal in *Halifax* on 27 June 2002 [2002] V&DR 117 following the decision of Neuberger J remitting the appeal back to the Tribunal.

9. Both of the Commissioners' alternative contentions rest on the basis that supplies under the arrangements, which were not shams and which would (apart from their purpose of avoiding tax) result in the place of supply being outside the UK under the VAT legislation, were however contrary to the purpose of that legislation. They therefore involve consideration of the purpose of the legislation as well as the purpose of the arrangements and transactions thereunder, both of which are in dispute.

The evidence

10. The documentary evidence was in three ring-binders which included contracts, board minutes, internal documents of the Appellants and presentations by KPMG before the scheme was implemented. After the evidence junior counsel agreed a most useful chronology.

11. A full transcript was taken of the oral evidence. Five witnesses gave evidence for the Appellants and were cross-examined. They were as follows:

> Nicholas Harding, managing director of Holdings and a director of RAL, Machines, Services and an associated company, Cyberslotz Ltd;
>
> Jeremy Garland, finance director of Holdings and a director of RAL, Machines and Services;
>
> Raymond Mercy, a director of Holdings and of CI;

Brian Curtis, a director of CI and a former director of Hambros' subsidiary in Jersey and a Jersey resident; and

Keith Anthony Jenkins, a director of CI and formerly managing partner of the Jersey branch of KPMG and a Jersey resident.

Statements by Heidi Jean Renee Soulsby, director of Orbis Management Ltd, Company Secretary to CI, and Mrs Tina Anne-Marie Kerrigan, trust manager who acted for Orbis Management Ltd, were agreed by the Commissioners.

12. The only witness for the Commissioners was Trevor Bainbrigge, employed by Services at the amusement centre at Reading as a unit manager from April to August 2002. His name had been provided to the Commissioners by the Appellants.

13. We now summarise the basic facts drawing on the documents, the agreed chronology and the explanations by the witnesses.

Arrangements before the scheme

14. In November 1996 a management team led by Mr Harding bought the shares in Rank Amusements Ltd from the Rank Organisation Ltd. Rank Amusements Ltd was renamed RAL Ltd. Holdings is the investment vehicle, which is 25 per cent owned by the management team and 75 per cent by Anderson Murray Johnston and Bank Boston, venture capitalists, who were represented on the board of Holdings.

15. Before 9 October 2000 RAL supplied gaming machine services, in addition to bingo machine and pool playing facilities, from premises which it owned or leased, using machines which it owned and employing its own staff, some 600; the machines were serviced under a contract with Rank Leisure Machine Services Ltd ("RLMS"), an unconnected third party, and the collection and banking of takings was carried out by Securicor Cash Services Ltd. The main activity was slot gaming using Amusement with Prizes ("AWP") machines. Some premises, but not all, also had bingo and pool machines. Holdings as representative member of the VAT group accounted for VAT on the net takings of the gaming machine supplies.

16. The machines were sited in 127 amusement arcades operated by RAL. There was no entry fee. The machines were operated by coins varying from 10 pence to £1. Customers pressed a button rotating three reels with symbols; if they came to rest in a certain order prizes of varying amounts were won. The machines were set to pay out up to 90 per cent of money staked. Members of staff witnessed larger payouts to avoid disputes.

17. The main customers were middle-aged ladies. There was music and refreshment trolleys were provided. The aim was to achieve a social atmosphere. Arcades were generally open from 9.30am to 8.00pm, six days a week. Some were open on Sundays for shorter hours. They were not in prime High Street sites.

18. RAL was licensed in relation to the premises and had the appropriate licences and permits for the machines.

Presentation of the scheme

19. On 6 January 2000, following a telephone call to Mr Garland, KPMG which had no previous relationship with the group offered to make a presentation of a possible VAT saving in respect of gaming and amusement machines subject to a confidentiality undertaking being given.

20. On 28 January the presentation was given to Mr Harding and Mr Garland. The visual aid was entitled, "KPMG's VAT Mitigation Proposals for Gaming and Amusement Machines." It contrasted £4.2 million VAT then payable with a nil liability using a Channel Islands company ("CICo"). CICo would recover VAT on the site rental, if opted for tax, and on the machines. KPMG would charge £75,000 plus VAT for an evaluation report and counsel's opinion and a fee of 25 per cent of the first year's VAT savings, 15 per cent of the second and 5 per cent of the next three year's savings. A challenge by Customs was anticipated.

21. On 29 March KPMG wrote accepting appointment as advisers to Holdings and to agreed group members on the terms set out in a letter and appendix. The feasibility fee of £75,000 plus VAT was payable in three instalments, the last being payable on receipt of counsel's opinion. It was not refundable but an equivalent amount was to be set against the seventh VAT saving fee, which latter fee is payable four weekly based on estimated VAT savings. The VAT savings fee remains contingent until accepted as effective by Customs, or until the appeal process is concluded or until three years have elapsed from the date of the VAT saving for any period without an assessment. KPMG were to assist in the preparation of claims under the 13th Directive, to review the direct tax matters connected with the new structure and to prepare and present an appeal at their own cost before a VAT Tribunal, subsequent appeals being at the group's cost. The terms were signed as accepted by Mr Mercy on 5 April 2000.

22. On 15 June 2000 KPMG presented a 16 page report to the board of Holdings. The "Executive summary" was as follows:

> "1.1 The restructuring recommended in Section 2 of this report could result in a gross saving of the VAT on the machine takings estimated to be £4,200,000 per annum based on current trading patterns.
>
> 1.2 The net saving will be less due to a number of factors including the cost of the restructuring and the ongoing cost of the new structure.
>
> 1.3 In our view HM Customs & Excise ('Customs') will regard these planning arrangements as 'unacceptable tax avoidance' and will seek to challenge the arrangements. However, a similar concept for telecommunications ran for nearly four years in most Member States of the EU before the UK, French and German Governments secured the unanimous agreement of all 15 Member States to amend the primary legislation and stop the concept.
>
> 1.4 Since at the moment we are not aware of any widespread use of these planning arrangements, and the fact *(sic)* that some EU Member States do not charge VAT on gaming machine income, unanimous agreement to amend the EC legislation could be difficult to achieve.

> 1.5 The proposed arrangements are sufficiently flexible to allow the restructuring to be modified to include any acquisitions the Company may make in the future, thereby increasing the savings.
>
> 1.6 However prior advice from KPMG must be taken on VAT and direct tax issues before new sites or businesses are acquired to ensure the benefits of the new arrangements are not prejudiced.
>
> 1.7 It should be possible to unwind the arrangements if the idea is subsequently blocked or successfully challenged by Customs. The cost of unwinding the arrangements should not be significant."

23. The report recommended that two new subsidiaries of Holdings be established, one resident in the Channel Islands ("CICo") and the other in the UK ("Ralstaff"). RAL would continue to rent the properties. RAL's staff would be transferred to Ralstaff. CICo would not have a UK office, or UK-based records, but would pay RAL a fee to place gaming machines in serviced premises. Ralstaff would contract to provide customer care, promotional services, cleaning and security services in relation to the machines to CICo and, in relation to the premises, to RAL, being remunerated accordingly by CICo and RAL. CICo would acquire the machines and would contract with a third party, RLMS, for maintenance of the machines, paying an appropriate fee. RLMS would carry out cash emptying and counting. CICo would contract with Securicor to collect the takings and bank them in CICo's account.

24. Under "Direct Tax" it was stated that CICo would be Guernsey incorporated and tax resident with a UK branch subject to corporation tax being part of Holding's corporation tax group. The transfer by RAL of machines and goodwill to CICo's UK branch should not crystallise any capital gains. The transfer of machines to CICO "should be done at tax written down value for capital allowance purposes and this will be reflected in the capital allowance treatment in both companies (paragraph 2.20)".

25. "Under VAT" it was stated that the transactions between CICo and RAL, Ralstaff and RLMS would all be liable to VAT, including the transfer of the machines to CICo. It was assumed that all RAL properties would be opted to tax. CICo would submit quarterly reclaims of the VAT charged to it under the "Thirteenth Directive on the basis that it is a Channel Islands resident company which is incurring VAT expenses in the UK, but is not making taxable supplies nor is it established in the UK."

26. Under "Licences" it was stated that the arrangements would not involve any change in the licensing obligations of the group. RAL would need its existing licences and CICo would need to be included.

27. The report included the following:

> "6.8 Customs' grounds for refusing the claims by CICo are likely to be either that CICo belongs in the UK or CICo has a UK agent (namely the parent company or a fellow subsidiary).
>
> .

> 7.4 All decisions relation to CICo must be made in Guernsey. Therefore the board meetings must be held there. KPMG Guernsey offers facilities for board meetings together with secretarial support if required.

.

> 7.8 In VAT terms CICo must have sufficient resources to enable it to carry out its business and it will need access to the relevant expertise. This can be either by way of employees or by the directors entering into contracts with third parties to provide the services they require.
>
> 7.9 Therefore in the circumstances of the restructuring, CICo will need to enter into contracts for the maintenance and emptying of the machines it provides.

.

> 7.14 All transactions between the Company, its subsidiaries and CICo should be on an arm's length basis to strengthen the commercial reality of the arrangements."

28. Section 8 of the report covered the accounts treatment in some detail. CICo's profit and loss account would be on a net of VAT basis showing recoverable VAT as an asset on the balance sheet. Paragraphs 8.10 and 8.13 read,

> "8.10 As far as the Company's consolidated group accounts are concerned, . the profit and loss account will reflect as turnover the entire takings from the gaming machines. Thus, on a Combined (or group) basis, the effect of the arrangements will be to convert what would otherwise have been output VAT on the takings from the gaming machines into turnover and, consequently, profit before tax.

.

> 8.13 The directors of CICo are likely to request a guarantee from the company, confirming that in the event of adverse results from the arrangements, the company will support CICo .".

29. The Board minutes of Holdings on 15 June 2000 recorded agreement "to move to the next stage in evaluation of Project CICo. Ray Mercy volunteered to be the co-ordinator of the project." An E-mail of the same day to Paul Hemmings of KPMG inquired whether it was of major importance for the machines to be owned by CICo given the delay in reclaiming VAT on replacement machines. Mr Hemmings responded on 19 June that the "respective merits of Ralmachines v CICo owning machines, plus the UK tax/valuation issues if the machines were sold to CICo" would be referred to tax counsel.

The decision to proceed - August 2000

30. Ray Mercy was on holiday until 3 July. A minute of Holdings' Board on 10 August 2000 read as follows:

> "The matter of Project CICo was discussed and the board approved the setting up of subsidiary companies in order to allow the CICo company to operate gaming machines within premises owned and staffed by RAL personnel. It was noted that the CICo company would receive all monies taken by its machines on RAL premises and that RAL would make a charge to the CICo company for supervising and safeguarding these machines. It was also noted that CICo intended to subcontract with RLMS for the provision of servicing and cash collection for its equipment. RCM would also research further whether the structure might allow us to take advantage of potential tax benefits for the machine company."

"RCM" was Mr Mercy. An e-mail by Mr Mercy to KPMG on 14 August included this,

> "The RAL Holdings board meeting on 10 August approved the creation of additional companies within the Group to take care of staffing, machine provision and CICo itself . The creation of a staffing company providing services at first to RAL Limited is the first essential as soon as possible."

31. By 16 August, Holdings' solicitors had started work on setting up a new staffing company to which employees would be transferred from RAL with new contracts of employment, which company would initially contract with RAL. On 18 August KPMG Guernsey were looking into clearance from the regulatory authorities to the incorporation of a Guernsey company managing gambling in the UK : restrictions only applied to gaming services provided there. Mr Hemmings advised that counsel should review the contracts between the new service company, RAL and CICo. Services was incorporated on 23 August.

32. On 25 August Mr Hemmings E-mailed Mr Harding stating,

> "The aim is to get as much substance in CICo as possible, without damaging their offshore status. A cash emptying contract with a third party is preferable to a contract with a fellow subsidiary."

33. On 31 August a draft Action Plan was produced by KPMG setting out 71 steps up to 'IMPLEMENT' starting with "Incorporate RalS and RalM in UK as wholly owned subsidiaries of RAL Holdings Ltd" and including the sale of machines to RalM and the transfer of staff to Ralstaff. It follows that by then it had been decided that a company would be formed to own the machines. At that stage CICo was intended to be Guernsey registered and based.

34. On 15 September Pamela Cook of KPMG met Mr Garland and discussed the potential tax planning opportunities resulting from the reorganisation of Holdings, including capital allowance aspects. On 26 September she wrote to Mr Garland regarding the balancing allowances obtainable on the transfer by RAL of machines which were short life assets at market value which was lower than the written down value of the short life asset pools; there was no mention of CICo. Meanwhile Machines had been incorporated on 18 September.

35. Further versions of the Action Plan were produced on 21 September, 27 September and 18 October. That on 21 September specified dates for the first time with "IMPLEMENTATION" on 1 December as step 72. CICo was to be Alderney registered but based in Jersey. Osborne Clarke, solicitors, had already been instructed by Holdings to prepare the agreements between CICo and the UK subsidiaries (Step 52). The first directors' meeting of CICo was to be on 6 November. Step 6, by 6 October, was to negotiate sale of machines to Machines. Mr Mercy had been selected as an industry-based director for CICo. KPMG were to arrange the direct tax status of CICo as an international business company and agree the tax rate (step 50).

36. On 2 October Jeni McLaren, RAL's Human Resources Manager, sent a circular letter to RAL staff, headed "Re: Change of employer". The first two paragraphs read as follows:

> "Further to Nick Harding's note in the Operations Brief on 5 September 2000, I am writing to confirm that the company is undertaking an internal reorganisation to make the structure more user friendly. This means that all staff currently employed by RAL Limited will transfer to RAL Services Limited with effect from 9 October 2000. We have also taken this opportunity to update your contracts of employment to bring them into line with current practice as detailed below.
>
> Your continuity of employment and other main terms and conditions such as pay etc will not be affected by this change in any way."

First phase - October 2000

37. On 5 October both Services and Machines applied to be registered for VAT giving the same address in Milton Keynes as that of Holdings. Services' application form gave its taxable supplies in the next 12 months as £7 million starting on 6 October; Machines gave anticipated supplies as £1 million. Both were registered.

38. A letter of agreement, signed by Mr Mercy on behalf of RAL and Mr Garland on behalf of Machines, provided for the sale to Machines of all AWP machines, bingo machines, pool tables, cash changing machines and accessories and spare parts owned by RAL for its business for £3,492,964 plus VAT, to be left outstanding on inter-company account interest free and payable on demand. Completion was to be on 9 October at RAL's offices when RAL would also assign the benefit of its three year contract with RLMS which ran from 1 December 1999.

39. Another letter from RAL to Services provided for the sale on 9 October of certain assets including coin counters to Services for £678,415 plus VAT, also left on loan, and for the assignment of an escrow agreement with Playsafe Monitoring Ltd relating to the Guardian System.

40. Those agreements were approved at board meetings of Machines and Services on 9 October at Milton Keynes, the directors present at both meetings being Mr Harding and Mr Garland; two representatives of the solicitors attended. The board of Services approved a 17 page contract for the provision of services to RAL prepared by the solicitors; it provided for a four weekly fee of £620,000. The services were set out in a schedule of five pages under the headings : Customer

Service, Promotions, Cash Management, Security, Machine Management, Periodic Checks, Health and Safety, Ancillary Services, Cleaning, Housekeeping and Administration.

41. Also on 9 October, the boards of Services and Machines, consisting of the same two directors at each meeting, approved an agreement of 12 pages between Services and Machines providing for Services to provide various services on a "when needed basis" relating to the gaming machines, including recommending and making purchases of machines, disposing of machines, monitoring income, carrying out collection procedures, arranging the positioning of machines, arranging their repairs when damaged, cleaning them externally and supervising the agreement with RLMS. The four weekly fee was £8,000. Under clause 4 Services was to give priority over all other business except for RAL, to provide all personnel and provide that they work to Machines' hours and comply with all reasonable directions notified by Machines.

42. On the same day, the board of Machines approved a master lease to RAL of the machines, which it had agreed to buy, under separate lease supplements for individual payments to be set out in the Supplement. The Supplement signed and exhibited did not specify the equipment or the payments.

43. The minutes of a Holdings board meeting on 10 October recorded Charles Henry, a non-executive director, as suggesting that "it might be possible in the future to use the CICo structure to our advantage when reviewing tax planning for Cyberslotz." Cyberslotz Ltd was an associated company engaged in internet gaming. The minutes contained nothing else relevant to the appeal.

Final Action Plan

44. The last Action Plan dated 26 October showed 30 steps as "Done" towards implementation at step 83. By then, following a meeting in Jersey, the selection of two Channel Islands residents, Mr Jenkins and Mr Curtis, to be directors of CICo and agreement of their remuneration was "Done". At this stage it had been decided that CICo would be registered in Alderney but its offices were to be in Jersey. An E-mail from Margaret Alexander of KPMG Jersey stated, "Counsel has advised that the offshore structure must have substance, in that it must employ its own employees." She referred to practical difficulties for CiCo in acquiring offices and employees in Jersey. She suggested relocating to Guernsey which had less restrictions, stating that "our new owners, Kleinwort Benson are supportive . . The work we have done on preliminaries would not be wasted, as it can be taken over by Orbis Guernsey, and I would hope that the directors could be retained." Orbis Management Ltd was the trust company arm of KPMG Guernsey.

45. On 2 November Holdings' board ratified the decision to base CICo's operations in Guernsey as opposed to Jersey. On 8 November 2000 CI was registered as a private limited company in Alderney with 10,000 £1 shares of which 9,999 were owned by Holdings and one by RAL. Mr Mercy, Brian Curtis and Keith Jenkins were appointed as directors.

46. The inaugural board meeting of CI was held at the premises of Orbis Management Ltd, Guernsey, on 8 November. A number of Steps in the Action Plan of 26 October were carried out. Step 61 read,

> "The Ral CI Ltd Board should then discuss and agree it will enter into negotiations with the other companies to operate and maintain the AWP and Change machines. RM to be instructed to negotiate."

The Board minute read,

> "IT WAS RESOLVED that the Company would enter into negotiations with other RAL companies and third parties concerned to operate and maintain Amusement With Prizes (AWP) and Change Machines."

47. At some date in November Project CICo was presented to area managers by RAL, using a Rollout Plan, as an "Opportunity to pay less Tax." Under "What needs to happen" appeared -

- "December 4th new bank books comes into force (Lloyds versus Girobank)

- Separate Petty cash, TPCC and Machine floats required
- New paperwork implemented
- Two separate addresses for paperwork
- Machine Float can only be used to run the machines
- Fast Figures (RAL Poole) to be sent via E-mail to RAL Channel Islands."

Area Managers were told to keep 27 November to 8 December 2000 clear to deliver All new paperwork. They were to separate floats on 1 December.

48. On 27 November a Board meeting of CI approved a draft contract with Services, a draft lease of the machines from Machines and a draft licence with RAL. It was noted that the fee for the licence "had yet to be agreed but would be in the region of 51.5% of the turnover, 85% of which to be paid now and 15% at the end of the financial year." Mr Jenkins and Mr Curtis were authorised to sign. It was resolved that Securicor be contacted with a view to a new contract to include cash counting, as Lloyds TSB, CI's bankers, were unable to count cash. It was minuted that on execution of the lease, CI would need to purchase approximately £1 million in cash floats to be funded by a loan from Holdings.

49. On 28 November an E-Mail from Securicor said that CI would keep the same account number as RAL, the only change to the contract being the address but cash processing was being added; a new contract for the bulk change service was being printed in the name of RAL.

Implementation of Second phase - 1 December 2000

50. On 1 December 2000 the second phase of the arrangements was implemented in accordance with the timetable in the Action Plans, starting with the exchange of contracts. The Board minutes of RAL, Machines and Services all stated that "the RAL Group had decided to proceed to the second stage of the reorganisation."

51. Machines entered into a new master lease with RAL, clause 11.1 of which terminated the lease of 9 October. Machines agreed to lease to RAL bingo machines, pool tables and similar machines together with accessories under separate lease supplements for individual rentals. The Board minutes of Machines on 1 December stated that the rentals were to be agreed. The agreement between Services and Machines (paragraph 41 above) was amended on 1 December by deleting arranging the positioning of machines; however this was not minuted.

Lease of machines to CI

52. On 1 December 2000 Machines as Lessor also entered into a lease agreement with CI as Lessee to lease AWP machines and cash change and similar machines listed in the Supplement for payments as set out in the Supplement. The lease included the following:

> "5.1 The Lessor agrees to provide the Equipment in good working order and at its own expense to keep the Equipment in such order.
>
> 5.2 The Lessee agrees at all times and at its own expense:
>
> (a) to keep the Equipment in the United Kingdom and in its own possession and control;
>
> .
>
> 6.1 The Lessor shall obtain . all licences and permits necessary to operate the Equipment in Gaming Centres operated by the Licensee .
>
> The Lessor shall inform the Licensee immediately in the event of the Lessor being refused any such licence or permit .
>
> 6.2 The Lessor agrees that at all times it is responsible for all risks of loss or damage to the Equipment save for damage caused by the gross negligence or recklessness of the Lessee, its servants, agents or contractors and agrees to insure and keep insured the Equipment ."

There is no definition of "Gaming Centres" or "Licensee" nor any reference to any licence apart from gaming licences. It is unclear whether "Licensee" is an error for "Lessee". The wording follows the Lease on the same date by Machines to RAL (see paragraph 61 below). Counterpart agreements with the supplement blank were signed by Mr Harding on behalf of Machines and Mr Jenkins for CI, being dated 1 December.

53. The Supplements were not dated and were signed by Mr Garland on behalf of Machines and by Mr Curtis for CI. The Equipment was "as per attached listing, which may change from time to time." Pages 1, 2, 86 and 124-6 of an asset register stock report dated 20 December 2000 were attached. We conclude from this that the supplement was not signed before 20 December 2000 although its commencement date was given as 1 December. CI was to pay £120,320 weekly on account (equal to £20.65 plus VAT per machine); every four weeks Machines was to submit a VAT invoice based on the number of sited machines at the end of the period and CI was to pay the balance.

CI Agreement with Services

54. We next come to the agreement between CI and Services. The draft agreement was approved by CI's board on 27 November and by Services' board on 1 December and agreements were signed by Mr Jenkins for CI and by Mr

Harding for Machines. Neither minutes mentioned VAT. CI is "the Company" and Services "the Contractor". Under clause 2 CI appointed Services as its exclusive contractor to provide the services set out in Schedule 2 on a "when needed basis". Six months' notice of termination was required by clauses 3 and 16. Clause 4.1 to 4.3 provided,

> 4. **Obligations of the Contractor**
>
> 4.1 The Contractor shall give priority to the provision of the Services over all other business activities undertaken by the Contractor save for any services it may agree to tender to RAL Limited and/or to any machine provider to the Company or RAL Limited, where the provision of services therein shall rank in order of priority equally with the provision of the Services.
>
> 4.2 The Contractor agrees to provide all personnel to perform the Services. The Contractor shall ensure that all personnel based at any of the Properties will work to the hours specified by RAL Limited and shall comply with all rules and regulations reasonably notified by the Company and/or, in the case of the Properties, by RAL Limited.
>
> 4.3 The Contractor shall keep detailed records of all acts and things done by it in relation to the provision of the services and at the Company's request shall make them available for inspection and/or provide copies to the Company."

Clause 4.4 (inter alia) required Services to "obey all lawful and reasonable directions of the Company". Clause 8 provided that Services should comply with Key Performance Indicators which were set out in Schedule 1 as follows:

> **"Schedule 1**
>
> (The Key Performance Indicators)
>
> - On the appointed day collect all cash from the Gaming Machines, accurately count and record the same and arrange banking to RAL (Channel Islands) Limited bank account in a timely manner. Diligently record all machine meter readings and electronically transmit these to RAL (Channel Islands) Limited office in the Channel Islands. 95% of all collections procedures to meet the above criteria.
>
> - All units to be operating a local promotion at all times.
>
> - To operate at least two mailshots to the Gold Card database members each year.
>
> - To act upon every customer complaint passed from RAL (Channel Islands) Limited office in the Channel Islands and to use reasonable endeavours to resolve any dispute or other query arising therefrom.
>
> - Cash exceptions (banking to meter readings) to be contained within 1.25% of turnover."

Under clause 11 CI paid £610,000 for each four weekly period; CI's copy stated that this was inclusive of VAT, Services' copy was altered to read exclusive being initialled by Mr Harding. Under clause 12 CI was to use "all reasonable endeavours" to procure that RAL should supply keys to each property and allow access and CI was to provide keys to each AWP machine and cash changing machine. Under clause 13.1 it was provided that CI would rely on Services' "skill, expertise and experience in performing the Services and also upon the accuracy of all statements made and any advice given by" Services. Under clause 14 prior written consent was required for subcontracting except in matters of a minor nature.

55. We set out the services in Schedule 2 in some detail because of their importance in understanding the business as well as their significance in the appeal. We italicise provisions which were not in the 9 October agreement between Services and RAL or where there was a substantial change; the headings were already in italics.

> "*Customer Service*
>
> - Provide uniforms and name badges as agreed with the Company for all staff whilst performing the Contractor's duties under this Agreement and ensure that such staff wear the same at all times;
> - To ensure that all *Gaming Machines* at the Properties are at all times clean and well presented;
> - Ensure Radio Quicksilver is playing at acceptable volume at all times;
> - Ensure the atmosphere at each of the Properties is friendly to all concerned; and
> - *Upon request of the Company, investigate customer complaints and report back to the Company.*
>
> *Promotions*
>
> .
>
> *Cash Management*
>
> - *Fill change machine as and when required from site float;*
> - On weekly basis carry out full cash collection *involving:*
>
> - *Record meter readings on Oyster unit;*
> - *Check Gaming Machine tubes or hopper float is full;*
> - *Empty cash boxes and count as weekly takings;*

- *On weekly basis carry out mid-week empty by emptying cash boxes and recording as part of weekly takings;*

- .

- At periodical intervals as required by the needs of the *Properties* go to local post office or bank and exchange notes for coins;

- Refill Gaming Machines *including change machines as appropriate;*

- .

- Reconcile cash from Gaming Machines and prepare banking for collection by security provider.

Security

.

Machine Management

- *Send information from the Guardian system via modem line to the Company.*

- *On weekly basis examine following areas of detail on the Guardian system:*

    - *Cash to meter exceptions (difference between actual takings and theoretical takings);*

    - *Percentage Payout highlighting the (difference between actual and planned percentage);*

    - *Check licence is correct by identifying licensable machines on site versus what is on the Guardian system;*

.

- Upon a customer reporting a *Gaming Machine* faulty following occurs:

    - If fault is *witnessed by a member of staff* pay the customer the claim in tokens (unless customer want (sic) cash) and record on appropriate paperwork;

- If fault *is not so witnessed* turn off the Gaming Machine and await engineer's visit. No payment to be made until verification is final *and Company approval has been given*; and

- To monitor and recommend to the Company the optimum level of licensed *Gaming Machines* within each of the Properties *and the optimum position within the Properties for siting of the Gaming Machines*.

Miscellaneous

- *On weekly basis carry out standards checklist to ensure operational standards are being maintained or that issues that need addressing are actioned;*

- *On daily basis carry out float check to ensure any differences are identified so as to enable swift remedy of any administration errors;*

- *Ensure all issues raised in standards checklist provided from time to time by the Company are actioned and dealt with ongoing basis;*

.

- Advise the Company of all proposals to changes in the law in the United Kingdom affecting the gaming centre business operated by the Company."

"*Promotions*" included raffles, party days, scratch cards, balloons and promotional giveaways, such as pens and posters. It also covered provision to Gold Card members of tokens or other prizes. "*Security*" included ensuring CCTV tapes are cycled and that no illegal activity occurs.

Agreement between Services and RAL

56. Also on 1 December Services entered into a contract with RAL to cover the bingo machines, pool tables and looking after the premises generally. The wording of clauses 2 to 7 were almost identical to that in the agreement between Services and CI, with the substitution of different parties. The Key Performance Indicators under clause 8 and Schedule 1 were much shorter:

- "At any one time 90% of unit staff will wear uniforms including badges.

- All properties to be open at the stated hours and close no earlier than the stated hours.

- The average 'Mystery Shopper' survey (which test all aspects of customer service) is to be no less than 85%."

Clauses 9 and 10 were identical. The payment under clause 11 was £10,000 exclusive of VAT every four weeks. Clause 12 was similar but RAL was to supply the keys to the properties and allow access and to supply the keys to the bingo machines and pool tables. There were no other material differences in the body of the agreement.

57. There were some differences in the Services in Schedule 2. Under "Customer Service" the reference to Gaming Machines was replaced by "Machines, tea, coffee and other drinks machines", the reference to complaints did not appear but

> "Ensure that customers visiting the Properties are offered the complimentary food and drink provided for this purpose by the company."

was included. Under "Promotions", there was provision to recruit Gold Card Members. Under "Cash Management", the part which we have italicised in paragraph 55 above does not appear. Under "Security", Services were required to open and lock the building and deactivate the alarm, keep a register of keys and check the security devices on closing. The italicised part of "Machine Management" and "Miscellaneous" did not appear. There were requirements for Health and Safety checks, sale of stamps and phone cards, cashing third party cheques, cleaning windows, hoovering the carpet, emptying ash trays and bins and for arranging rubbish collection and managing lights, heating and air conditioning, none of which were in the CI agreement. There was also provision for a complete accounting service and for administration and secretarial services, which were not in the CI agreement.

The floats

58. On 1 December 2000 the Board of RAL resolved to sell to CI the machine and unit floats at its amusement centre properties as at that date for £1,059,699, the price having been calculated on a £1 for £1 basis. CI were to be directed to pay the proceeds directly to Holdings as partial repayment of a debt owed by RAL.

59. On the same day the Board of Holdings resolved to lend £1,060,000 to CI interest free, unsecured, to be repaid on demand. This would be set off against the sum due to Holdings at the direction of RAL.

Licence from RAL to place AWP machines

60. Also on 1 December 2000 RAL granted CI a licence to place AWP machines in its gaming centres. CI was entitled to provide, instal, operate and maintain AWP machines and cash-changing machines, to use the cash-counting machines and to store cash in the safes. RAL agreed to provide electricity, not to allow anything to be placed so as to restrict the public's use of the machines, to allow public access during opening hours to play, to arrange for the premises to be kept clean and tidy and heated, ventilated and lit. Nothing was to confer on CI any right of exclusive possession or occupation of any part. The payment was specified in the schedule as 50.5 per cent of the Machine Takings, which were defined as the gross takings without any deductions. 80 per cent was payable each four weeks with the balance at the year end. In the CI minutes of 27 November the

provisional figures had been 51.5 per cent and 85 per cent (see paragraph 48 above).

Machines lease to RAL

61. Again on 1 December 2000, Machines and RAL entered into a lease under which Machines leased bingo machines, pool machines and ancillary equipment. The earlier lease of 9 October (paragraph 42 above) was terminated. RAL was described as the Lessee. Clause 6.1 is identical to clause 6.1 of the Lease to CI with the substitution of "Amusement Machine Centres" for "Gaming Centres." Again the agreement contains no definition of "Licensee": it can only refer to RAL, the Lessee.

RLMS

62. The contract between RAL and RLMS referred to at paragraph 38 above was not produced in evidence. The board minutes of RAL and Machines contain no record of the contract being novated to Machines or of a new contract between RLMS and Machines. Mr Mercy's statement that there was a contract between Machines and RLMS was not challenged and it is clear that RLMS carried out the servicing of machines throughout. From the oral evidence, RLMS engineers visit each site daily except for Sundays but at no fixed time and all problems concerning the functioning of machines are referred to them. RLMS has a warehouse, where some 500 machines belonging to Machines are stored, and lorries which it uses to transport machines between sites as needed. Machines relies on RLMS to perform all servicing, transport and storage, having no staff of its own and relies on Services to perform any functions not sub-contracted to RLMS. Machines' agreement with Services (paragraph 41 above) includes supervising the agreement with RLMS.

Securicor Cash Services Ltd ("Securicor")

63. No copy of the agreement between RAL and Securicor before 11 December 2000 was in evidence. An agreement taking effect from 11 December 2000 covered bulk cash and bingo and snack bar cash processing. On 3 January 2001 it was noted at a CI directors' meeting that Securicor would not be issuing a separate contract for CI, although one had been requested, but would invoice CI. In the event a contract running from 1 December 2000 was signed on 20 February 2002. £6420.79 a month was payable for "Cash-in-Transit/Business-Link". The services are not clearly set out but appear to involve weekly collection of containers with cash and cheques from 125 sites, cash processing and banking. Up to £20,000 could be carried in a container. Lloyds TSB are not prepared to count the cash but rely on Securicor to do so. The money is handed over to Securicor by Services' staff acting for CI.

Gold Cards

64. Gold Cards referred to in the agreement between CI and Services are mailed to any customers who ask for them and fill in an application form. There is no payment and the holder receives no legal rights. The cards can be used to add to the promotions on offer at any RAL Gaming Centre or for entry into Gold Card Draws for machine and bingo players only. The application forms state that the cards remain the property of RAL Group which can terminate the scheme at any time. Under "Data Protection" the form states,

> "RAL Services Limited collects and uses the information that you have given and may share it with other members of the RAL group of companies. RAL Group Companies will use your information primarily to enhance and improve promotional offers and to let you know about them by either post or e-mail."

The application forms are issued by Services staff and the cards are despatched from Milton Keynes.

Events from 1 December 2000

65. On 1 December 2000 CI took a lease for 3 years of offices at L'Islet, Guernsey, at an initial rent of £7,500 a year. Marilyn Hockey was employed as Guardian System manager from that date at £22,000 a year. The position of Financial Controller was advertised but was not filled until 12 January 2001 when Barry Stevens was engaged at £30,000 a year. The Guardian System is used to monitor cash from some 5000 individual machines and the movement of machines.

66. An Operations Brief by Services dated 6 December detailed new forms to be used by site managers. RAL 1001 (new) is to be used to record machine takings, initial machine floats, tube monies out, unit cash float, machine tokens float and amount banked; these are to be posted to Guernsey weekly with copy paying-in slips to Lloyds Bank, Channel Islands. Another form is to record machine float movements. Oral evidence was given that this is fed into the Guardian System by Marilyn Hockey.

67. On 13 December Mrs Kerrigan of Orbis Management recorded Mr Mercy as telephoning her and saying that "there may well be some further operations to be run from Guernsey - an internet gaming Co which is currently in its early stages." At that point CI's cheque book had not yet arrived.

68. Directors' meetings of CI were held in Guernsey on 3 January and 14 February 2001. At the first meeting it was noted that Securicor would not be issuing a separate contract to CI although this had been requested; a software maintenance agreement with Playsoft was signed and it was noted that the Operations Manuals had not yet been set up. Trading and cash flow were reviewed. On 14 February it was noted that the tax status of CI is Guernsey resident. It was recorded that the first VAT reclaim had been submitted on 25 January 2001.

69. The composition of the initial VAT reclaim of £355,541 was as follows:

Renting Machines Machines £ 71,680

Staffing Services Services £106,750

Licence RAL £172,913

Equipment and installation Playsafe Monitoring Ltd £ 2,046

Cash collection Securicor £ 2,152

70. On 19 February 2001, Mr Harding, Mr Garland and Mr Mercy met with two KPMG representatives at Milton Keynes to consider the VAT reclaim, no

acknowledgment having been received of the claim submitted on 25 January. KPMG's note included the following,

> "Ray [Mercy] . reported that the Guernsey office was up and running. It had furniture, even including a fridge. Seven telephone lines, fax and ISDN lines. He said he that RAL (Channel Islands) Limited was currently employing two staff, Marilyn who was the machine controller and Barry who was the financial controller. He said that Barry was still on a learning curve of the company's accounts but that Marilyn had become very good on machine controls. RM also reported that they had established a Lloyds Link which meant that they had daily bank information and could automatically transfer funds from Guernsey to the UK. Funds could not be transferred on the UK's order to or from Guernsey. Ray also reported that there were minor start-up teething problems, principally banking areas where the bank had funds in the wrong accounts. This had happened both ways but these had been sorted. Ray also reported that there was a new contract with Securicor, whereas previously there had just been a name change on the old contract. The contract had been signed by Keith Jenkins, director, in the Channel Islands."

Mr Mercy had reported that all machines had CI labels. There was then discussion of the additional information Customs might require including "the purpose of the arrangement". The note continued,

> "One of the purposes of the arrangements was to minimise the tax burden in the group. This was achieved by reducing the payment of VAT in relation the machines, and any other benefits which accrued, such as crystallising the balancing allowances on machines, changing the accounting procedure for short life assets, whilst of benefit to the company were also tax motivated savings.
>
> NH said that from his point of view the biggest benefit of the scheme was enhanced shareholder value and he would consider that this was something that the directors of RAL (Channel Islands) Limited could consider using in their response to Customs.
>
> A further purpose was to position the group to be able to expand overseas and to be able to move forward with business development plans that required the use of the internet. It was noted that other groups within the betting sector had developed an offshore presence and RAL did not intend to get left behind in these developments."

71. On 2 March 2001 Mr Garland, as Group Finance Director, wrote to Mr Mercy, RAL Services Ltd, at his home address, formally informing him of the forthcoming disposal of the units at Watford where there were 41 machines and at Stockport where there were 50 machines and asking him to inform Mr Jenkins and Mr Curtis of the decision inviting any questions. The letter also informed Mr Mercy of RAL's decision to open four new greenfield sites during 2001 which would accommodate around 160 machines, one site to be open the next week, and asked for confirmation at the next CI board that "they would like to encompass those new sites within the existing arrangements".

72. On 19 March Mr Mercy was informed of another forthcoming disposal. On 20 March the Holdings board approved a proposal to acquire premises in Paisley. The proposal had been prepared by Byron Evans, business development director of Services. The capital cost was £59,000, mainly refurbishment and new machines. The financial projections were on a group basis making no mention of CI, Machines or Services or of RAL Ltd as a separate entity. Under "Opposition" Mr Evans stated that there were two other amusement centres in Paisley, Nobles with 42 machines and a local operator with 30 machines and a café. This was in an "exceptionally busy town centre". The proposal stated,

> "As it has been shut for many months now, it is therefore assumed that the existing business will have been absorbed by the two other operators in the Town Centre and our projections are based on a 'new opening'".

He forecast a pay-back period after depreciation of 1.8 years. Neither the Paisley project nor any of the other site changes was mentioned in CI's board minutes of 3 April 2001.

73. CI Board minutes of 3 April record an information memorandum regarding CI being sent to KPMG and to discussions being in progress relating to the proposed internet licences in Alderney. Letters in April 2001 mentioned the possibility of a casino in Jersey and opportunities in Holland and Eastern Europe. Holding's Board Minutes of 14 May 2002 contained the following,

> "It was reported that the possibility had arisen for the issue of Internet Gaming licences in the Channel Islands. Clearly, this had been one of the original reasons for the establishment of RAL CI Ltd ."

Meeting with Customs

74. On 25 May, having only received an acknowledgment of the claims from Customs, Mr Mercy sent a fairly detailed statement about CI's activities to the Commissioners. The Commissioners replied with an extensive list of questions. CI provided more documents and a lengthy meeting between directors of the Appellants and Customs took place on 3 July with representatives of the Appellants' solicitors and KPMG present. On the following day Mr Bob Brown, a Customs officer, sent a six page note setting out his understanding of what was said.

75. This note included the following:

> "**Principal Business Activities**
>
> 7. The group as a whole operates in the gaming industry, its market currently confined to England, but with aspirations for expansion into Europe, particularly Holland. It has a Bingo operator's certificate, which will allow it to run cash Bingo in due course, but the current Bingo operation is limited to prize Bingo. Bingo itself is a relatively small part of the overall business. The main business activity is slot gaming.
>
> 8. The group has no gaming machines as defined by the Customs' legislation. The slot gaming machines are AWP machines. In

addition there is a small number of video games machines (about 30). The total number of machines is about 5,500.

9. The group's supplies are exclusively to the general public in England. The supplies are made from premises owned by the group. It is not part of the group's business to place machines in (say) pubs. The supplies are instead made from premises owned (usually held on lease) by the group. (RAL is the company which holds these leases.) The premises are described in the industry as "licensed gaming centres", and admission is allowed to persons over 18 years of age only.

10. In one or two premises (e.g. Wednesbury) there is a café on the premises. But in the main the business is to provide slot gaming. Currently there are about 132 premises run by the group. In about 20 of these premises prize Bingo is also run. Where that happens, a separate area of the premises is used for that purpose.

Group Management Structure

11. There are area managers in the group, responsible for about a dozen sites each. Area managers report to an Operations Director. There are two Operations Directors (whose title does not denote company directorship), one for the North and one for the South of England. The Operations Directors report to the "Managing Director" (whose title does not denote company directorship). The Managing Director is Martin Lyall. Martin Lyall reports to Nick Harding who is a director of Holdings, RAL, Machines and Services.

The Activities of the Individual Companies (since 1 December 2000)

12. RAL is the property arm of the group, and also operates the prize Bingo. It licenses the properties to CI, thereby giving it the right to site machines in the premises. At a few sites there is also a cheque cashing service offered, and this activity is proper to RAL.

13. Services is the group's "people company". It employs all of the group's staff (with the exception of the two CI directors [and two CI employees] who are resident in Jersey). The staff are made available to the other group companies under various intragroup contracts and essentially the staff run the licensed gaming centres.

14. Machines owns the 5,500 or so machines used by the group, including the Bingo equipment. In short, all the coin operated machines are owned by Machines. In the main part this is outright ownership, although Machines holds a small amount of equipment under Hire Purchase agreements on a trial basis. Hire Purchase may be used more frequently in future by Machines as a means of acquiring coin operated machines, if this "trial" is successful. Machines' activity is to provide licensed machines to CI for use in CI's activity. Machines is thus responsible for obtaining licenses for the machines, for acquiring the machines themselves, and for keeping them in good repair. The last of these activities is subcontracted to a company in the Rank Organisation (RLMS). The first two activities are carried out by staff employed by Services.

15. CI's activity is to provide to the public the use of the licensed machines made available to it by Machines on the premises made available to it by RAL. It is thus CIL which contracts with the public. Each machine bears a notice, which explains that the machine is being provided by CIL, and gives a telephone number for complaints. This telephone number connects the complainer to CIL's office in Guernsey. CIL is able to carry out its activity by subcontracting most of the day to day work to others. For the most part this work is done by staff employed by Services. However, CIL itself contracts directly with some arm's length suppliers. For example, cash is collected from the slot machines on the premises by staff employed by Services, and those staff fill in bank paying-in slips. The cash is then collected and actually taken to the bank by Securicor, under a direct contract with CI. (Prior to the restructuring the Securicor contract was with RAL.)

.

17. For direct tax purposes CIL considers itself resident in Guernsey. It is thus liable to pay corporate income tax in Guernsey on its world wide profits, but this is relieved by double tax relief. It considers itself to be established in the UK for corporation tax purposes, by virtue of the machines (which are provided to it by Machines) being located in the UK. The result is that it will pay UK corporation tax on the profits arising from the slot machine activity, and will not pay Guernsey income tax on this amount, as it will be relieved under double taxation arrangements. But it will pay Guernsey income tax on its Guernsey investment income, which is likely to be mainly bank interest arising from its Guernsey bank accounts.

The Thinking Behind the Restructuring

18. The decision to restructure was taken by the board of Holdings. The restructuring was first suggested to RAL by the KPMG VAT Department. Its predominant aim is to increase group profitability by reducing the amount of VAT paid by the group, after taking account of VAT recovered by the group. Before the restructuring, the group paid VAT on the takings from the slot machines. Since the restructuring, the UK companies within the group (notably RAL, Machines and Services) have been paying (a slightly smaller amount of) VAT on the services provided to CIL. But the main advantage will arise if CIL can successfully recover this VAT under the 13th VAT Directive, without incurring a corresponding output VAT liability on the takings from the slot machines.

19. While the restructuring was first suggested by KPMG as a VAT saving arrangement, there were other aspects to the group's thinking, which bore on its decision to adopt the arrangements. The group is interested in obtaining a casino licence in Jersey. While CIL is strictly based in Guernsey, it is nevertheless felt that this presence in the Channel Islands is an advantage when it comes to obtaining such a licence. Similarly, the group is interested in obtaining an internet gaming licence in Jersey, so that it can relocate its internet gaming servers (which are currently located in Costa Rica) more conveniently in Jersey. Again, it was felt that a

presence in Guernsey was helpful in this respect. CIL's Channel Islands resident directors are in fact resident in Jersey, and are able to work on these matters. On the matter of internet gaming, that it is an area for possible future expansion. It is likely that such expansion will take place in a company called Cyberslotz. Cyberslotz is not currently a member for the RAL group, but it has investors in common with Holdings, and there may be further restructuring to integrate Cyberslotz into the RAL group. Work done by CIL's directors in Jersey may ultimately benefit the group, once Cyberslotz is integrated into it.

The Intragroup Contractual Arrangements

.

22. These contracts were not negotiated between the various companies in the sense that, in each case, representatives from each company set around a table and bargained. However, there were discussions at group level, involving individuals who were collectively directors of all of the group companies, and these discussions led (for example) to price adjustments, which changed the budgeted profit to CI. The current budgeted profit for CI is about £700,000, and the out-turn to date is slightly short of that. In short, the cross charges are considered by the group to equate to open market value, as far as can be ascertained in a case where there is no obvious market comparator for a person providing (say) licensed gaming machines to another company.

23. As far as concerns CIL's agreement to the contracts, this was fully discussed among all three directors, and the Jersey directors were not the type simply to sign where they were told. They applied their minds (and their commercial experience) to the matter, and concluded that the contracts were in the best interest of their company.

Assignment of Arm's Length Contracts

24. . In the case of the contract between RAL and the Rank Organisation machine service company (RLMS), the beneficial assignment of this agreement from RAL to Machines was effected in October 2000 without Rank's knowledge, but Rank were informed later (when it came to discussions about an annual price increase under the ongoing agreement). .

25. In the case of the contract between RAL and Securicor, this was replaced with two contracts. The first remained between RAL and Securicor, and related to Bingo monies, which remained the property of RAL. The second was a new agreement between Securicor and CIL, for the collection of slot machine money, which was now the property of CIL.

Licences and Permits

26. There is no correspondence between KPMG and the group on the matter of licences and permits. The group considered which of the group companies would most properly hold licences (for gaming

machines, granted by Customs and Excise) and permits (for premises, granted by Local Authorities). It was decided that licences should be held by Machines and that permits should be held by RAL, given their respective roles following the restructuring.

What Happens Where

27. In essence, the whole of the slot machine operation takes place in the UK, with broadly four important exceptions:

(a) *CIL's accounting takes place in Guernsey*. While staff employed by Services empty the machines in the UK, fill in paying-in slips in the UK, and transmit accounting information to Guernsey via a dial-up modem, and while Securicor take the money and pay it in to a bank branch located in the UK (but paying in the money to CILs' account with Lloyds Guernsey), the accounting controls and other accounting functions for CIL take place in Guernsey. There is a full time financial controller in Guernsey who runs a management and statutory accounting system which is compatible with the system of the UK companies. He reconciles bankings to information provided from the UK premises, and follows up discrepancies. He accounts for costs, and seeks approval from directors for payment of bills. He provides four-weekly management accounting information, which is transmitted back to the UK via a secure modem for consolidation with the other companies' results to produce group management accounting information. His post is in essence a new one, created as a result of the restructuring. While some accounting functions previously carried out in the UK are now carried out by him, most of his work has been created by the new structure. The UK accounting function has not been able to reduce its staff as a result of work "moving" to Guernsey.

(b) *"Machine management" takes place in Guernsey.* There is a full time "machines manager" in Guernsey. By contrast with the financial controller post, this is a post which was previously filled in the UK, is now filled in Guernsey, and no longer exists in the UK. The postholder is Marilyn Hockey. The machine manager does not manage maintenance or ordering of machines. Rather, her role is essential one of financial control. She analyses and acts on information reported to her on the financial performance of each of the group's 5,500 machines. This information is reported to her via a computerised system called "Guardian". The information comes from the machines' internal meters. (Contrast the financial controller's information, which comes from data input by

Services' staff on the various premises, paying in slips, bank statements etc.)

(c) *Some Complaints are Dealt With in Guernsey*. On each slot machine there is a telephone number for complaints. No telephone is provided for use by complainants who have to make their own arrangements to phone. This number connects to a dedicated phone in the Guernsey office. This phone is answered by the machine manager (most of the time), the financial controller or any of the directors who happen to be in the office. In practice there are relatively few complaints by phone. Staff on the UK premises (employed by Services) are expected under the agreement between Services and CIL to deal with any complaints made on the premises. In case of doubt or difficulty, they will contact CI for instructions.

.

28. To put the above functions into context, the group has some 600 staff, employed at over 130 premises in the UK, along with a number of subcontractors in the UK providing (for example) machine maintenance and secure cash transit. The Guernsey operation has two full time staff, essentially involved in accounting and financial control, two part-time Jersey resident directors, and one part-time UK resident director. (The UK resident director is a full-time employee of Services, but spends only part of his time in his capacity as CI director, the rest as a director of Holdings.)"

76. KPMG responded on 12 July substituting a new paragraph 27(d) and an additional paragraph 29 as follows:

"27(d) *The directors of RAL (CI) Ltd carry out all their functions in the Channel Islands*

The directors' overall supervision and all decision making takes place in the Channel Islands, at board and other meetings. In addition, the two Jersey resident directors authorise cheques in Guernsey. Work carried out outside Guernsey is normally work done by the Jersey resident directors at home, or in lobbying the Jersey authorities for e.g. a casino licence. The work done by Ray Mercy in the UK is for RAL Services Limited, for example occasionally visiting premises to see that the operations are being carried out satisfactorily. In his capacity as an employee of RAL Services Limited RM provides information and advice to the board of RAL (CI) Limited under the terms of the contract between the two companies; and then, when in the CI, he sits as a board member to assist in the decision making process there.

Additional paragraph 29

The directors of RAL Holdings Limited do not believe that these arrangements are likely to be significant in the context of some 250,000 gaming machines in the UK of which only approximately

> 40,000 are operated in the Licensed Gaming Machine sector. Of the operators in this sector the majority are sole traders and RAL believes that there are probably only two companies which would have the necessary resources to establish a similar group structure. These are The Noble Organisation (based in Team Valley) and the Shipley Group of Companies, (based in Tamworth). These two operators are responsible for c8000 machines, making c13,500 machines together with RAL, out of a total market of 250,000."

The only other amendments were of a minor nature.

77. On 18 July Mr Mercy provided answers to questions from the Overseas Repayment Unit raised in June. That was the final communication before the decision on 28 August 2001.

Evidence of the witnesses

78. This brings us to the evidence of the witnesses. Much of this is derived from the documentary material which we have already covered and except where necessary we do not repeat this. Their evidence is however material to the purposes of the Appellants in the various transactions and the way in which the arrangements operated in practice. The six live witnesses gave evidence confirming their statements and were cross-examined. The statements and the transcripts of the oral evidence are of course available in the event of an appeal. At Mr Vajda's request and with Dr Lasok's agreement, witnesses who had not been called were not present in court, although this is not normal Tribunal practice.

Mr Harding

79. In his statement Mr Harding said that under new arrangements in October 2000, RAL "was broken up in order for the various facets of the operations to be run and developed as separate businesses by discrete companies within the RAL Holdings Group." He covered the initial approach from KPMG at the end of 1999, the meeting on 28 January 2000, the presentation to the Board on 15 June (paragraph 22 above) and the decision to evaluate the proposals. He stated that Mr Mercy and Mr Garland established that the restructuring would produce a corporation tax saving of £238,000 in that year and "would increase the focus on specific aspects of the business." His statement outlined the initial steps with the incorporation of Machines and Services and the initial contracts.

80. He stated that on 10 October Mr Henry had raised the possible benefit to Cyberslotz Ltd of the CICo structure. (It appears that this company was set up in January 2000.) Cyberslotz is now providing internet-based betting and gaming with payment by card. Gaming is provided by a computer system located in Costa Rica there being currently no licences available to locate UK internet gaming in the UK. The suggestion was that the server could be located in the Channel Islands instead of Costa Rica making it cheaper to look after the equipment; furthermore Alderney tax on licensed internet gaming would be lower than the UK tax. He stated that the Board decided to wait until Guernsey allowed internet based gaming systems; the possibility of a licence in Guernsey was discussed again on 14 May 2001.

81. He stated that it had been "anticipated that the compartmentalisation of the operations of RAL would allow the various operations to be run more innovatively and efficiently, while also increasing the potential for the development of each

business into new, related areas." Machines had been approached by gaming companies to enter into a distribution agreement to get discounts; it had supplied £100,000 worth of machines to Thomas Estates Ltd and was negotiating with another company. Services had been approached by a company to provide staffing and management of its sites. RAL could market its premises to additional third parties and was entering into a sub-lease with Cyberslotz, which was now a full group company.

82. He told the Tribunal that CI involved hardly any additional administrative burden; he receives management reports and accounts a day later than before but the CI office is cheaper than the offices for the same people in Milton Keynes. There is an extra half person overall. He said that RAL does not need CI's consent to rent premises to a third party or to add a new property or to make a decision as to running its bingo pool and snooker facilities. Machines could lease machines to a third party or contract with a manufacturer without CI's approval, nor is CI approval needed for staff appointments by Services or for contracts with third parties.

83. Mr Harding said that RAL group uses mainly low-tech machines; about 1,000 of RAL's 5,500 machines are high-tech, the rest are low-tech. There are about 1,000 amusement centres in the low-tech sector with an average of 40 machines, catering mainly for middle-aged ladies who come to the centres specifically to play the machines. Most of the 250,000 machines in the UK are high-tech machines situated in pubs and clubs and used casually mainly by males under 25; the group buys high-tech machines second hand. The low-tech and high-tech markets are distinct. The low-tech sector in which RAL group is involved is highly fragmented with RAL group, Noble Organisation and Shipley Group, the leading players, only accounting for a third of that sector.

84. He said that the RAL group trades under the name "Quicksilver", this being the name on the shop fronts. Most customers are Gold Card Members of whom there are 52,000. They put the card into a special machine which registers them as having come in and sometimes pays extra prizes. CI machines have a special sticker; the special Gold Card machine does not and is presumably an RAL machine. Staff provide free food and drink on request from a trolley. Promotions are advertised on a board both for Gold Card Members and for other players. Other notices tell customers that they can ring the Guernsey office for a Gold Card form with £10 worth of free games and can ring with complaints about machines. Staff wear a gold and silver uniform with a Services tag and name badge.

85. Cross-examined, Mr Harding said that Martin Lyall, managing director of Services, submits a report of some 12 pages to each Holdings Board meeting covering all normal areas. Mr Lyall receives management reports on each site as does Mr Harding. Mr Lyall comments on site targets and profitability, unusual incidents, security and competitor activity, focussing on the existing businesses. There is a report from the finance director, Mr Garland, and Mr Mercy reports orally on his activities.

86. He said that managers down to unit level have salaries with bonuses linked to profits. There are annual appraisals. Mr Lyall's bonus is based on the entire Quicksilver business. The Holdings board remuneration committee approves annual staff pay increases. The financial information on the Quicksilver business is available to the board when requested. All group staff are employed by Services, apart from CI staff and Mr Harding himself.

87. Mr Harding said that it was unlikely that KPMG's scheme would have been agreed if the main fee had not been contingent, the group cash flow would not have stood it. He agreed that the sole purpose of KPMG's proposals at the time of the engagement letter was VAT saving. When considering the June KPMG Report (paragraph 22 above) the cost was a factor. There was KPMG's £75,000 and around £50,000 legal and other costs. Annual administrative costs are £235,000 in the Channel Islands. Some jobs from Milton Keynes went there. He wanted to be sure that it was not enormously expensive. The possibility of unwinding the arrangements if challenged was a factor. At that stage he had no idea where the Channel Islands company would be resident. There was no mention of Machines at that stage, only Services. The detail of the Channel Islands structure was a matter for KPMG who were being paid for this. He agreed that the sole purpose of the June Report was VAT saving.

88. He said that the transactions between Holdings and its subsidiaries were on an arm's length basis in the sense that they are independent companies and do not interfere with each other, apart from through the contracts : everything was commercially at arm's length as though they were not parent and subsidiary or associated. He remembered discussion about a guarantee to CI but not when. CI is not trading profitably because it has not received the reclaims. It was taken as read by Holdings board that support will continue until the VAT issue is resolved.

89. Mr Harding said that he had no involvement in Project CICo between the June Report and the Board meeting of 10 August : Mr Mercy was dealing with it. He did not remember any written report; Mr Mercy reported orally. Project CICo was a VAT savings scheme, but Mr Harding thought the board wanted to be assured that there were other good reasons. He could not remember whether he was aware then of a possible machine company. Mr Mercy was instructed to get on with the project. He said that he could not remember which Board meeting was first on 9 October or how long the meetings lasted; it was probably half an hour each; they were pretty detailed.

90. He said that setting up CI involved more than VAT savings. Although not written down, the other purpose was to make the business more efficient. A separate service company made it easier to focus staff. Cyberslotz staff were also moved to Services; Cyberslotz was then only a fledgling company not yet up and running. He agreed that it was no more efficient at the time to transfer RAL staff to Services, but it would possibly have been more efficient in the future: it was about taking the company forward. There was no discussion on 1 December as to providing services for third parties. The solicitor talked them through the agreements on 9 October. Mr Harding agreed that since he was a director both of Services and Machines he was in a sense agreeing with himself and that there was no real commercial negotiation. He could not say why no price was specified in the lease between Machines and RAL (see paragraph 42 above).

91. He accepted that the contracts with payment figures blank only made sense on a Group agreed basis. Decisions on disposing of Units, on acquisitions and on movement of machines between sites were all approached on a Group basis.

92. Mr Harding said that the decision to locate CI in Guernsey was because of the difficulty of getting licences in Jersey to recruit staff; no licence was needed in Guernsey. The communications to Alderney were not good enough to locate there. Mr Harding said that from Day 1 he asked Mr Mercy, "What else can we do in the Channel Islands?" He accepted that the other benefits were a consequence of the arrangements : a very useful by-product. They helped to tip the balance because £75,000 was a large sum up front. He regarded the possibility of an

internet gaming licence in Guernsey as important but said that Guernsey is still not issuing licences.

93. Mr Harding said that the management information pack which he receives regularly contained a sheet for each unit. It is on a pyramid basis going through areas and regions. There has been no change since before the reorganisation apart from some information on machine sales. There is no separate information for RAL or Services. Asked why there has been no change, he said that the benefits are not always reflected in the accounts. Services can get business from small private companies who would be reticent to deal with a competitor. He said that he can see how the separate companies are performing although this is not in the accounts. RAL has not provided arcade facilities to any competitor, although it has sub-let properties which it cannot assign.

Mr Mercy

94. Mr Mercy's statement said that CI was formed:

> "to achieve a reorganisaton of the group's UK activities and to position the group for a possible overseas expansion that might also involve the internet. In addition the restructuring enabled there to be significant savings on a one-off basis in corporation tax, and ongoing savings of value added tax."

The reorganisation effectively into divisions had enabled a clear focus to be developed. Casinos in the Channel Islands, gaming activities throughout the internet and gaming machines in Europe are all being explored : all are expected to require a Channel Islands company. The Jersey legislature has been debating e-commerce and internet gambling legislation since late 2001. CI is tendering for a casino licence in Guernsey and pursuing the possibility of a licence in Jersey. In December 2001 CI started detailed research into developing the gaming business in Spain and has explored possibilities in the Netherlands.

95. Mr Mercy told Mr Vajda that he visits Guernsey for 2/3 days a week and has a desk and computer at the office. Fast figures come through by E-mail. Guernsey accounts are produced in Guernsey; the Holdings board does not approve CI's budget. He said that he and Mr Harding had discussed benefits other than VAT saving in June or July 2000; he had not mentioned them at the 10 August meeting. If he had mentioned benefits, there was a risk of someone saying, "All right, tell us exactly what the benefits are." It was unclear then whether there was a corporation tax benefit, so he was asked to research. If the only issue had been VAT saving, the scheme would have been implemented faster. He did not know when the decision was taken to set up Machines. He knew that Thomas Estates had shares in Cyberslotz, but that had not affected the transaction with Machines. Eventually it was intended that Machines should have its own business.

96. He said that the contractual payments were directly related to costs, with a factual basis. They were the same sort of contracts as if at arm's length. It was basically between himself and Mr Garland. The other CI directors accepted them when he told them the figures were fair. Wages and salaries were a large element in the £610,000 four weekly payment to Services, which was intended to make a small profit, on the £610,000. He agreed that the payments to Machines made no provision for alterations; although there was a constant turnover of machines it was not expected that their overall asset value would vary materially. The licence payment to RAL was reduced because he thought the original figures would stretch CI's resources. He said that in fact the current CI shortfall is being funded

by RAL, since CI has only made the 80 per cent payments, leaving the 20 per cent outstanding. Services and Machines are being paid in full.

97. Mr Mercy said that there had been no need to tell the area managers of the commercial reasons at the presentation (paragraph 47 above) since they would not necessarily be involved. The CI office had meant greater focus on exceptions which had reduced them slightly; he accepted that this could have been done in the UK. He said that the CI administrative expenses of £138,830 in December 2000 had included start-up costs; the figure for 2001 was £235,000. He estimated the additional cost to the group of CI to be around £100,000 a year, of which £20,000 is to Mystery Shopper for monitoring for which CI has greater need.

98. Mr Garland said that the weekly fast figures are produced by CI and distributed on a historic basis as before the reorganisation to those who need to understand what is happening in the various units. (The list contains thirteen names from Mr Harding downwards.) He estimated the incremental cost to the group of CI, after unit-related costs including start-up costs spread over two years but excluding VAT and tax, as £250,000 a year. The budget produced by CI is consolidated with the UK budgets to give a group budget for approval by Holdings Board which also approves capital expenditure and acquisitions of units. £713,000 was the estimated VAT saving net of costs to March 2001 before corporation tax. He said that separate management accounts are not produced for Machines and Services, only trial balances: in 2001 Services made about £330,000, Machines made about £700,000 and RAL £4.8 million. The Holdings Board is interested in the consolidated group result rather than the individual companies; Mr Harding however can see anything. CI data is replicated to the Milton Keynes server. Figures are produced to enable management to measure the group business broken down into regions, areas and units so that corrective action can be taken if they are underperforming.

99. He said that he did the majority of the work in calculating the payments under the inter-company agreements with some input from Mr Mercy. He took the total payroll costs of Services, included a sustainable profit element, and split this between CI, Machines and RAL; he did not know what percentage was CI, but it was high because most of Services' 600 staff are field-based. The charge by Machines to CI was also calculated on the basis of Machines' costs; the figure of £120,320 came before £20.65; it included cash changing machines but not coin counters. The recharges were set on the basis that CI would recover VAT; on that basis CI would make around £900,000 a year before corporation tax; he and Mr Mercy had not considered what would happen if the VAT could not be recovered. He said that he and Mr Harding were running the AWP machines business looking at the profitability of the group as a whole; the only part he was not involved in running was the Channel Islands. He had starting thinking about capital allowances in May or June 2000; as far as he was aware, crystallisation of deferred allowances which were quite large could have been achieved by a sale to CI; but the sale to Machines was quicker. Before CI was set up there were discussions as to benefits other than tax and VAT although they were not minuted : not everything discussed was minuted..

100. Mr Curtis told Mr Vajda that he had originally been approached by Margaret Alexander in October 2000 and had met her and Mr Mercy; at the outset they told him of a VAT savings scheme by moving offshore; they also mentioned a possible casino and developing in Europe. At first he was told that it would involve half a day a month but this changed rapidly to two days. He said that he always examines exceptions or shortfall figures before monthly CI board meetings.

Marion Hockey sorts out initial discrepancies with the area manager; a rate of 1.25% is acceptable, sometimes they get exceptions down to 0.6% per cent but it is the trend which is important. He said that he had only visited the UK twice on CI business but whenever in the UK he visits a unit if possible. He said that CI does have a business plan although not in writing. He agreed that before April 2001 there was nothing in the board minutes about discussions as to a Jersey casino or gaming, but said that it was "absolute nonsense" that documentation was created to show there was other activity. He said that there was still uncertainty about a casino or gaming in Jersey, although there is in Jersey no law prohibiting internet gaming. He said that investigations in Holland and Spain were in line with what he was originally told but he had not yet been to the continent on behalf of CI. He said that CI's draft accounts were qualified because it is basically insolvent without the VAT refund. The 50.5 per cent licence payment to RAL was considered to be the industry norm.

101. Mr Jenkins told Mr Vajda that the original approach to him was by Margaret Alexander who said that RAL was looking to set up offshore, focussing offshore for development of business offshore, and that there would initially be half a dozen meetings a year. A meeting followed at which he saw a copy of the June Report (para 22 above). He was told that there would be a VAT benefit and other benefits. Initially it was intended that the company should be in Jersey but there was a problem in proving a benefit to the Jersey authorities and it was decided to form an Alderney company based in Guernsey. The location of the office was agreed by Holdings. He was to travel from Jersey monthly and to work at home on one day a month. In December 2000 he visited Milton Keynes and went through the procedures in the office, including the Guardian reports, and also met Brian Morgan of Cyberslotz, discussing internet gaming developments. Mr Jenkins said that when appointed he knew little about the business although he had wide experience of business as an auditor. The contracts had been explained to him as being on "a sort of arm's length basis." Mr Mercy was involved in the detail of the negotiations. The contracts were agreed at group level between the representatives of the various companies. The licence with RAL (paragraph 60 above) was altered to help CI's cash flow. He said that complaints are received in Guernsey and logged by Marion Hockey; out of office boards they go to the UK. Marion Hockey contacts the area manager who sends back the resolution by E-mail. In re-examination, he said that the original plan was for an office with staff and a server in Jersey with a similar business to the present structure on the basis that they could possibly develop internet gaming and casinos locally; he had been told that splitting up the group business would enable refocussing on certain activities, such as sales by Machines to other organisations.

Mr Bainbrigge

102. Mr Bainbrigge said in his statement that as unit manager he had been responsible for cash control which involved himself and up to three staff for up to two hours twice a week. This involved emptying the machines, counting and reconciling the takings, completing accounting and banking forms, preparing and bagging the cash for collection by Securicor and entering details onto the Guardian system. Discrepancies over £2 were reported to CI. Change machines were regularly restocked with change for notes. Each member of staff had a change float. £1 coins were obtained from the post office as needed. He could not recall any customer telephoning Guernsey with a complaint but would not necessarily know.

Findings of fact

103. We were invited to make findings of fact in certain areas. This we do as appropriate. Other findings are contained in our conclusions. The amusement arcades are of sufficient size to constitute fixed establishments. We are satisfied that real functions are performed at the CI office in Guernsey. However, the four Appellant companies do not in fact function independently of each other and many key decisions, in particular as to the acquisition and disposal of units, are taken by the directors of their common parent, Holdings; CI, RAL and Machines could not function without the human resources provided by Services. Except for inputs provided under contracts by RAL, Machines, Services and Securicor, CI has no real involvement in the day-to-day management control of the provision of gaming services, its involvement being directed rather to monitoring the services and the cash flow after the event. All marketing is in the UK and all supplies are enjoyed by customers in the UK. There is no reason to believe that any change in the arrangements is apparent to customers, the facilities enjoyed by customers being unchanged. The arrangements involve some additional costs. We found the justification for the transfer of all staff to Services to be wholly unconvincing except in the context of the avoidance scheme. There was no evidence of any monitoring of the staff costs attributable of the different group companies and it seems to us that the sub-contracting of staff functions makes it more difficult for CI to monitor and control costs borne indirectly by it, in particular staff costs. Such control as there is appears to be exercised from Milton Keynes. The purpose of Project CICo was to avoid VAT. Such other benefits as there may be from the establishment of a Channel Islands company are speculative and arise from a desire to exploit its existence as opposed to being purposes in themselves. We accept Mr Harding's term "useful by-product", although the utility has yet to be proved.

The legislation

104 Article 9.1 of the Sixth Directive provides as follows:

> "1. The place where a service is supplied shall be deemed to be the place where the supplier has established his business or has a fixed establishment from which the service is supplied or, in the absence of such a place of business or fixed establishment, the place where he has his permanent address or usually resides."

That paragraph is therefore based on the supplier. Articles 9.2, 9.3 and 9.4 derogate from Article 9.1 in specified circumstances, none of which apply. Although Article 9.2(c), which provides that the place of supply of services relating to entertainment and similar activities shall be the place where the services are physically carried out, might appear to apply to the supply of gaming machine services being entertainment, *Berkholz v Finanzamt Hamburg - Mitte - Altstadt* (Case 168/84) [1985] ECR 2251 was decided on the basis that Article 9.2 (c) was not relevant to such supplies, see page 2254 and 2259.

105. Section 7(10) of the VAT Act 1994 provides,

> "(10) A supply of services shall be treated as made -
>
> (a) in the United Kingdom if the supplier belongs in the United Kingdom; and
>
> (b) in another country (and not in the United Kingdom) if the supplier belongs in that other country."

Section 9(2) provides,

> "(2) The supplier of services shall be treated as belonging in a country if -
>
> (a) he has there a business establishment or some other fixed establishment and no such establishment elsewhere; or
>
> (b) he has no such establishment (there or elsewhere) but his usual place of residence is there; or
>
> (c) he has such establishments both in that country and elsewhere and the establishment of his which is most directly concerned with the supply is there."

106. Article 2.1 of the Thirteenth Directive covers refunds in the circumstances claimed by CI to exist. So far as material it provides,

> "1. Without prejudice to Articles 3 and 4, each Member State shall refund to any taxable person not established in the territory of the Community, subject to the conditions set out below, any value added tax charged in respect of services rendered . to him in the territory or the country by any other taxable persons . , in so far as such . services are used for the purposes of the transactions referred to in Article 17.3(a) . of [the Sixth] Directive ."

Under Article 1.1 "a taxable person not established in the territory of the community" means a taxable person within Article 4.1 who during the relevant period "has had [inter alia] in that territory neither his business nor a fixed establishment from which business transactions are effected." Article 17.3(a) applies to transactions relating to economic activities within Article 4.2 carried out in another country which would have been deductible if performed within the territory of the country.

107. Section 39(1) of the VAT Act 1994 provides that the Commissioners may, by a scheme embodied in regulations, provide for the repayment to certain persons of VAT on supplies to them in the UK which would be input tax if they were taxable persons in the UK. Subsection (2) states to whom it applies and provides that it does not apply to persons carrying on business in the UK; subsection (2)(b) also refers to "rules adopted by the Council . about refunds".. Section 39(1) and (2) are not happily worded and it seems to us that section 39(2)(b) does not apply since the Council did not adopt any rules pursuant to the Thirteenth Directive. If that is the case the Appellant is entitled to rely in the direct effect of the Thirteenth Directive. We were not addressed on this. Subject to that, Part XXI of the VAT Regulations 1995 are the relevant regulations. Regulation 186 provides,

> "186. . a trader shall be entitled to be repaid VAT charged . on supplies made to him in the UK if that VAT would be input tax of his were he a taxable person in the UK."

Under regulation 185, in Part XXI a "trader" means a person carrying on business and established in a third country and who is not a taxable person in the UK. Regulation 189 provides that Part XXI does not apply to any supply which he has used for any supply by him in the UK.

Submissions as to fixed establishment

108. Dr Lasok, for the Appellants, submitted that section 7(10) and 9(2) of the VAT Act 1994 which differ in wording from the Sixth Directive must be construed and applied to produce the same result as that under Article 9, see per Moses J in *Customs and Excise Commissioners v Chinese Channel (Hong Kong) Ltd* [1998] STC 347 at 352d. "Establishment" in section 9(2) must bear the same meaning as "fixed establishment" in Article 9 and "establishment . which is most directly concerned with the supply" must mean "fixed establishment from which the service is supplied."

109. *Berkholz* [1985] ECR 2251 at paragraph 18 established that a fixed establishment from which the services in question are supplied must be "of a certain minimum size and [have] both the human and technical resources necessary for the provision of the services . permanently present", see also *ARO Lease BV v Inspecteur der Belastingdienst* (Case C-190/95) [1997] STC 1272 at paragraph 16.

110. He submitted that a fixed establishment must have all the human and technical resources required for the services actually supplied. He referred to *Customs and Excise Commissioners v DFDS A/S* (Case C-280/95) [1997] STC 384 at paragraph 27. He said that there might be a difference between services essential to a service of the type in question and those actually provided, however this case did not turn on that.

111. Dr Lasok said that there must be the staff or structure enabling management decisions to be taken, see paragraph 19 in *ARO*. Sub-contractors did not suffice in that case, see Fennelly A-G at paragraphs 30 and 31. *Berkholz* showed the need for a permanent presence to maintain the machines, the machines themselves being insufficient to constitute a fixed establishment.

112. He said that it did not suffice that there were contractual arrangements with third parties for the necessary services to be provided. In order to have a fixed establishment a trader must "possess" the resources, see *ARO* at paragraph 19. There was no suggestion in *EC Commission v France* (Case C-429/97) [2001] STC 156 that the services could be located in France merely because the foreign suppliers sub-contracted to French operators, see paragraph 51-2.

113. Dr Lasok said that *DFDS* was not directed at whether there was a fixed establishment in the UK but at whether it was the establishment of the Danish parent. In that case by the terms of the contract the parent company controlled the entire business of the UK subsidiary. The parent subsidiary relationship was not determinative: the critical question was whether the UK subsidiary had the necessary independence not to be a mere auxiliary organ of the Danish parent. He referred to paragraphs 25-28 of *DFDS*. He said that in that case there was only one contract. Here the Commissioners relied on a series of different contracts to show that CI has the necessary resources for a fixed establishment; the maintenance capability is provided by RLMS which is an unrelated company. Article 9.1 expressly contemplated the possibility of there being no fixed establishment.

114. He summarised the argument against there being fixed establishments in the UK as follows: (1) the services provided by RLMS which was an unrelated company are an essential part of the necessary resources; (2) Mr Harding and Mr Mercy had given unchallenged evidence that CI provides necessary services from Guernsey; (3) Services, Machines and RAL, although associated companies, are

all independent companies whose development cannot be controlled by CI. He said that the facts are thus quite different from *DFDS*.

115. Dr Lasok said that if the Commissioners succeeded on the fixed establishment issue they faced the problem that the Directive had not been properly implemented in section 9: there was no basis for section 9(2)(c). The place where the supplier has established his business is the point of reference unless it does not lead to a rational result or creates a conflict with another Member State, see *ARO* paragraph 15. Non-taxation, otherwise than from a conflict between Member States, is avoided only in the specific situations defined in Article 9.3, see *Dudda v Finanzamt Bergiseh Gladbach* (Case-327/94) [1996] STC 1290, paragraph 20. It is not irrational for the place of supply of services to be outside the EC even though the place of consumption is within the EC, see *EC Commission v France*, paragraph 52. Paragraph 22 of *DFDS* was explained by the peculiarities of the Tour Operators provisions.

116. Mr Vajda for the Commissioners said that the test as to fixed establishments was correctly summarised by Moses J in *Chinese Channel* [1998] STC at pages 352-3:

> "(1) It must be of a certain minimum size with the permanent human and technical resources necessary for the provision of the services;
>
> (2) Where the company operating the fixed establishment is a different legal entity from the supplier, the company operating the premises on behalf of the supplier must not operate independently, this being a matter of function and substance, nor mere legal form; and
>
> (3) The service must be supplied from the fixed establishment."

He said that the 127 arcades fulfil all three conditions.

117. He submitted that it is not necessary for all human and technical resources to be in the fixed establishment nor do they have to be employed by the supplier.

118. Mr Vajda said that in *Berkholz* the gaming machines were on ships and were only intermittently maintained; in that case the permanent business establishment gave a rational result, see paragraph 17. He relied on the general principle that VAT should be charged at the place of consumption, see the Advocate-General at paragraph 2, which was picked up by the Advocate-General in *DFDS* at paragraph 30.

119. He said that in *ARO* [1997] STC 1272 the main work was in drawing up and negotiating the car leases, see paragraph 18 : the agents were not directly involved in that. A fixed establishment required a minimum degree of stability (paragraph 15); there must be an adequate structure to supply the services on an independent basis (paragraph 16) and it must have a sufficient degree of permanence (paragraph 19). The supplier did not need its own staff provided the structure was there : paragraph 19 was alternative. In that case, as in *Berkholz,* the business establishment gave a rational result. *Lease Plan Luxembourg SA v Belgium* (Case C-390/96) [1998] STC 628 followed *ARO* without adding anything to it.

120. In *DFDS S/A* [1999] STC 384 the Court of Justice said that when deciding between the place where the business is established and a fixed establishment "the actual economic situation is a fundamental criterion", see paragraph 23. Avoiding tax was not confined to establishment in another member state. In that case the Danish parent argued that the UK subsidiary being a separate legal entity was independent of it : the Court said that this was not sufficient in view of the subsidiary's contractual obligations and the fact that it was wholly-owned, it was merely an auxiliary organ. In that case the staff were not DFDS A/S employees and the contract sufficed. In deciding whether the UK establishment was of the "requisite minimum size" the Court had applied a threshold test.

121. Mr Vadja said that the Court expressly endorsed paragraphs 32-34 of the Advocate-General's opinion. He had pointed out that the wording in Article 26.2 is the same as in Article 9.1. Where both primary criteria are in point, it is necessary to look for the rational result, see paragraph 34. It is necessary to look at the economic realities rather than mere form, see paragraph 35. Fixed establishment is an eminently economic concept, see paragraph 37.

122. He said that there is no prescribed way in which the minimum permanent presence and resources are provided, the concept being economic rather than legal. It is irrelevant whether there is one legal body at the premises as in *DFDS* or three as here. It does not matter whether in terms of contract law the work is performed by another entity or whether there is no contract at all. It is necessary to look at the services provided.

123. Mr Vajda submitted that the position in direct tax law must be relevant : CI made returns on the footing that it had a UK branch or branches. He relied on the OECD Model Tax Convention and the similarity between Article 5 and the Sixth Directive.

124. He said that each amusement premises has the necessary permanence with staff permanently employed on behalf of CI to perform a number of tasks essential to the gaming machine supplies. They police age limits, witness large payouts, provide change, empty floats and handle complaints. Two staff are always present. It could not be said that the operation of the slot machines at the premises is carried on independently of CI. None of the companies is acting independently of the others.

125. He said that taxation of the gaming machine supplies by reference to the Guernsey establishment would not produce a rational result: the services are marketed in the UK and physically delivered and enjoyed here; it would distort competition since other operators are taxable in the UK. Distortion could be caused by undertakings moving abroad. Here the choice of establishment had been for avoidance reasons. The result would conflict with Article 2 of the First Directive providing for a general tax on consumption; he referred to *Customs and Excise Commissioners v Primback Ltd* (Case C-34/99) [2001] STC 803 at paragraph 48. The gaming services cannot not legally be provided in Guernsey. Taxation by reference to the fixed establishment would harmonise with direct tax.

126. Mr Vajda said that the facts in the present case are not the same as in *EC Commission v France* [2001] STC 156, paragraph 51; the French submission would have involved double taxation, see paragraph 34 of the Advocate-General. Moreover in that case the services could lawfully be performed in Germany.

<u>Conclusions on fixed establishment and Article 9.1</u>

127. In view of the difference between the wording of section 9 and Article 9.1 we follow Moses J in *Chinese Channel* and concentrate on Article 9.1

128. The most recent interpretation of Article 9.1 by the Court of Justice was in *ARO* [1997] STC 1272 at paragraphs 15 and 16 as follows:

> "15. Furthermore, as regards the general rule in Article 9.1 of the Sixth Directive, the Court has held that the place where the supplier has established his business is a primary point of reference in as much as there is no purpose in referring to another establishment from which the services are supplied unless reference to the main place of business does not lead to a rational result for tax purposes or creates a conflict with another member state. It is clear from the aim of Article 9 and from the context in which the concepts are employed that services cannot be deemed to be supplied at an establishment other than the main place of business unless that establishment has a minimum degree of stability derived from the permanent presence of both the human and technical resources necessary for the provision of the services (see *Berkholz* [1985] ECR 2251, paras 17 and 18).
>
> 16. Consequently, in order to be treated, by way of derogation from the primary criterion of the main place of business, as the place where a taxable person provides services, an establishment must possess a sufficient degree of permanence and a structure adequate, in terms of human and technical resources, to supply the services in question on an independent basis."

129. The initial issue is thus whether CI has fixed establishments in the UK. If it does have such establishments, the further issue arises whether reference to the place of business in Guernsey does not lead to a rational result.

130. *Berkholz* shows that the permanent installation of gaming machines is not sufficient to constitute a fixed establishment. It must have "the permanent presence of both the human and technical resources necessary for the provision of the services."

131. The resources necessary depend on what the services are. In *Berkholz* the employment for two days a week of workers to keep in good order, repair and replace the machines and to empty them was not sufficient. The Court referred at paragraph 18 to the machines being "maintained intermittently."

132. Although the coins used to operate the machines are treated under section 23(1) as the consideration for the consumer to play and to receive any payout, there is no contract. While this does not mean there is no consideration or supply (see *Town and Country Factors Ltd v Customs and Excise Commissioners* (Case C-498/99) [2002] STC 1263) it creates difficulties in identifying the supplies. Clearly the services provided involve the machines functioning properly, having the necessary float and not being so full that they will take no further coins. The services to achieve this were all provided by the employees in *Berkholz* twice weekly. The services provided also require somewhere clean and safe where the players can stand in reasonable comfort when playing.

133. However it does not seem to us that all inputs are "resources necessary for the provision" of the gaming services to the customers. Refreshments, Gold Card

benefits and advertising are inducements to play rather than resources necessary for playing.

134. In the present case CI has no staff presence of its own at all in the UK. That is however not decisive, since in *DFDS* there were no employees of the parent at Harwich. In *ARO* at paragraph 19 the Court referred to "its own staff or a structure ." using the alternative.

135. In *DFDS* the structure comprised a wholly-owned subsidiary, with 100 staff operating from premises belonging to it and with "various contractual obligations imposed" on it by the supplier, its parent, showing that it merely acted "as an auxiliary organ of its parent." It does not appear from the original Tribunal Decision (No.12588) or the Report for Hearing for the ECJ at [1997] 1 WLR 1037 that the term "imposed" used by the Court of Justice did more than reflect the parent subsidiary relationship.

136. In the present case the only permanent presence of human resources is that of Services, a wholly-owned subsidiary of the parent of CI. The obligations were not imposed on Services by CI, although the contractual terms were in reality fixed by or on behalf of their common parent, Holdings, as were the contracts with RAL and Machines. There is nothing unusual about this within a Group. Osborne Clarke had been instructed by Holdings to prepare the agreements between CiCo and the UK subsidiaries by the time of the Action Plan of 21 September (paragraph 35 above) several weeks before CI was formed. Whatever "negotiations" took place were not concerned with the principle.

137. The question arises whether the structure necessary for a fixed establishment can be fragmented between different legal entities and if so whether Services, Machines and RAL which provide the necessary resources are merely acting as auxiliary organs of CI or are independent of CI.

138. The mere fact of a parent subsidiary relationship does not of itself suffice to make an establishment of a subsidiary a fixed establishment of its parent, see *DFDS* paragraph 26.

139. In *DFDS* it was the combination of parent subsidiary relationship with the contractual obligations of the subsidiary which showed that the subsidiary was acting as a mere "auxiliary organ" of the supplier. It was because DFDS Ltd was acting as a mere auxiliary organ of its Danish parent that DFDS Ltd's premises and resources constituted a fixed establishment of its parent. It was not independent of its parent when providing tour operator services on behalf of its parent.

140. At paragraph 22 the Advocate-General said that, because of its contractual link with its parent, DFDS Ltd's agency business could be carried on only in relation to the parent unless it agreed otherwise. He continued "Besides, as the agency agreement defines the relations between the parent company and the subsidiary, the latter has no effective independence from the former in the conduct of its business." He concluded that "having regard to its legal form, the English company acts as an auxiliary to the parent company."

141. The decision was thus on the basis that DFDS Ltd had in fact very little autonomy from its parent : that lack of independence was crucial in the decision that it constituted a fixed establishment of the supplier which was its parent.

142. In the present case Services, Machines and RAL, are all wholly-owned subsidiaries of the supplier's parent company. In practical terms we can see no material difference from the position if they were subsidiaries of CI, particularly since Services and Machines were formed with a view to providing services to CI and, in the case of Services, with a view to providing services on behalf of CI.

143. The agreements with RAL and Machines provide CI with the machines and with the right to use the premises on a continuing basis.

144. Human resources are provided by Services under the agreement of 1 December 2000. This contains a detailed schedule of services the performance of which involves staff presence throughout opening hours, see paragraph 55 above. Those services together with the resources provided by Machines and RAL provide the necessary human and technical resources to enable CI to make the gaming machine supplies to customers. Insofar as management on site is needed, it is provided by the Unit managers. Although Services is not precluded from undertaking other business and in any event makes supplies to RAL and Machines, the agreement provides for Services to give priority to CI over all other business activities apart from services for RAL and Machines.

145. We do not consider that the type of management undertaken from Guernsey is necessary for the actual provision of gaming services to customers. It is primarily directed at monitoring results after such provision and the subsequent handling of cash. It is wholly different from management of the car leases in *ARO*. Here the management of the provision of the supplies to customers was provided by Services.

146. Viewed as a whole, we consider that the result of the combination of the facts (1) that Services, Machines and RAL were all subsidiaries of CI's parent, (2) that Services, Machines and CI were established for the purpose of CI making supplies using resources provided by Services, Machines and RAL, (3) that the contracts were designed to have that effect and (4) that the services are supplied to CI and supplies are made by CI pursuant thereto, is that Services is acting as a mere auxiliary to CI when providing the necessary human resources.

147. It does not seem to us to be relevant to decide whether RAL in providing the premises and Machines in providing the machines are acting as mere auxiliaries of CI. It would be anomalous if the existence of a fixed establishment depends on whether or not the actual premises and equipment are leased from an independent party. What does matter is the human resources and the availability of the other resources. If necessary however we would hold that RAL and Machines were acting as mere auxiliaries of CI in providing the premises and the Machines.

148. Dr Lasok relied on the fact that one essential technical resource, that of maintenance of the Machines, is provided by RMLS, an unconnected company. There is no doubt that maintenance of the Machines is a necessary resource. RLMS has no contract with CI but provides its services to Machines, which is obliged under Clause 5.1 of its contract with CI to provide and keep the equipment in good order at its own expense. RLMS attends daily at each arcade. Since the obligation of Machines is continuous it does not seem that the fact that RLMS staff are not present all the time is relevant. In any event the reference in *ARO* to "permanent presence" of technical resources cannot logically mean permanent attendance of maintenance personnel. If that was the case no office reliant on computers can constitute a fixed establishment unless it has computer maintenance resources on site at all times.

149. We conclude that the 127 amusement arcades are fixed establishments from which CI supplies gaming services.

150. We next consider whether reference to the Guernsey establishment does not lead to a rational result for tax purposes (see *ARO* paragraph 15).

151. Since a fixed establishment can only be relevant if the service is supplied from there, the question cannot logically be determined by the fact that the service is supplied from there : otherwise a fixed establishment from which the service is supplied would always override the place where the supplier has established his business.

152. In *Chinese Channel* Moses J said this at page 356b,

> ". If the actual economic situation was the predominant test, no priority would be given to the main business test. The question would always be to determine the place from which the service was supplied. Yet the court has never adopted such an approach."

153. Moses J expressed doubts as to whether the UK legislation properly implements the interpretation by the Court of Justice of Article 9. While it may be that section 9(2)(c) does not correctly implement Article 9, that did not prevent a conclusion in *DFDS* that the fixed establishment was the place of supply applying Article 9. Dr Lasok did not suggest that any deficiency in section 9(2)(c) had the effect that a fixed establishment could not take priority : such an argument would conflict with the answer given by the Court of Justice in *DFDS*.

154. Later on the same page Moses J said that it was by no means clear that non-taxation only occurring outside the EU was relevant to whether the business test leads to a rational result.

155. *DFDS* is in fact the only case considered by the Court of Justice where there has been a conflict between the two criteria under Article 9.1. In *Berkholz* and *ARO* it was held that there was no fixed establishment.

156. At paragraph 19 of *DFDS* the Court said that:

> "regard is to be had to [a fixed] establishment from which the services are supplied only if the reference to the place where the supplier has established his business does not lead to a rational result for tax purposes or creates a conflict with another Member State (see *Berkholz*, para 17)."

157. The Court said at paragraph 21 that the company had pointed out that the place of business would have the advantage of a single place of reference for all its business covered by Article 26, but that, as the UK had pointed out,

> "that treatment would not lead to a rational result for tax purposes in that it takes no account of the actual place where the tours are marketed which, whatever the customer's destination, the national authorities have good reason to take into consideration as the most appropriate point of reference (paragraph 22)."

158. That paragraph and the following two paragraphs make specific reference to tour operators however, given the reference in paragraph 17 to the rules under

Article 9.1, it does not seem to us that the observations are confined to tour operators. It seems to us that the Court was identifying particular aspects arising from tour operators while applying general principles.

159. At paragraph 23 the Court said that "Consideration of the actual economic situation is a fundamental criterion for the application of the common VAT system." In the context that was clearly directed at the choice between the two Article 9.1 criteria. The Court then pointed out that for travel agents the fixed establishment approach took account of the possible diversification of their activities in different countries. Still at paragraph 23 the Court continued,

> "Systematic reliance on the place where the supplier has established his business could in fact lead to distortions of competition, in that it might encourage undertakings trading in one member state to establish their businesses, in order to avoid taxation, in another member state which has availed itself of the possibility of maintaining the VAT exemption for the Services in question."

If this was intended to be confined to tour operators or travel agents we would have expected specific reference to them as in the preceding sentence. Furthermore it addresses possible avoidance of taxation in the context of a rational result for tax purposes.

160. We can see no logic in treating the possibility of avoidance by relocating outside the Community differently from the possibility of avoidance by relocating in another Member State. If possible avoidance of the former type is relevant to a rational result, logically the latter type is also. Furthermore if the possibility of avoidance is relevant, logically intentional avoidance must be also.

161. It seems to us that when we consider whether treating Guernsey as the place of supply does produce a rational result, the fact that location there was specifically to avoid tax is a relevant factor. Here a group trading in the UK has established a subsidiary in the Channel Islands specifically to avoid tax on supplies marketed in the UK.

162 It is also relevant that because of their nature the gaming services provided from the UK establishments can only be provided physically in the UK because that is where the machines are situated. We are not however impressed by Mr Vajda's point that gaming machines are not legal in Guernsey.

163. The resources necessary for the supplies are provided and have to be provided in the UK. Such resources as are provided from Guernsey are directed at complaints after supplies have been made and monitoring the handling of the cash received.

164. The operation of gaming machines in the United Kingdom will in the normal course of events be taxable in the UK. RAL group's supplies before 1 December 2000 were so taxable. We consider that taxation by reference to the Guernsey business establishment of CI does not lead to a rational result.

165. We conclude therefore that CI does have fixed establishments in UK from which gaming machine supplies have been made since 1 December 2000 and that those are the place of supply. From this it follows that CI was liable to register from that date and is liable to pay VAT on those supplies; it is not entitled to repayment under the Thirteenth Directive but is entitled to input tax relief.

166. On this basis the decisions adverse to RAL, Machines and Services, being alternative to do not arise. However this is a complex case and in the event of an appeal we turn to consider the Commissioners' alternative contentions.

Submissions on the Commissioners' alternative decisions

167. Although the appeals are by the Appellants, it is convenient to consider the Commissioners' submissions first since those of the Appellant are a response.

168. The Commissioners' skeleton argument set out the submissions, which are alternative to each other, as follows:

> "The supplies of slot gaming machine services are made by RAL directly to customers in the UK through its licensed premises" (we call this "the *Halifax* submission").
>
> "The arrangements constitute an abuse of the VAT rules on the part of the Appellants."

In closing Mr Vajda altered the first submission from "RAL" to "RAL Holdings group". We note that any supply by RAL Ltd is to be treated as a supply by Holdings as the representative member of the VAT group, see section 43(1)(b).

169. Mr Vajda said that the RAL submission arises if the Tribunal concludes that the Commissioners' fixed establishment argument fails either because CI does not have a fixed establishment or because the assumption that CI is the supplier is incorrect. Logically the submission that RAL is the supplier could therefore precede the fixed establishment issue, since if CI is not the supplier, the fixed establishment issue disappears.

170. He said that the *Halifax* submission depends on the economic reality of the arrangements. The concept of supply is an autonomous concept of Community law with an economic rather than a legalistic meaning; so also must be the identity of the supplier.

171. He said that the Appellants' case depends on the effect of the contracts; however the contractual position is not decisive. In *Customs and Excise Commissioners v First National Bank of Chicago* (Case C-172/96) [1998] STC 850, the Court of Justice departed from the contractual position in determining that there were supplies for a consideration, see paragraphs 30-33. In *Customs and Excise Commissioners v BT plc* [1999] STC 850, the House of Lords looked at commercial reality when deciding whether delivery of the cars involved a separate supply of services, see Lord Slynn at page 766e and Lord Hope at page 769e. In *Eastbourne Town Radio Cars Association v Customs and Excise Commissioners* [2001] STC 606, the rights changed under private law but in commercial reality there was no change, see per Lord Slynn who approved Laws J in *Customs and Excise Commissioners v Reed Personnel Services Ltd* [1995] STC 588 at page 595 and cited Jacobs A-G in *Glawe* at pararraph 18.

172. Mr Vajda referred to *Card Protection Plan Ltd v Customs and Excise Commissioners* (Case C-349/96) [1996] STC 270 at paragraphs 28-29 and [2001] STC 174, HL at paragraph 22, to *Faaborg-Gelting Linien A/s v Finanzamt Flensburg* (Case C-231/94) [1996] STC 774 at 779 and 783, to *DFDS* at paragraph 30 and to *Fischer v Finanzamt Donaueschingen* (Case C-283/95) [1998] STC 708 at paragraph 19. He said that the most important economic

factor is that of final consumption, because that it is what the system is designed to tax, see *Elida Gibbs Ltd v Customs and Excise Commissioners* (Case C-317/94) at paragraph 24. None of those cases concerned tax avoidance.

173. He said that transactions for the avoidance of tax with no business purpose are not economic activities giving rise to supplies, see *Halifax plc v Commissioners of Customs and Excise* [2001] V&DR 71 at paragraphs 51-55 and 59, *BUPA v Commissioners of Customs and Excise* (2002) Decision 17588 at paragraphs 75 and 90-95 and *Blackqueen Ltd v Commissioners of Customs and Excise* (2002) Decision 17680 at paragraphs 67 and 82-4. Such transactions are alien to the purposes of the Sixth Directive. In *Halifax* the intra-group contracts did not give rise to supplies. In the present case, unlike the position in *WHA Ltd v Commissioners of Customs and Excise* (2002) Decision 17605 at paragraph 74, Machines and Services have no "distinct and continuing businesses and business functions." The approach of the Edinburgh Tribunal in *RBS Property Developments Ltd v Commissioners of Customs and Excise* (2002) Decision . should not be followed : the facts here are very different.

174. Mr Vajda said that the concept of supply cannot be determined by how transactions are classified under domestic law, see *Staastssecretaris van Financiën v Shipping and Forwarding Enterprise Safe BV* (Case C-320/88) [1990] ECR I-285 at paragraphs 7-8. In *Eastbourne Town Radio Cars* a mere change in legal form did not change the VAT position where there was no change in economic substance. He referred to *Customs and Excise Commissioners v Church Schools Foundation Ltd* [2001] STC 1661 at 1672, and to *Town and Country Factors Ltd v Customs and Excise Commissioners* (Case C-498/99) [2002] STC 1263. The objectives of VAT include ensuring that consumption is taxed, see *Customs and Excise Commissioners v Primback Ltd* (Case C-34/99) [2001] STC 803 at paragraph 48.

175. He said that the contemporary documents could be accepted as reliable evidence of the purpose of the arrangements. He did not "quibble" with the accuracy of the board minutes although there were no real negotiations on the payments under the contracts. The minutes were important for what they did not say. The relevant purpose was that at 10 August 2000 when Project CICo was given the go-ahead. The other date on which the Tribunal should focus was the date of the decision under appeal, 28 August 2001.

176. He submitted that the evidence of Mr Harding, Mr Mercy and Mr Curtis should be approached with extreme caution; he stated that he did not say that of Mr Garland, Mr Jenkins and Mr Bainbrigge.

177. Mr Vajda advanced the following contentions on the facts:

> "1. In economic terms, nothing has changed in relation to the actual supply to the customer;
>
> 2. Very little of substance has changed in delivering the service to the customer;
>
> 3. The intra-group contractual changes relate solely, or predominantly, to the intention to avoid VAT on those supplies;
>
> 4. If those contractual changes were to have any effect in VAT terms, this would lead to a distortion of competition;

5. If those changes were effective, the result would fail to give effect to the overall purpose of the Sixth Directive, which is meant to be a tax on consumption; and

6. In all the circumstances of the case, the RAL VAT group remains the supplier of slot machine gaming services to the public in the UK."

178. He said that there is still a direct link between the money put into the machine by the customer and the services supplied to the customer by the RAL VAT group. RAL is the leaseholder and controls access, opening times and refreshments. The fact that the cash belongs to CI does not displace the direct link between RAL Group and the customer because the group has effective control over the money because of the way in which CI is run; he relied on *SAFE* at paragraph 7.

179. He said that the sole purpose of Project CICo was tax avoidance. Any other purposes were de minimis and any benefits were consequences rather than a purpose. He submitted that the position is the same today although the Tribunal should decide on the facts at 28 August 2001. If there is a material change in the future the Appellants can ask for the decision to be changed and the deregistration decisions revoked.

180. Mr Vajda said that his contentions as to abuse of rights only arise if the Tribunal concludes that CI does not have a fixed establishment in the UK and also that apart from the abuse argument on a true analysis the supplies are by CI.

181. He said that it is well settled that there is a principle of abuse of right in Community law. He adopted the analysis by the Tribunal in *BUPA* at paragraphs 118 to 125. *Emsland-Starkë GmbH v Hauptzollamt Hamburg-Jonas* (Case C-110/99) [2000] ECR I-11569 confirmed the principle of abuse in relation to obtaining benefits from Community rules. Two elements are needed for a finding of abuse : (1) objective circumstances in which the purpose of Community rules is not achieved despite formal observance of the conditions and (2) a subjective element, being an intention to obtain an advantage from the rules by creating artificially the conditions laid down, see paragraphs 52-53 of *Emsland.*

182. Mr Vajda said that, although a Directive could not of itself impose obligations on an individual (see *Faccini Dori v Recreb Srl* (Case C-91/92) [1994] ECR I-3325 at paragraphs 20-25), here the Directive has been implemented and the abuse principle merely denies an advantage. There was no basis for the conclusion in *BUPA* that the abuse principle did not apply to domestic legislation implementing a Directive. The implementation of a Directive does not exhaust its effects, see *Marks & Spencer plc v Commissioners of Customs and Excise* (Case C-62/00) [2002] STC 1036 at paragraph 27; the Advocate-General rejected the approach of the Court of Appeal, see paragraphs 26-44. Here the refund is claimed under the Thirteenth Directive and the abuse principle applies. He said that the consequence of the arrangements involving an abuse of rights is that the repayment claim fails and the RAL is accountable for output tax.

183. He said that the objective conditions are fulfilled : the purpose of the VAT system is to tax final consumption in a neutral manner which does not distort competition; the UK taxes gaming machine services provided within its territory at the standard rate and the arrangements would frustrate that intention, violating the principle of neutrality. VAT should be applied so as not to distort

competition between undertakings, see *Naturally Yours Cosmetics Ltd v Commissioners of Customs and Excise* (Case 230/87) [1988] ECR 6365 at 6376.

184. Dr Lasok for the Appellants said the Commissioners' alternative arguments based on *Halifax* and on abuse of rights only arise if the Tribunal holds that the place of supply is in the Channel Islands by reason of the operation of the place of supply rules. The Commissioners are thus seeking to circumvent those rules.

185. He said that in *Dudda v Finansgericht Bergisch Gladbach* (Case C-327/94) [1996] ECR I-4595 at paragraph 32 the Court of Justice said that the risk of avoidance and abuse by suppliers of services who established their businesses in one Member State but supply their services in another could not alter the interpretation of Article 9.2(c). He said that the wording of Article 9 is not wide enough to give a broad construction to avoid tax avoidance or abuse. In *EC Commission v French Republic* (Case C-429/97) [2001] STC 156 at paragraph 52 the Court rejected the argument of the French government that the interpretation of Article 9.1 as covering the composite supply could result in non-taxation if the main contractor was established outside the Community : that possibility arose from the geographical limits of the VAT rules.

186. He said that non-taxation resulting from the operation of the Sixth Directive could not be contrary to or inconsistent with its spirit and purpose.

187. He said that there was no legal basis for deregistering Machines and Services. It had not been argued that they were not taxable persons within Article 4.1. The removal of their supplies was inconsistent with the VAT system. The Commissioners' real objection was to the fact that supplies to consumers are made by CI. This is not a basis for asserting that the supplies by Machines and Services are contrary to the spirit and purpose of the Sixth Directive.

188. Dr Lasok said that the evidence did not support the contention that the transactions had no purpose save the avoidance of VAT. Commercial benefits of establishing a company in the Channel Islands had been identified before the incorporation of CI. The decision of the Edinburgh Tribunal in *RBS Developments* (2002) was correct, in particular page 28; this was not a case which was wholly artificial with no reality.

189. He said that Article 27.1 provides for special measures derogating from the Directive to combat avoidance but has not been utilised. Article 9.3 contains limited powers to avoid double taxation, non-taxation or distortion of competition but again does not apply. The *French Republic* case showed that there was no general principle enabling the Commissioners to tinker with the results of applying Article 9. If there had been a general power to take steps against tax avoidance, *Direct Cosmetics Ltd v Commissioners of Customs and Excise* (Case 5/84) [1985] ECR 617 could not have been decided as it was.

190. Dr Lasok said that if, which he did not accept, *Halifax* was correctly decided, it did not support the conclusion that supplies made in the context of a continuing business can be disregarded. The fact that a structure is tax-driven so as to involve more than one company does not detract from the reality of the activities, see *WHA* at paragraphs 74 and 88. He said that the approach in *Halifax* only applies to transactions entered into by both parties solely for tax avoidance, see *Halifax plc and Others v Customs and Excise Commissioners* [2002] STC 402 and *BUPA* at paragraph 110. *Halifax* would not entitle the Commissioners to disregard transactions involving third party suppliers or customers. *Halifax* was about a de facto grouping by which supplies by a third party were directed to the actual

consumer, Halifax plc, without diversion through inserted intermediaries. Both Machines and Services had made supplies to third parties. It is CI which makes the supplies to customers even if intervening transactions are disregarded.

191. Turning to the Abuse of Rights issue, Dr Lasok said that the repayment claims were made under regulation 186. The right to repayment is a right under domestic law since the Thirteenth Directive has been implemented; it is not a case of relying on the direct effect of the Directive.

192. He said that there is no abuse of rights principle in English law. *Diamentis v Greece* (Case C-373/97) [2000] ECR I-1705 was concerned with a national provision penalising abuse of rights.

193. The Sixth Directive contains no general abuse of rights principle. Article 9 takes account of the risk of non-taxation and distortion as to place of supply. An anti-avoidance rule not authorised under Article 27.1 would be unlawful, see *Direct Cosmetics*, paragraph 37.

194. Dr Lasok said that in essence the Commissioners' case is that although CI does not have a UK establishment but does make supplies, a repayment claim is abusive because it is artificial. That if correct would counter the repayment claim but it would not make CI accountable for output tax. For CI to be liable for output tax the Commissioners would have to show that it is an abuse for CI not to have a UK establishment. The system of VAT has to be logical. The abuse of right argument fundamentally undermines the common system of VAT.

195. He said that *Emsland-Stärke* involved a Community Regulation rather than a Directive which had been implemented. The Community has no competence itself to impose obligations on individuals where it is acting by a Directive rather than a Regulation, see *Faccini Dori* at paragraphs 20 and 24. In *Marks & Spencer* [2002] STC 1036, although the Directive had been implemented, there had been maladministration by the state. Here the reclaims were not based on any claim of maladministration.

Conclusions as to the Commissioners' alternative decisions

196. The starting point of both alternatives is that, although the contracts between CI and the other companies in the group were intended to avoid VAT, those contracts were genuine transactions with legal consequences. If they had been shams, as for example if they had never been approved by the CI directors, they would have no legal effect and RAL would have been the supplier throughout. The *Halifax* submission and the abuse submission would be unnecessary.

197. The legal effect of the sale of the gaming machines by RAL to Machines and lease to CI is that the coins inserted by customers become the property of CI. It would be impossible on a purely contractual analysis to suggest that the gaming machine supplies are by RAL.

198. The *Halifax* submission involves disregarding the contracts for VAT purposes not because they have no effect in private law but because their sole object was tax avoidance. In *Halifax* the Tribunal held at paragraph 48 that the transactions were genuine although each was to avoid tax and nothing else.

199. In this case we are satisfied that the purpose of Holdings in establishing CI and the purpose of CI and the other group companies in entering into the contracts was to avoid VAT by arranging for future gaming machine supplies to be made by a Channel Islands subsidiary which could recover input tax without paying output tax. The decision by Holdings to establish CI, Machines and Services was taken before Mr Garland and Pamela Cook discussed the capital allowance aspects, and the capital allowance aspect did not require the intervention of a Channel Islands company. Project CICo did not have as its purpose the reorganisation of the group in the interests of focus and efficiency, or the exploitation of casino or other gaming opportunities in the Channel Islands or elsewhere. We accept that having decided on the reorganisation, those involved have been seeking to use it to its best advantage and that the CI directors have been on the look-out for any opportunities. That is no more than sound business sense. It does not make them purposes of the contracts. If activities in the Channel Islands apart from the offshore gaming machine supplies were intended from the outset, we do not understand why an E-mail in late October was referring to the need for the offshore structure to have substance and its own employees (see paragraph 44).

200. That brings us to the question of the result of the structure being set up to avoid VAT. In *Halifax* the Tribunal decided that as a matter of statutory construction the avoidance transactions did not involve "economic activity" and did not result in supplies, see paragraph 55 : they gave rise to neither output tax nor input tax. With respect to the destination of the supplies made by the arms-length builders, the Tribunal in *Halifax* applied the approach of Laws J in *Reed Personnel* and looked beyond the contracts to conclude that The Halifax plc was the recipient of the supplies, see paragraph 60.

201. As we have already stated, as a matter of private law CI is the owner of the gaming machine proceeds. The fact that this is the result of contracts within the group designed to avoid tax does not alter the fact that CI rather than RAL received the proceeds. In *Halifax* the Tribunal did not disregard the contracts involving the builders, it rather concluded that in all the circumstances the supplies by the builders were to The Halifax plc, finding specifically at paragraph 59 that the benefit of the building works enured to The Halifax plc

202. The supplier before the CICo project was RAL. The first alternative decision of 28 August 2001 was that RAL was the supplier throughout. The skeleton argument was on this footing. During the hearing Mr Vajda varied this to the RAL Holdings VAT group. He relied on the fact that CI is a wholly-owned subsidiary of Holdings which has effective control over it. He relied on *Safe* [1990] ECR I-285 as establishing that Holdings had effective control over the money. *Safe* was however wholly different, being concerned with whether a supply had occurred within Article 5(1) when a contract gave de facto control over property but did not give legal control. It is not authority to pierce the corporate veil. The matters to which Mr Vajda pointed in paragraph 178 do not in our judgment make RAL or the Holdings VAT group the supplier instead of CI which received the consideration for the gaming machine supplies.

203. The fact that the result of the transactions is that CI avoids VAT because of the operation of the place of supply rules cannot affect the application or interpretation of those rules, see the *French Republic* case. Indeed we did not understand Mr Vajda to contend otherwise.

204. Mr Vajda also submitted that if the intra-group contractual changes were effective they would fail to give effect to the overall purpose of the Sixth Directive

to tax consumption. We regard this proposition as going well beyond *Halifax*. Furthermore it ignores the fact that under Article 9 it is clearly possible for services consumed within the UK to escape tax because of the place of supply rules. Although VAT is a general tax on consumption it only taxes consumption resulting from a supply for consideration within the country in question by a taxable person acting as such, see Article 2.

205. We also observe that if our earlier conclusions as to fixed establishment are incorrect because the avoidance of taxation is not relevant, it would be surprising if a similar argument succeeded on the *Halifax* approach.

206. The arguments as to Abuse of Rights fall down in our view at Mr Vajda's stage one: the objective circumstances in which the purpose of Community rules is not achieved. As we have just pointed out although VAT is designed to be a general tax on consumption, see Article 2 of the First Directive, the Sixth Directive lays down specific circumstances in which supplies are taxable. If by reason of the provisions of the Sixth Directive a supply is not subject to tax, we do not accept that this is contrary to the purpose of the Directive unless it is clearly contrary to the purpose of the specific provision by reason of which it escapes tax. This is particularly so in the case of Article 9 since its effect can have surprising results and Article 9.3 specifically recognises that non-taxation may result in hiring out forms of transport. Special measures under Article 27.1 require Council authority. Potential distortion of competition is inherent in the place of supply rules.

207. It seems to us that there is less difficulty in applying the Abuse of Rights concept to combatting abusive input tax claims and indeed Thirteenth Directive repayment claims than to undoing the effect of the place of supply rules. However, on the footing that our conclusions as to fixed establishment are incorrect, in the present case CI has made supplies which are treated as made outside the UK by operation of the place of supply rules and has used services for the purposes of its supplies within the Thirteenth Directive.

208. If we had concluded that the purpose of the Community rules was not achieved, we would have held that the Appellants intended to obtain an advantage by artificially creating the conditions laid down.

209. We do not go into the further problem of whether the place of supply rules and the Thirteenth Directive have been properly implemented and if not whether the Abuse of Rights principle which is not a principle of English law can be invoked by the Commissioners, since this aspect was not fully addressed in argument and is a pure question of law. At paragraph 115 Dr Lasok said that Article 9 is not properly implemented whereas at paragraph 195 he said that the Directive had been implemented.

Summary

210. We conclude that the amusement arcades in the United Kingdom are fixed establishments from which gaming services are supplied by CI and that treating the place in Guernsey where CI has established its business as the place of supply would not produce a rational result. We therefore dismiss the appeals of CI.

211. The decisions against which RAL, Machines and Services appealed, being alternative may not fall to be decided on this basis. However insofar as they do fall to be decided, those appeals are allowed. We are satisfied that the purpose of

Holdings, in establishing CI, Machines and Services, was to avoid tax and that the purpose of its subsidiaries in entering into the intra-group contracts was the same. However we do not consider that the transactions which produce a result by the application of the place of supply rules can be such as to fail to give effect to the overall purpose of the Sixth Directive. We also hold that the Abuse of Rights principle does not apply in this case because the Respondents have not shown the objective circumstances in which the purpose of the Community rules is not achieved.

212. Although the Appellants have succeeded on some issues, it is the Respondents who have succeeded overall. Mr Vajda applied for costs. Advance notice had not been given to the Appellants; however this was clearly a substantial and complex case comparable with High Court cases, see the Statement of Mr Robert Sheldon MP (*Hansard* 13 November 1978, cols 91-92), and the Appellant must have expected such an application. We direct that if not agreed within three months, the costs be taxed or assessed by a costs judge on the standard basis under Rule 29(1)(b) of the VAT Tribunals Rules 1986.

THEODORE WALLACE

CHAIRMAN

RELEASED:

LON/01/979-RAL.WAL