TC01866

Value Added Tax - Whether capital costs, incurred by the Appellant, were directly and immediately related to supplies made by the Appellant, so as to rank as deductible input tax - how supplies under a licence, rather than a lease or sub-lease were treated for VAT purposes - how to deal with a relatively minor category of supplies made by the Appellant to its parent company - decision in principle - Appeal allowed

FIRST-TIER TRIBUNAL **Reference no: LON/2009/0691**
Un-numbered appeal in 2012

TAX

GOSLING LEISURE LTD

Appellant

-and-

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS

Respondents

Tribunal: HOWARD M. NOWLAN (Tribunal Judge)
RICHARD LAW

Sitting in public at 45 Bedford Square in London on 6 to 8 February 2012

James Henderson, counsel, on behalf of the Appellant
Christiaan Zwart, counsel, on behalf of the Respondents

DECISION

Introduction

1. This was an appeal in relation to whether very significant capital costs, claimed by the Appellant to have been incurred by it, on making major alterations completely changing the internal lay-out and configuration of a large pre-existing steel-clad warehouse-type building, were costs directly and immediately connected with the supplies (all, or possibly only the great majority, of which were standard-rated supplies) allegedly made by the Appellant. Whilst that is the main point in issue in this appeal, there were a number of further complications, and we consider that the clearest way to explain matters is to give an unusually full description of the facts and issues in this Introduction.

2. The Appellant's parent company, Gosling Sports Park ("GSP"), a company limited by guarantee, operated as the trustee of a charitable trust that provided recreational and sporting facilities for members. We were invited to a site visit, in which we saw that the facilities, covering a 54-acre site, were very comprehensive and extremely impressive. They included a football pitch, a running track, a banked cycle circuit, countless covered and open-air tennis courts, a dry ski-slope, badminton courts and several other sporting facilities. These activities were conducted on land, the freehold of which was owned by the relevant local council, over which GSP initially had a 99-year lease, and over which, prior to the major construction work involved in this appeal, the residue of that original lease was surrendered, in return for the re-grant of a 125-year lease.

3. For many years, whilst GSP and thus the trust conducted all the sporting activities, any activities that were not strictly sporting or recreational, had been conducted by the Appellant, rather than by GSP. The Appellant had been formed many years ago, the division of activities having been required by the Charity Commissioners in order that GSP's and the trust's activities should be purely recreational. Prior to the alterations that are the subject of this appeal, the Appellant's function had been limited to the provision of bar, café and catering services for the members, and for a short period prior to the major construction work, to the provision of an activity area for children, referred to as "Jungle Mania".

4. Although the agreement was said to have been lost, the Accounts of the Appellant always contained a paragraph to identical effect to the one below, taken from the 31 March 2007 Financial Statements of the Appellant, reciting that:

> *"Under the terms of a written agreement GSP provides management services to the company* (i.e. the Appellant) *that include the provision of utilities, hire of fixtures and fittings, licence of the premises as well as the services of the Chief Executive Officer and other senior staff. The management services provided during the year under review cost £50,000"*.

The paragraph went on to state that GSP charged rather more substantial, and accurately calculated, amounts for the secondment of the identified staff who conducted the Appellant's bar, café and catering functions. To save administrative costs, GSP employed all staff, whether they were involved in providing GSP's own sporting and recreational activities, or whether they were seconded to the Appellant to enable the Appellant to provide its bar and café services, and any of the Appellant's

services in the Jungle Mania activity. This management charge was geared to the actual employee costs of the seconded employees.

5. The split of functions between GSP and the Appellant, albeit occasioned by the need to preclude GSP from undertaking non-charitable functions, was quite convenient from a VAT point of view. GSP's services were all exempt for VAT purposes save for the management charges rendered against the Appellant, whilst the Appellant's services were standard-rated. Although thusVAT was charged in respect of the management charge just referred to and the secondment charges, that was all off-set as input tax in calculating any liability or refund due in respect of the Appellant's standard-rated services.

6. We were told, not surprisingly, that if the Appellant made a profit, that profit was paid as a "gift aid" payment to the charity.

7. During 2007, the Directors of GSP, and to a lesser extent the Directors of the Appellant (most of whom were directors of both companies) planned a fairly major alteration to the overall facilities offered. One of the major largely steel buildings on the site had been used for playing bowls. The plan in 2007, to the displeasure of the regular bowls players, was to change the entire interior configuration of the relevant building, and build a spa area, to comprise treatment rooms, changing rooms, steam rooms, a very sizable heated spa pool with numerous jets and fountains, and two complex machinery rooms to provide the heating, pumping, and de-humidifying requirements of the spa pool. These changes did not affect the frame, the steel cladding or the fairly low-pitched roof of the building. Whilst the building had been open to the laminated timber joists and steel brackets or the roof when used for bowls, the creation of all the spa facilities resulted in a ceiling being installed above the pool, the machinery rooms and the treatment and changing rooms. This ceiling to the lower floor space created a sufficiently large upper-floor space to facilitate the creation of an enormous gym. During our site visit we saw countless people exercising on cycling and other machines. It is irrelevant to indicate whether there were 50 or 100 machines in the gym area. In short, it was a very substantial gym. The overall renovation also included a refurbishment of the entire main canteen area, and the construction of a relatiely small extension to that area.

8. The directors who were planning the major redevelopment considered that the spa and treatment activities were not sporting activities in the requisite sense for charity and VAT purposes, though the gym activity was a sporting activity. They thus concluded that the most sensible course would be for GSP to fund the redevelopment work by borrowing from a bank (eventually Barclays), contributing the money borrowed into the Appellant in return for the issue of shares, whereupon it would be the Appellant that entered into the construction and other project contracts, and the Appellant that was invoiced for, and that thus paid for all the construction work. The total construction costs were in excess of £5 million.

9. The aim then was that the Appellant would conduct the spa and treatment activities, and receive the gross revenues in respect of them, along with the gross revenues for most of the Jungle Mania functions, and for all the café and bar services. GSP would then purchase, and pay for, the exercise machines in the gym that would be used in providing its sporting activities. In real property terms, it was then essentially implicit that the Appellant's licence (i.e. the one referred to in the Accounts, recorded in paragraph 4 above), would extend to the entire refurbished area, and to the separate area used for the Jungle Mania activity, and then there would

be a licence back to GSP, in which the Appellant would supply and charge for the use of the gym area by GSP.

10. The origin of the VAT dispute stemmed from the fact that, although documentation established that GSP had borrowed from Barclays for the express purpose of subscribing capital in the Appellant, that share capital had plainly been subscribed in tranches designed to match calls for payment from the contractors, the Appellant had been the relevant party to the construction contract for all the building works, and the Appellant's accounts clearly included as assets all the new building works that resulted from its capital expenditure, there was no sub-lease or available copy of any licence, reflecting what we have referred to as the licence from GSP to the Appellant (mentioned in the lost management agreement). Even if the management agreement that was said to have been lost had indeed existed, we were obviously unable to tell whether it had been drafted in terms that would extend the licence merely from the original café area to the major building on which all the construction work was undertaken. Equally there was no sub-underlease, or documented licence back of the gym area. In addition to there being no written documents governing these implicit arrangements, HMRC also contended that GSP's original 99-year lease, and possibly the new 125-year lease contained clauses that precluded GSP from granting sub-leases in various circumstances. More relevantly the Charities Act also deemed any disposition of property by a charity, including any lease or sub-lease but not a licence, to be void unless various requirements had been met or consent had been granted by the Charity Commissioners. It was accepted that the requirements had not been met, and that no consent had been sought.

11. We should add that, whilst the two associated companies had been dilatory in creating documentation, it did appear that both parties accepted that the Appellant had some form of licence over the areas in which it was providing services. The operation of original management agreement to which reference was always made in the accounts was marginally modified in 2008, the year during which the construction work was undertaken, simply increasing the charge for senior management time in that year. Thus the aggregate payment paid by the Appellant went up from £50,000 to £200,000 for that one year, and then dropped back again for later years. For present purposes, however, the significant point is that the reference in the accounts always remained in the form recorded in paragraph 4 above, indicating the parties' acceptance that there was some form of licence.

12. In the reverse direction, correspondence between the Appellant and HMRC made it fairly clear that whilst GSP would directly own the moveable equipment (the exercise machines) in the gym area, GSP would take some form of licence back from the Appellant in respect of the improved gym area, and it was the Appellant that had contracted to obtain, and paid for, the new floor area that enabled the gym to be created. The Appellant had sought to engage HMRC in discussion in relation to how the Appellant should deal with the fact that the gym area was to be used not by it (other than in the sense of licensing it to GSP), but by GSP. The Appellant's principal suggestion had been that during 2008 when the work was being undertaken, and the Appellant was simply receiving the standard-rated revenues from the café, bar and Jungle Mania activities, the Appellant should obtain a 100% deduction for the VAT invoiced to it in respect of the construction services, albeit that it acknowledged that part of this deduction should eventually be reversed under the capital goods scheme in later periods when the gym was in operation, and when GSP should be paying the Appellant for the use of the gym. Were that rent then to be exempt rent for VAT purposes, the capital goods adjustment would be made.

13. We should also add that during 2009 and 2010, GSP paid no rent to the Appellant for the use of the gym. We were however told that, still without any documentation being finalised, in 2011 GSP paid £45,000 retrospectively for each of the years 2009 and 2010, and paid the same amount currently in 2011 to the Appellant for the use of the gym.

14. In view of the various restraints on the creation of sub-leases by GSP, HMRC's essential contention was that the Appellant had incurred capital expenditure on improving land owned by someone else (i.e. GSP), and that this feature precluded the Appellant from claiming an input deduction for any of the construction costs, albeit that it was the Appellant that was plainly receiving all the gross income generated from all the non-sporting (i.e. the lifestyle) activities undertaken by the Appellant in the renovated building.

15. The fundamental question of principle that we were asked to decide was whether the Appellant should be able to deduct the VAT included in the VAT-inclusive invoices that had been rendered to it, and paid for by it, to the construction company and other project suppliers, this revolving around whether these costs were directly and immediately connected with the taxable supplies made by the Appellant.

16. There are, unfortunately, a number of secondary complications in relation to this Appeal, which we must now summarise.

17. When HMRC first gave consideration to the VAT implications of the Appellant's claim to deduct the input VAT charged in respect of the construction services, HMRC initially conceded a "without prejudice" deduction for 75% of the capital costs. This was apparently on the basis that approximately 75% of the floor area of the refurbished building was to be used for standard-rated supplies to be rendered by the Appellant, whilst 25% of the floor area was to be used by GSP.

18. In due course, when the matter had been considered by specialists, HMRC concluded that this treatment had been wrong, and HMRC suggested that, because the Appellant had spent money on improving another entity's land, the Appellant was entitled to no deduction.

19. In its turn, the Appellant responded (as we have largely explained in paragraph 12 above) that it considered its entitlement to deduct input VAT in relation to those areas from which it alone was rendering supplies to be entirely justified. Whilst it had initially expected a 100% deduction under the "standard method" in 2008, when it had solely made standard-rated supplies, it expected this to be reversed to some extent in due course to reflect GSP's use of the gym area. While the Appellant suggested that this adjustment under the capital goods scheme would produce a coherent end result, the Appellant was certainly ready to discuss other ways of achieving a sensible result. HMRC refused to engage in any discussion along these lines, however, since under its primary case, the Appellant was entitled to no deduction for any of the input VAT, so that the secondary question simply did not arise.

20. Whilst HMRC had indicated that the initial grant of a deduction for 75% of the input tax was to be reversed, HMRC had not made an assessment to recover what was (in its view) the wrongly conceded input deduction, though HMRC was still in time to make such an assessment. But for the rather extraordinary turn of events that we will now mention, doubtless HMRC would have made an assessment to recover that

initial deduction given for 75% of the input tax related to the construction work. The Appellant's appeal would then have amounted to an appeal against the assessment that it should refund the input deduction in respect of the 75% element, and a claim that it was properly entitled to a deduction for the denied 25% element. The Appeal would possibly then have extended to what the correct treatment should be for the fact that in due course, the Appellant would be receiving rent, possibly on a VAT-exempt basis, for the provision back of the gym area to GSP.

21. Very shortly before the Appeal was due to come on for hearing, for some rather obscure reason HMRC sent the Appellant a cheque for the VAT input deduction in respect of the 25% element of the claim that had always been denied. We were never told why this payment was made.

22. One consequence of this rather surprising payment, particularly as it was paid before HMRC had actually made an assessment in conformity with its decision that the 75% deduction granted had been wrongly granted, was that it appeared that the Appellant's appeal had effectively been vacated, because the Appellant had been granted the deduction for both the 75% and now the 25% elements that it was claiming in its original appeal.

23. HMRC then made an assessment (roughly a month prior to the date fixed for the original appeal to come on for hearing on 6 February 2012) to recover the entire 100% of the input deduction that had then been granted or conceded in one way or another, and the Appellant then appealed against that assessment. This thus explains why at the head of this decision there is a reference to the original 2009 appeal number, which had been thought to be the appeal that the parties would be contesting, until the rather extraordinary issue of the cheque referred to in paragraph 21, and it explains why there is a second reference to "an un-numbered new appeal".

24. This rather confused state of affairs leads to a number of complications, which we summarise as follows:

(i) Firstly, both parties agreed that we should decide the issue of principle, in relation to whether we held there to be the required direct and immediate link between the incurring of the construction costs by the Appellant, and the standard-rated supplies rendered by the Appellant, such that the claimed input deduction should be confirmed.

(ii) The Appellant then asked us, quite properly, to make it clear that our decision would not relate to two matters, namely detailed quantum of the VAT input claim, and the issue of whether HMRC were indeed in time, in terms of the four-year cut off point, for making the new assessment referred to in paragraph 23 above. In terms of quantum, we should explain that the parties had not engaged in detailed discussions in relation to quantum, and that whilst claims had been made in various VAT periods for a VAT deduction of £752,443, it was conceded by the Appellant that there might be some ineligible amounts in that claim, and that in the other direction, some additional claims might be due.

(iii) There was then, rather naturally, contention as to whether the feature that matters of quantum should be left to be dealt with in due course should extend to the fairly fundamental issue of how the Appellant should deal with the licence back of the gym area, or at least the feature that the gym

area was to be used by GSP and not the Appellant. This issue arose principally if the Appellant won the appeal on the fundamental point. Was it, in other words, then appropriate as the Appellant had always claimed to confirm the initial 100% deduction, in the expectation that that deduction would be marginally reduced, over time, under the capital goods scheme? The Appellant asked us to deal with, or at least to give some guidance in relation to, this matter, whilst the Respondents asked us to ignore it, as a matter of quantum.

(iv) The matter just raised was itself influenced by one of the Respondents' contentions, namely that for supplies in relation to land to be exempt, there now had to be a lease interest of some sort, and that a licence would not suffice. Were this correct, it would simplify the point just made (if at least we concluded that GSP had not granted an actual lease to the Appellant, so that the Appellant could not have granted any form of sub-underlease back to GSP), in that it would result in the analysis that the Appellant was only rendering standard-rated services. Naturally, GSP would fail to recover the VAT charged in respect of the rent charged for the use of the gym, and that might be the broad equivalent of the capital goods scheme having reversed some of the Appellant's initial input deduction under the capital goods scheme, but at least this approach, if correct, would simplify matters in the hands of the Appellant.

(v) Finally there were two issues in relation to costs. The 2009 Appeal had been brought under the VAT and Duties Tribunal rules, and the Appellant had asked for its costs. Were it to prevail in the appeal, the issue arose as to whether its claim for costs would be undermined by the fact that in form we were now essentially hearing the 2012 Appeal, i.e. the un-allocated current appeal. In addition there was the quite difficult matter as to whether we should exercise our discretion under paragraph 7(3) of Schedule 3 to the Transfer of Tribunal Functions and Revenue and Customs Appeals Order, 2009, to apply the old pre-2009 costs rules should we consider it permissible to deal with costs, as the one outstanding matter under the original March 2009 appeal.

The evidence

25. The principal evidence was given by Mr. Michael Edmonds, who had been the Finance Director of both GSP and the Appellant at the time of the construction work, and when the structure of the transactions was evolved. Mr. Edmonds and the other two witnesses had all in fact ceased to work for either company by the time of the hearing, and no current employee appeared before us. We accepted all Mr. Edmonds' evidence. We have reflected some of that evidence in giving some of the relevant facts in the Introduction, and will give further facts from paragraph 27 onwards. In those paragraphs we will both record facts that emerged in evidence, and where appropriate will give, and indicate that we are giving, findings of fact.

26. We have already mentioned that we were asked to undertake a site visit by the Appellant. Again we will mention below two points that struck us on our site visit.

Additional facts

Facts relevant to the fundamental division of activities between GSP and the Appellant

27. The Appellant was formed in 1994. It was said, and we entirely accepted, that the Appellant was formed at the request of the Charity Commissioners, in order that GSP and the trust would conduct exclusively charitable activities of providing sporting and recreational activities. Non-sporting activities, such as catering were thus to be provided by the separate company, GSP's wholly-owned subsidiary, namely the Appellant.

28. Shortly before the major reconstruction of the interior of the former bowls venue, the Jungle Mania area was created. This was a playarea, adjacent to a further café area. The play area appeared to involve numerous brightly coloured well-padded spaces adjacent to each other, and on different levels, through which children could climb and jump. Meanwhile their parents might have tea or coffee in the adjacent café area. There was an interesting point in relation to the Jungle Mania area, in that whilst it was primarily considered to be non-sporting, so that it should be operated, along with the adjacent café, by the Appellant, it was possible for parents to book the whole area for a party, and then possible (if they wished) to book a GSP trainer to give the children instruction in some form of gymnastics. Consistently therefore, charges for the basic play area and food and drink were levied by the Appellant, but charges for sporting instruction by GSP.

29. This basic division of activities governed the planning of the re-modelling of the old bowls area that was planned in 2007 and undertaken throughout the first eight months of 2008. It was considered that the quite plush reception area, equipped with a sales area where people booking in for massages could buy fairly expensive-looking preparations, and of course the numerous exotically named treatment rooms and steam rooms were not areas in which sporting activities were conducted, so that the activities in those areas should be operated by the Appellant, and not GSP. Similarly the extremely large spa pool, almost to the size of a moderate size public swimming-pool, with its very warm water, water jets and fountains etc, along with large changing areas were again not considered to be sporting activities, so that again they should be conducted by the Appellant.

30. A fact that Mr. Edmonds confirmed, when we asked him how gross revenues were allocated between GSP for the sporting activities, and the Appellant for the café and bar services, the non-training use of Jungle Mania by children, and the entire use of the spa, treatment rooms and steam rooms was that there was a strict division of revenues. In other words everything charged for the services said to be provided by the Appellant was a gross receipt received by the Appellant, whilst the revenues for all the sporting activities were charged by, and received by, GSP.

31. The feature that most of the activities in the greatly modified former bowls area were to be non-sporting activities that ought, in terms of the overall division of activity and the requirements of the Charity Commissioners, to be conducted by the Appellant had a major bearing on the planning in relation to which company should contract for, and pay for, the construction work. Attention was always also given to the feature that each company would be providing some facilities in the modified building, so that there were various permutations as to how that reality would be dealt with. Since the major work would be on areas of the building where the Appellant would be providing services, the structure chosen was that the Appellant would alone enter into the construction contract, and other project advisory agreements, and it

would then make the use of the area to be used by GSP, i.e. the gym area, available to GSP on a form of sub-licence basis.

32. Whilst the following point is, in part, one of submission rather than fact, the point was made by the Appellant that not only was the chosen structure adopted in order that it should conform with the division of activities required by the Charity Commissioners, but it was suggested that there was no aim to achieve any sort of artificial VAT advantage. The Appellant thus always recognised that in some way, there would be no recovery, or at least no ultimate recovery, of input tax charged in relation to the construction services insofar as facilities were used for GSP's sporting activities. The only aim and expectation was the seemingly unexceptionable aim that insofar as the construction costs borne by the Appellant were used in the provision of entirely standard-rated services by the Appellant, the Appellant should be able to deduct that input tax.

33. Whilst it verges further into contentions, it actually appears that HMRC would have accepted that that end result would have been fair and correct, but for HMRC's contentions based on various arguments to the effect that:

- the Appellant had no sub-lease of any building areas;
- the terms of GSP's head-lease precluded the grant of a sub-lease to the Appellant, as did the Charities Act;
- the Appellant had no licence to occupy any parts of the buildings; and
- it followed that the Appellant could hardly grant sub-licences back to GSP if it no rights over the buildings in the first place.

Had all the formal steps of granting leases or licences been taken, however, it seems that HMRC would have accepted what seems to us to be manifestly obvious, namely that the broad end result mentioned in paragraph 32 would indeed have been fair and appropriate. Furthermore it would almost certainly have been accepted that the Appellant was not entering into the sort of scheme where additional companies were interposed with a view to allowing input tax recovery, when in reality none was due. Presumably, with the appropriate grants of rights etc, HMRC would have accepted that the aim was simply to achieve a realistic allocation of inputs between a majority of taxable, and a minority of exempt, supplies.

Further facts in relation to the financing structure

34. Reverting more to a strict summary of the facts, we repeat that it was indeed the Appellant that entered into the construction and other project contracts. GSP borrowed all the required funds from Barclays Bank; it contributed everything borrowed into the Appellant in return for periodic issues of shares, and the Appellant met all the project costs, as it was liable to do under the various contracts. Barclays took a charge over GSP's interest in the land, and required the Appellant to guarantee GSP's obligations under the Barclays loan, and to give a charge in support of its guarantee over all its assets. The security package was, in other words, exactly as we would have expected.

35. For accounting purposes, the Appellant reflected everything spent by it on improving the facilities as an asset in its accounts.

Whether the Appellant had any form of sub-lease or licence, and the constraints upon the grant of sub-leases

36. As we mentioned in paragraph 4 above, the Accounts of the Appellant had annually reflected a recollection that under a written agreement, GSP was rendering various services to the Appellant, and that those services included a "licence of the premises". We also mentioned that the agreement referred to had been lost, and there was indeed some issue as to whether it had indeed ever existed, although this point was not argued before us. We can give no conclusion in relation to that, and ultimately we find the point to be largely irrelevant. Were it relevant, we comment that it would have been surprising for the accountants to allow this statement to be recorded in the Accounts without verifying that it was true. Whether it was true or not, nobody now had any idea what the agreement might have said.

37. We were shown GSP's original 99-year lease from the council, and the substitute 125-year lease that we believe was taken out largely to increase the security given to Barclays Bank. The former, not that this is relevant, precluded the grant of sub-leases, whilst the latter, and thus the current, lease permitted short (less than 7 year) sub-leases, and it permitted 5 longer term sub-leases provided that various formalities were complied with. They had not been complied with as regards any conceivable purported sub-lease to the Appellant.

38. More relevantly, clause 36 of the Charities Act 1993 invalidated any disposal of land or grant of any form of lease or sub-lease by a charity, unless various requirements had been complied with, or the consent of the Charity Commissioners had been obtained. These requirements had not been met, and no consent had been sought. The Charities Act appeared to impose no similar prohibition on the grant of licences.

39. Reverting to the terms of the head-lease, Clause 3.9.1. did provide that "the Tenant must not part with possession of the Premises or any part of the Premises or permit another to occupy them or any part of them except pursuant to a transaction permitted by and effected in accordance with the provisions of this Lease". Counsel for HMRC appeared to concede that the grant of a licence might not conflict with this clause, presumably because of the acceptance that the reference to permitting another party to occupy the premises should refer to an "exclusive right of occupation" that might well not be granted with a licence.

40. We should also mention that we were shown two documents, drafted in 2010. Neither had been executed, apparently on the advice of the Appellant's counsel. Whether this was because the late execution of the documents would colour or confuse this Appeal we do not know. Moreover, since none of the witnesses were currently employed by either company, we were not told whether the intention was that the documents would in due course be executed. Were they to be executed, we should mention that the first was a sub-lease from GSP to the Appellant of the lifestyle parts of the buildings, with an annual rent of £45,000. The other was a modified Management Agreement. In short, and with much more detail, the brief mention of one old agreement providing for these various rights (i.e. the one referred to in paragraph 4 above) was to be codified into a sub-lease and a separate management agreement, and it was clear that the sub-lease was to be granted over all relevant lifestyle areas.

41. We have already mentioned that retrospective rent, or at least payments of some description, were made by GSP to the Appellant for 2009 and 2010, and a current payment was made for 2011, all in the amount of £45,000. Implicitly therefore, had

the draft agreements mentioned in the previous paragraph been executed, the Appellant would have been paying £45,000 rent for the building space, used for lifestyle operations (but essentially for the buildings in their unimproved state), whilst GSP would have been paying the same amount for what would doubtless have been a sub-underlease back to GSP for the improved gym area.

The relative construction costs of areas to be used by the Appellant and GSP

42. We mentioned in the introduction that at one time, HMRC conceded a without prejudice deduction for 75% of the construction input tax, based on the broad understanding that of the areas affected by the 2008 construction works, 75% of the floor space would be occupied and used by the Appellant, and 25% by GSP. We should refer to the plainly correct claim by the Appellant (without at this point addressing its relevance) that in terms of allocated costs, vastly more of the construction cost than 75% was attributable to facilities to be used by the Appellant. One of the things that struck us in the site visit was that it was manifestly obvious that a very high proportion of the construction costs would have been attributable, as the Appellant claimed, to the spa area, and to the astonishingly large machinery and equipment required to provide water heating, water circulation and de-humidification to the very large spa.

43. Whilst the following point was not claimed and no evidence was given about it (save for our observations during the site visit), it almost appeared tenable to suggest that the gym area emerged by accident, and that relatively few costs were specifically attributable to its creation. It seemed obvious that whilst the whole building had earlier been void to the laminated roof timbers and steel brackets, when it was used for bowls, the proposed new utilisation was bound to have required the creation of ceilings above all the treatment and changing room areas. Even more obviously, the need to control the humidity in the spa area, and to confine that humidity-controlled area to a manageable size would have made it vital to provide a ceiling to the spa area. The required spans for suspended ceilings were also so considerable that, whilst perhaps heavier duty RSJs had to be used to accommodate the gym in the upper-floor area created, even if that area had been left empty, very substantial RSJs would still have been required to create the ceilings that were required, quite apart from the plans for the gym. Since the ultimate roof structure was changed in no way during the reconstruction, it was arguable that the only expenditure specifically attributable to the gym area was any cost in ensuring that the floor that would have had to be created in any event was strong enough to support the gym activities, as well as a few internal partition walls created in that space.

44. We were given no break-down of figures, and so we simply record that the Appellant's suggestion that much more than 75% of the cost was attributable to areas intended to be used by the Appellant, and less to the gym than the split, based on relative floor area suggested, was very realistic.

Inter-mingling of usage

45. We mention finally, in summarising facts, the second factor that struck us both in the site visit. This was that whilst an attempt had doubtless been made in the draft sub-lease that we mentioned in paragraph 40 above to ensure that GSP granted the Appellants a sub-lease on those areas of the buildings used for "lifestyle" as opposed to sporting activities, there would appear to have been some difficulty in achieving that. There were several occasions where we noted that in adjacent rooms, there

were sporting activities in one and lifestyle activities in another. There were also a great many "common parts" in that entrances and various corridors led to areas used for the different purposes and used by the different companies. This may have created no insuperable difficulty for a property lawyer, though we were left with some impression that a licence for permitted, but not exclusive, occupation of various parts of the building, with fairly flexible provisions for changing the utilisation of areas of the building, would have made very good sense.

The contentions of the parties

46. The Appellant's contentions are essentially a response to the contentions and the case advanced by the Respondents so that it will be clearer to deal with the Respondents' contentions first.

The contentions on behalf of the Respondents

47. It was contended on behalf of the Respondents that:

- the Appellant certainly had no sub-lease of the building on which ostensibly it incurred expenditure;
- the terms of GSP's lease precluded the grant of a sub-lease unless certain formalities were complied with and section 36 of the Charities Act 1993, which was even referred to in the head-lease, contained similar provisions;
- none of the formalities required under the head-lease or the Charities Act had been complied with, and certainly failure to comply with the formalities under the Charities Act would have rendered any sub-lease purportedly granted void;
- whilst there was probably no bar in the head-lease to the grant of licences, and certainly none in the Charities Act, there was no evidence that a licence had been granted by GSP to the Appellant (other than whatever licence over the bar and café areas had been granted by the lost management agreement), and when no break-down was even suggested in relation to the rent payable by the Appellant for any claimed licence, or the suggested duration or other terms of such a licence, there would be no licence that amounted in VAT terms to a "letting of immovable property";
- it followed that the Appellant had incurred capital expenditure on "improving someone else's land";
- the right analysis was that GSP was conducting the activities from the areas attributed by the Appellant to its activities, and that the Appellant was thus just a manager of those activities for GSP;
- it accordingly followed that there was no "direct and immediate link" between the incurring of the expenditure by the Appellant and any supplies made by the Appellant, with the result that the Appellant was entitled to no deduction in respect of the input tax included in the construction and other project invoices.

48. The Respondents also contended that, whilst the UK domestic statute had provided that certain supplies under leases "and licences" might be exempt for VAT purposes, recent ECJ case law had clarified that supplies under licences were always taxable, or that at the very least, were the Appellant to succeed in claiming an input deduction for the construction costs, any provision of any form of vague licence back to GSP over the gym area would not be an exempt supply for VAT purposes.

49. The Respondents also contended that we ought to confine our decision to the primary point at issue, namely the entitlement or lack of an entitlement to an input

deduction, all geared to the "direct and immediate link" contention, and we ought to leave over the issue of the treatment of the user of the gym area for the parties to deal with as a separate matter.

The contentions on behalf of the Appellant

50. It was contended on behalf of the Appellant that:

- the issue of whether the Appellant had a sub-lease or even a licence in relation to the building areas on which the Appellant had incurred construction costs was irrelevant to the entitlement of the Appellant to an input deduction for those costs;
- there was a "direct and immediate link" between the expenditure incurred by the Appellant on the construction works, and the supplies made by the Appellant because, whatever the property law or contractual position, it was the creation of the new spa and other areas that enabled the Appellant to provide the services that it provided, and for which alone it received the consideration;
- the arrangements between GSP and the Appellant were not VAT-inspired, but long-term arrangements for a division in activities required by the Charity Commissioners that rendered it essential that it was indeed the Appellant, and not GSP, that should be providing the various "lifestyle" services that were not strictly sporting activities;
- if the Appellant needed some form of licence to sustain its claim for an input deduction, which was denied, the feature that the mislaid management agreement had referred to a "licence of the premises", coupled with the estoppel-like features whereunder GSP had contributed capital to the Appellant with a view to the Appellant undertaking all the construction work, and the feature that GSP had plainly known that the Appellant was treating the product of its expenditure as assets in its accounts, would give the Appellant whatever legal rights it might need over the buildings in question to sustain its VAT claim.

51. The Appellant requested us to clarify that we were excluding anything from our decision that related to the points mentioned in paragraph 24(ii) above but asked us to give at least some guidance in relation to the points mentioned in paragraph 24(iii) and (iv) above. The Appellant reported that HMRC had repeatedly refused to enter into any dialogue in relation to these points, leading to the risk to the Appellant of there being a further dispute about these matters, even if the primary point in this Appeal was decided in its favour. The Appellant stressed, as we could well understand, that GSP and the Appellant were not wealthy substantial companies, but companies seeking, with some financial difficulty and essentially on a non-profit making basis, to provide vast sporting and lifestyle activities for the residents of Welwyn Garden City, and that the Appellant could ill-afford one VAT dispute, let alone two.

Our decision

52. We agree with the Appellant that the Respondents' concentration upon strict property law and licence matters has occasioned irrelevant confusion in this case and that those matters have very little bearing on the key issue of whether the input tax suffered by the Appellant was attributable, or "directly and immediately linked" to the

supplies that the Appellant made. It may nevertheless be simplest to deal with those property law points first.

53. We accept that the Appellant had no sub-lease of any part of the property. Indeed nobody contended that it did have such a sub-lease. Even the mislaid management agreement was said to have referred to nothing other than a "licence to the premises"; no lease was granted in writing, and when no specific rent was payable by the Appellant, and no length of term of any lease was specified or suggested, it is self-evident that there was indeed no strict sub-lease. The most that was asserted was that from the period when the Appellant was operating the café and bar areas, it was certainly not a trespasser. It had some form of licence to use the required areas, and some of the £50,000 management fee that has always been paid was attributable to such licence. It was notable that the other supplies (excepting the services of the CEO and other senior staff) were incidental supplies related to the licence of occupation rights.

54. Had a sub-lease been granted, the feature that that grant would have failed to comply with the fairly modest requirements of the head-lease would not have undermined the grant itself. The grant might have entitled the head-landlord (the council) to damages, or the right to forfeit the head-lease, but aside from the fact that we would have been astonished if the council had sought either remedy, in the meantime the Appellant would have had a sub-lease. This is irrelevant since there had been no purported grant of a sub-lease.

55. We accept that the grant of a sub-lease would have been void under the Charities Act. Whether this would have resulted in the analysis that the Appellant was a trespasser on GSP's land, or that the Appellant still had a licence, we are unclear. The point is again irrelevant since there was no purported grant of a sub-lease, and we consider that even if there had been, neither of the possible consequences that we have just mentioned would have had any bearing on the correct VAT position.

56. We do however decide that the Appellant was certainly not a trespasser on GSP's land. The cumulative effect of the following features must, we say, lead to the conclusion that the Appellant had at least some form of licence to occupy the land areas on which the Appellant incurred substantial expenditure.

- Some original agreement appears to have conferred some form of licence on the Appellant to have at least joint occupation rights over the café and bar areas of the buildings originally used by the Appellant.
- Whether that was so or not, GSP had acquiesced in the feature that the Appellant's accounts always represented that it did have some such licence rights.
- The requirement that the Appellant should provide those services, and only those services, that the Charity Commissioners required to be undertaken by a separate subsidiary of GSP occasioned an entirely credible and essential reason why the Appellant should have some sort of licence, to enable it lawfully to be on the land to render the services that it had to supply.
- The whole planning of the renovation project involved GSP being the initiator of the plan that it should contribute share capital to the Appellant, that the Appellant should be the party to all the relevant project contracts, that the Appellant should incur and pay all the project costs and then reflect the product of its spending as assets in its accounts. In contrast therefore to

many of the "licence by estoppel" cases, GSP was not merely knowingly standing aside, observing the Appellant improving GSP's land, but it was positively promoting, and facilitating everything that GSP did.

57. It is irrelevant for us to decide what remedies a court might have granted, had GSP sought to evict the Appellant from the land, without offering any compensation for the spending incurred by the Appellant. We are quire clear that the Appellant would have had an excellent chance of some form of redress, had GSP acted in that way. That might have resulted either in the Appellant being confirmed in some form of lawful continuing possession of the land, or at the very least in the reimbursement of all the expenditure that the Appellant had incurred. The reality, however, is that GSP has not taken such action and it is virtually unthinkable that it might do so. In this regard, we will turn one of the Respondents' observations back against the Respondents. VAT should be chargeable on what has happened, and not on what might happen, and certainly not on what will almost certainly not, and could not, happen. At present, therefore, we conclude that the Appellant is lawfully occupying land as to which the council has the freehold, GSP has a head-lease, and the Appellant has some form of licence. Accordingly the Appellant is lawfully using all the facilities that it has created (ignoring the gym at this point) absolutely, solely, immediately and directly in rendering the supplies that it, quite clearly, is providing.

58. Whilst the Respondents themselves had not posed this question to Mr. Edmonds, we thought it appropriate to check that not only was the Appellant the purported supplier of all the lifestyle services that it was suggested that it was providing, but that the Appellant indeed received all the gross turnover attributable to those activities. We have already mentioned that Mr. Edmonds confirmed that the café, bar, catering, spa, massage and non-training Jungle Mania gross receipts were all received by, and naturally reflected in the accounts of, the Appellant. We consider there to be nothing remotely odd or unusual in the Appellant operating by using seconded staff, where all the staff were employed by the one and only employer, GSP. We accordingly conclude that in every relevant sense, it is the Appellant and not GSP that is operating the lifestyle activities, and rendering all the relevant services.

59. We might mention in passing that we attach no significance whatsoever to the feature that customers and members of GSP might have been unaware of the identity of the supplier of the various activities. Equally the fact that Health and Safety notices might have been displayed under the name of GSP is of no significance. It is commonly the case that customers have no idea which company in a group is rendering different activities. There are examples, in retailing, for instance on different companies:

- owning, or holding leases to, the stores;
- employing the staff;
- managing the operation of the stores; and
- holding the stocks.

The feature that customers will virtually always be oblivious to those details does not mean that they are unreal, when the companies operate in the correct manner that they have chosen. The same applies in this situation, all the more so because the division of activity is one that the companies have been required to adopt to meet the requirements of the Charity Commissioners.

60. The factual conclusion that we have reached in paragraphs 57 and 58 above, namely that in every sense it is the Appellant that is rendering all the lifestyle services makes the contention, advanced by the Respondents, and mentioned as the penultimate bullet-point in paragraph 47 above completely untenable. We accept that, had the right factual analysis been that the Appellant was just a manager, and that beneficially the trading in providing all the lifestyle services was undertaken by GSP, then the Appellant would have been entitled to no off-set for the input VAT. But that factual proposition is simply untenable.

61. The observation that we have accurately recorded in the ante–penultimate bullet point in paragraph 47 above is also over-simplistic. The Appellant has of course incurred capital expenditure in relation to land and fixtures, where the council is the freeholder, GSP the head-landlord, and the Appellant almost certainly some form of licensee. The critical point however is that all of that expenditure was designed to facilitate use, activity and revenues solely for the Appellant and not GSP, let alone the council. And this is precisely what is currently happening.

62. This Appeal is not, therefore, remotely in the ballpark of the cases where an appellant claimed a deduction for solicitors' bills in relation to a share sale, on the basis that the solicitors' services very indirectly generated cash that was used in the appellant's business. It is not in the domain of advertising services principally designed to sell sofas, whereupon the sale of sofas enabled the then appellant to earn commissions for some form of insurance. This case involves the Appellant directly and immediately incurring costs in creating facilities, for no other reason than to render services from and with those facilities, and to earn and own the whole of the gross turnover referable to those activities.

63. This case appears to be so clear to us that it is almost superfluous to mention, and expand on, an example that we aired during the hearing. We will do so, however, because we consider that it illustrates our approach quite neatly.

64. Assume, first, the operator of a taxi business, who decides that he needs to expand and he therefore steals a car, with a view to using it as a taxi. He then has to incur expenditure on repairing the car in some ways, and fitting taxi meters etc, and on this occasion is charged for the work by an honest garage, so suffering VAT. Unusually for the dishonest thief, he then reports all his turnover for VAT purposes, and claims an input deduction for the garage bills. They would manifestly be deductible. That taxi operator would clearly have poorer title to the car than the Appellant in this case has to be on, and to use, GSP's land.

65. In the second example, the taxi operator is not dishonest. His parents however are elderly and no longer wish to drive their car, so that without giving it or transferring it to their son, they simply allow him to use it indefinitely. This example is now closer to the GSP/Appellant situation. It seems even more obvious that when the car is now intended to be used solely for taxi purposes, and solely to generate turnover for the son, the son would again be entitled to deductions for input VAT included in the garage bills.

66. In the third example, the son has five taxis in a straightforward manner but pays for the servicing of a car that either (i) his parents still use for entirely private purposes, or (ii) some other person uses in some way that involves the making of exempt supplies. These two sub-examples are close to what the Respondents claim in their ante-penultimate and penultimate bullet points in paragraph 47 above. We

entirely agree that in those factual situations, the claim for input deductions by the son would be improper and indeed fraudulent. The difficulties with the Respondents' two contentions are that the realistic summary of what is happening in this case is as we have described it in paragraphs 57, 58 and 60 above. It is wholly remote from the suggested facts of this third example.

Our decision, in principle, on the fundamental issue

67. Our decision, in principle, on the issue of whether the Appellant has established that the construction and other project costs that it bore in 2008 were attributable, or directly and immediately related, to the supplies that the Appellant made is that that point has indeed been established.

Issues relating to the licence back of the gym area to GSP, or to the general feature that it was implicit that the gym area was not to be used by the Appellant directly in rendering lifestyle or indeed sporting facilities, but was only to be used by the Appellant in the sense of that area being provided in some form to GSP

68. Whilst the technical arguments in relation to leases, sub-leases and licences were largely irrelevant to the fundamental matter addressed in the preceding paragraphs, we accept that those matters are now relevant to the nature of whatever rights the Appellant may have had to the building areas involved in the reconstruction, and to the basis on which the gym area was made available for use by GSP.

68. We have already indicated that the Appellant asked us to seek to give some guidance in relation to this matter, and that HMRC asked us to treat it as an excepted matter of quantum. In terms of compounding the way in which the parties have failed to engage in any clear dispute as regards this matter, on which we might sensibly reach a decision, we note that:

- the Appellant's skeleton argument had largely ignored this significant additional matter;
- the Appellant conceded that there were various possible ways in which some 2008 or later denial or reversal of the deduction of input tax in relation to the construction costs in relation to the gym might be dealt with, including the adoption of "special methods";
- the Respondents had refused to engage in any discussion in relation to this matter;
- the Respondents had suggested to us that whilst the relevant Schedule to the VAT Act, 1994 had suggested that both leases **and licences** of property might qualify as exempt supplies, the latest ECJ decisions had effectively changed the position such that non-exclusive licences to use property could no longer rank as exempt supplies, so that the Appellant was inherently therefore rendering taxable supplies to GSP when making the gym area available;
- the Appellant had had virtually no opportunity to dispute the somewhat surprising contention mentioned in the previous bullet point; and finally that
- whilst no evidence was given to whether the draft agreements referred to in paragraph 40 above were to be finalised, and to whether those written agreements were anyway regarded as merely documenting what was implicitly agreed, the execution of those agreements might have at least some practical bearing on how this current matter should be resolved.

70. In view of the total absence of clearly defined opposing positions, advanced by the parties, and of the impossibility of our considering whether some special method, mentioned by neither party, might be appropriate in this case, we conclude that we cannot decide the secondary matter in this decision. We will endeavour to offer very limited guidance, however, on two points.

The Respondents' claim that supplies under non-exclusive licences cannot be exempt supplies of "lettings of immoveable property"

71. We observe, firstly, that were the Respondents correct to say that the provision of services under a licence, as distinct from a lease, could never be exempt supplies, then this would appear to simplify matters. For unless any extraordinary point was advanced, geared to the observation that the Appellant had not contracted to receive rent, or payments however described, for the provision of the gym to GSP, until retrospective rent was paid in 2011 for the years 2009 and 2010, the feature that the licensing of the gym would be a taxable supply (on the Respondents' licence contention) would have the following simple consequences. As regards the Appellant, the Appellant's utilisation of all the improved areas would involve rendering taxable supplies of one sort or another. Accordingly there should be no partial disallowance of input tax. VAT would be chargeable in respect of the rent charged against GSP, and GSP would obviously fail to recover the VAT, since all its supplies of sporting services are exempt supplies.

72. Whilst the point was not fully argued before us, our tentative view is that we are not satisfied that the Respondents are correct to suggest that a licence to use land cannot now rank as an exempt supply.

73. We certainly accept that there cannot at present be any form of sub-underlease, running from the Appellant to GSP, because if any sub-lease from GSP to the Appellant would be void under the Charities Act, as we accept, the Appellant can certainly not grant and create an estate in land in favour of GSP when it itself has no such estate.

74. The Respondents based much of their contention in relation to the suggested revised treatment of licences on the ECJ cases of *Belgian State v. Temco Europe SA* [2005] 1 CMLR 23. and *Gabriele Walderdorff v. Finanzamt Waldviertel* (Case C-451/06). It was claimed that those cases, in indicating that there were five prerequisites before a grant of rights could rank as a "letting of immoveable property", undermined the contention that any licence from the Appellant to GSP could comply with the requirements. One failed requirement was the grant of the right of exclusive occupation (inherently unusual with a licence), one was the entitlement to rent, and the third was the grant of the right for "a term".

75. The decision in the *Walderdorff* case related to the grant of fishing rights over two defined areas of water. It appeared that the conclusion that there was not, in that case, a "letting of immoveable property" was based not so much on the semi-active feature that fishing rights involved the provision of an active service by the grantor (somewhat akin to the right to play golf on a golf course), but on the feature that the grantor reserved the right to use the fishing rights herself at any time, and to bring any guest into the area to enjoy the fishing rights as well.

76. We consider the *Temco* case to be rather more significant. In that case, the grantor granted occupation rights to three of its affiliated companies. There was no

identification of which company might occupy which part of the building in question. There was no defined term of years to the right of occupation. The "contracts had been entered into for the duration of the transferees' activities", and the "transferor's board of directors [was] entitled at any time without notice to require the transferee to vacate the premises". Finally the rent chargeable was calculated in a complex manner, and was certainly not just specified in the grant in fixed amounts.

77. It was held in the *Temco* case that there had been a "letting of immovable property". The decision seems to us be important in two respects. Firstly there are a number of references to the fact that considerable significance attaches to the issue of whether the rights granted are essentially the passive rights to use property, rather than semi-active rights where the grantor can sensibly be seen to be providing some sort of active service. Secondly, the case confirmed that there was still a "letting of immovable property" where there was some significant erosion of the three of the suggested prerequisites of that status mentioned in paragraph 74 above.

78. As regards the first of those points, in paragraph 20 of the decision the ECJ made it clear that:

> *"While the Court has stressed the importance of the period of the letting in [numerous] judgments, it has done so in order to distinguish a transaction comprising the letting of immovable property, which is usually a relatively passive activity linked simply to the passage of time and not generating any significant added value from other activities which are either industrial and commercial in nature, such as the exemptions referred to in Art.13B(b)(1) to (4) of the Sixth Directive, or have as their subject-matter something which is best understood as the provision of a service rather than simply the making available of property, such as the right to use a golf course, the right to use a bridge in consideration of payment of a toll."*

79. This point seems to be highly relevant in the present case. Unlike many of the cases dealing with whether there has been a "letting of immovable property", such as the golf course and vending machine type of case, the fundamental rights purportedly granted in this case (in both directions) were nothing other than rights to occupy immovable property, and in reality to do so for a long period of time. The consents (both from the council under the head-lease and from the Charity Commissioners) would, we imagine, have been formalities, neither of which would have occasioned any real impediments, and both of which might presumably be obtained retrospectively for confirmatory grants. But leaving those details aside, the rights fundamentally involved and in effect implicitly granted were classic rights over immovable property in the nature of licences, if not leases.

80. Turning now to the second of the points clarified by the *Temco* case, paragraphs 21 and 22 of the decision make it clear that there is no need for any period of utilisation to be fixed at the time of the letting, and that entirely flexible provisions are acceptable. As we mentioned, in that case the grant was for the "duration of the transferees' activities", and the grantor could determine it at any time. Similarly in the present case, whilst we will not venture into the area of the implied terms that might or might not have been realistic, we consider it clear that the rights granted were meant to be for very long terms. Furthermore, the feature that the whole purpose of the arrangements was that the Appellant should incur all the expenditure on the construction almost certainly gave the Appellant some estoppel-type protection

for its right of occupation, just as the feature that the proposal that GSP was to operate the gym, and own all the exercise equipment in it, confirmed the same for the licence back of the gym area. The rights granted in this case were either not revocable, or at least not revocable without compensation being paid, and so these rights were more consistent with "lettings of immovable property" than the revocable rights in *Temco.*

81. Paragraph 23 of the ECJ decision in *Temco* makes it clear that payment to the landlord need not be strictly linked to the passive provision of accommodation, but can take into account other "provision". It is very relevant in this context that whilst we accept that the old lost agreement also provided for the services of the CEO and senior staff of GSP, the other services mentioned in the notes to the Appellant's accounts referred simply to the licence to the property, the provision of utilities, and the hire of fixtures and fittings. All those rights seem to be us to be entirely consistent with the fundamental grant being a "letting of immovable property", and a hire of some equipment.

82. Paragraphs 24 and 25 of the decision dealt with the right of exclusive occupation and what qualifications there can be to this without undermining the grant of rights as a "letting of immovable property".

> *"24. Lastly, as regards the tenant's right of exclusive occupation of the property, it must be pointed out that this can be restricted in the contract concluded with the landlord and only relates to the property as it is defined in that contract. Thus, the landlord may reserve the right regularly to visit the property let. Furthermore, a contract of letting may relate to certain parts of a property which must be used in common with other occupiers.*
>
> *25. The presence in the contract of such restrictions on the right to occupy the premises let does not prevent that occupation being exclusive as regards all other persons not permitted by law or by the contract to exercise a right over the property which is the subject of the contract of letting".*

83. Paragraphs 26 and 27 of the decision are then particularly important in emphasising the essence of the test, and the feature that the term "letting of immovable property" is principally designed to distinguish passive lettings from active services, in other words the first of the points mentioned in paragraph 77 above and dealt with in paragraphs 78 and 79 above:

> *26. As regards the transaction at issue in the main proceedings, it is for the national court to consider all the circumstances surrounding it in order to establish its characteristics and to assess whether it can be treated as a "letting of immovable property" within the meaning of Art. 13B(b) of the Sixth Directive.*
>
> *27. It is also a matter for that court to establish whether the contracts, as performed, have as their essential object the making available, in a passive manner, of premises or parts of buildings in exchange for a payment linked to the passage of time, or whether they give rise to the provision of a service capable of being categorised in a different way.*

84. As regards, finally, the need for the payment of rent, we accept that the related nature of the companies in the present case has led to the entitlement to rent being dealt with in a slightly unsatisfactory manner. However the Appellant has

apparently always paid the £50,000 amount referred to in paragraph 4 above, and since most of the services said to be granted in return for that payment were consistent with the letting of property, we consider that at least some part of that payment was indeed the equivalent of rent. Were the agreements mentioned at paragraph 40 to be executed, this would put the point beyond doubt, and would appear to be irrelevant for VAT purposes. More clearly still, with the retrospective payments of rent that GSP has paid for the use of the gym, and the current payment made for 2011, it seems that there have been clear payments of rent of £45,000 for the utilisation by GSP of the improved gym area.

85. Whilst we acknowledge that the standard-rated or exempt nature of licences was not fully argued before us, and indeed the Appellant barely had an opportunity to address the point, we consider that there is nothing in either of the ECJ cases to which the Respondents referred us that led us to doubt that there were licences in each direction (from GSP to the Appellant in respect of all the areas used and occupied by the Appellant and from the Appellant to GSP in respect of the renovated area that became the gym).

86. We decide that the services rendered under these two grants were indeed exempt licences for the occupation of property, with all the characteristics required to rank within the European notion of "lettings of immovable property".

The consequence of confirming the exempt nature of the licences

87. If the conclusion in paragraph 86 is correct, it does re-open the question that both parties assumed had to be decided, namely how to deal with the partial disallowance, or reversal of input deduction, to reflect the fact that the Appellant's intended use of the areas on which it incurred construction expenditure were not to be wholly taxable supplies.

88. Whilst we understand the Appellant's expectation as to how this feature should be dealt with and we make no comment on it or on other possible approaches to the issue, we will mention one point.

89. The only one observation that we make has a possible bearing on both when the adjustment should be made and, in terms of quantum, by how much there should be an adjustment. This observation is that this case, while in some respects somewhat similar to the facts of *St. Helen's School Northwood Ltd v. HMRC* [2007] STC 633, where a swimming pool was used by a school for both standard and exempt supplies, the difference is that in that case there was simply one indivisible swimming pool. In the present case, we assume that if the Appellant had constructed an entirely separate gym in a separate building, and all the costs of that separate building could be identified, the appropriate result would have been to deny an input deduction altogether for the input tax charged in respect of the separate building since the supplies made in respect of that expenditure would have been entirely exempt (on the assumption that our conclusion in paragraph 86 is correct).

90. We are not clear whether it would be appropriate to seek to identify those costs attributable to the construction of the gym area in this case, and then deal with them as just postulated. We understand that achieving a sensible split would be more difficult than in the example where there was a clearly separate building, and it also occurs to us that if the point made in paragraph 43 above (geared to the reality that the ceiling of the spa and other areas automatically created the floor of the gym) might

lead to some complication. In our site visit, we certainly noted however that absolutely no change had been made to the roof and ceiling of the gym area itself, so that the expenditure on the floor and the few internal partitions appeared to be the only expenditure specifically geared to the gym. Were the point in paragraph 43 correct moreover, such that the gym almost materialised by accident at little additional cost other perhaps than the cost of some additional strengthening to the floor, the attributable expenditure might be rather less still.

91. As a tentative observation we would simply say that we would expect the quantum of disallowed expenditure to be rather less on the approach of trying to identify the gym expenditure in isolation, than the likely disallowance geared to ratios based on the relationship of £45,000 exempt rent to the Appellant's total income, particularly if the utilisation of the spa area has proved to be rather disappointingly low.

Costs

92. The Appellant concluded its Skeleton Argument by observing that the Appeal was one that had commenced before the VAT and Duties Tribunal, and so we were asked first to exercise our discretion under paragraph 7(3) of Schedule 3 to the Transfer of Tribunal Functions and Revenue and Customs Appeals Order 2009 ("the Transitional Order"), and apply the costs regime of the old VAT and Duties Tribunal; and secondly we were asked to award the Appellant its costs, were the Appellant successful.

93. At the end of the hearing, we made the observation that whether or not the correct conclusion was that the appeal that we had actually heard was the un-numbered First-tier Tribunal appeal, to which the new costs regime clearly applied, we considered that it was very likely open to us to treat the request for costs as one attributed to the original pre- April 2009 appeal. After all, even if the substantive point in that appeal had been entirely settled by the full payments eventually made by HMRC, there can still be a dispute about costs. Accordingly we intimated that we considered that we were not precluded from dealing with the claim for costs under that appeal.

94. There is of course another possible approach. On the reasoning that the appeal that we heard was actually a new 2012 appeal, it might be appropriate to conclude that we could award costs in respect of the new appeal That, however, raises the questions of whether we ourselves could now designate the new un-numbered and un-designated Appeal as Complex, whether any of the three tests for justifying such an allocation would be satisfied, whether it would matter that in reality most of the costs (until the last two weeks before the hearing) had been related to the pre-April 2009 appeal, and to a further issue under Rule 10 of the First-tier Tribunal Rules 2009 ("the 2009 rules"). The point may be rather technical, and of course the assumption is that all new appeals will have been designated at the outset as falling within one of the four categories, but rule 10 still permits us to award costs in a Complex appeal only "if proceedings have been allocated as Complex", a phrase that fairly obviously envisages a prior designation, and that in almost every case but this one would indeed involve a "prior designation.

95. Whilst we might say now that we consider that this appeal has been on the borderline (indeed on all three relevant tests) of properly ranking as a complex appeal,

and of being designated as Complex, we do not propose to deal with costs in relation to the new appeal.

96. The next introductory point that we must mention is that HMRC sent an e-mail to the Tribunal Judge very shortly after the hearing to the following effect:

> *"I refer to Judge Nowlan's proposal* (i.e. the one referred to in paragraph 93 above) *as to the costs order he would be minded to make in the event that Gosling Leisure Ltd were to succeed in relation to the point of principle heard by the Tribunal on 6-8 February. In all the circumstances of the case, the Commissioners do not intend to make any submissions to the effect that, were Gosling Leisure to succeed, the Tribunal should not make the order in the terms proposed by Judge Nowlan. For the avoidance of doubt, the Commissioners understand that the basis of such an order would be that the costs should be assessed (pursuant to rule 29(1)(b) of the 1986 VAT Tribunal Rules) if not agreed.*

97. The final introductory point to make is that the Appellant's counsel provided the Tribunal judge by e-mail and after the conclusion of the hearing with a copy of Mr. Justice Warren's decision in the case of *HMRC v. Atlantic Electronics Limited*, recently released by the Upper Tribunal, which has been read very carefully.

Our decision in relation to costs

98. We should firstly state our critical assumption, based on the point that the Appellant's two requests mentioned in paragraph 92 would make little sense if the Tribunal had already given any Direction about the applicable costs regime, that no such Direction has been given. Had a Direction been given, for instance that the new costs regime should be applied, we would of course abide by that Direction, both because it would be right to do so, and because there is the strongest indication in Mr. Justice Warren's decision that that is the only appropriate course for us to follow. Had the Direction been in the reverse direction, conceding the application of the old VAT Tribunal rules, we would obviously have accepted that direction, and would then grant the requested award of costs. It seems, however, fairly obvious that unless someone has completely forgotten the outcome of earlier Applications, no Direction in relation to costs can have been applied for.

99. As we have already said, we reject the possibility (if indeed it is a possibility) of now designating the new unnumbered Appeal as a Complex appeal and granting the Appellant costs on that approach. We consider that the designation of this case as either Standard or Complex would have been a borderline matter, and that it could perfectly properly have been designated as Complex. As Mr. Justice Warren observes, this conclusion can properly still have some bearing on whether we choose to exercise our discretion under the Transitional Order to apply the old costs regime.

100. Whilst HMRC has given the indication that we have recorded in paragraph 96 above, and whilst there is obviously considerable significance to this confirmation, we consider that it would not be proper to grant costs on the basis of this confirmation without giving at least some consideration to the right approach to doing what achieves a fair and just result, and to complying with the indications given in Mr. Justice Warren's decision.

101. We turn now to the factors that we consider justify us in exercising our discretion under paragraph 7(3) of Schedule 3 of the Transitional Order to apply the old costs regime in this case, and to award the Appellant its costs.

102. We should first note the point that the original Appeal only commenced in March 2009. This occasions two observations. Firstly in relation to Mr. Justice Warren's suggestion of applying the old costs regime to the pre-April 2009 litigation costs and the new regime to the later costs, virtually all the costs would fall on the latter side of that dividing line. On the other hand, had the Appeal commenced a few weeks later, and had it been designated as Complex, and had the Appellant not opted out of the costs regime applicable to Complex appeals, then the Appellant could have sought its costs.

103. We next note that in its Skeleton Argument, the Appellant requested that we operate the old Costs regime, and grant the Appellant its costs if it was successful. Mr. Justice Warren would have considered that application for the old rules to apply to be made very late in the day. We consider, however, that it was certainly not made at the end of the hearing, at some point when arguably the Appellant might have considered that the hearing was "going in its favour". We rather sense that the Appellant was reasonably confident that it had a good case from the outset, and we see no reason to suppose that this had somehow become more obvious to it, by the time the Skeleton Argument was produced.

104. The fact that the Appellant applied for the two orders just referred to is quite significant in a number of ways. It clearly indicates that the Appellant thought that an award of costs would be quite appropriate, and to some extent it indicates that the Appellant would have been unlikely to have opted out of the costs regime, had the case started one month later, and had the case (as we consider to be realistic) been designated as Complex.

105. We now address the possible reality that this approach is over-generous to the Appellant. For the Appellant might have taken the view that if it applied for the old regime to apply, and it applied for costs if successful, this would still be a "one-way-bet", because under the Sheldon statement, this case would very likely have been one where HMRC, had they been successful, and had the old costs regime applied, would not have sought their costs. Accordingly the Appellant's request for the old costs regime to apply might simply have been based on the likely expectation that if the old regime rule was to apply, the application for costs would have been a one-way-bet, in which it could only win.

106. We are not clear whether the indicators for designating a case as Complex roughly match the circumstances under the old Sheldon statement, where HMRC would themselves have sought their costs, had they won the appeal under the old rules. On the reasoning that the indicators for the two different matters are not that dissimilar, we conclude that the Appellant's application for costs was not plainly a cynical "one-way-bet", and that it did suggest that the Appellant would not have opted out of the costs regime, had the case been designated as Complex.

107. We entirely accept that the Appellant has only made its application for the old costs regime to apply very late in the day, and that this has been singularly unfortunate in terms of the guidance that Mr. Justice Warren has now given.

108. In the Appellant's favour, however, we note that:

- the only indication that an early application has to be made in one way or another in relation to costs is the feature that an Appellant now has 28 days in which to opt out of the costs regime for post –April 2009 cases, designated as Complex, and this Appellant could understandably, and entirely rightly, have regarded this point as being completely irrelevant to its case, if at least the *Surestone* case, precluding the classification of transitional cases is correct;
- there was nothing in the Transitional Order that really clarified that the Appellant's application as regards the old costs rules had to be made at a very early point;
- it is now too late for this Appellant, or indeed any other appellant in a similar position to adopt the guidance offered by Mr. Justice Warren, because it is now three years too late to follow it; and finally
- there is some force in the observation that if a taxpayer commences litigation it might legitimately expect the rules that operate when it takes its decision to litigate to remain in force for its litigation.

109. The reasons why we now grant (subject to the point made in paragraph 98 above) the two orders that the Appellant has requested in paragraph 92 above are that:

- HMRC has conceded that it would not oppose the requested orders, so that implicitly it considers them reasonable;
- we consider that more attention should be given as regards awards of costs in this type of case to applications by the Appellant, rather than the Respondents, first because the old costs regime was deliberately somewhat more favourable to appellants, and secondly because the choice in relation to costs as regards Complex cases under the new regime is given to the taxpayer and not to HMRC;
- we consider that this case was at least close to being properly classified as Complex, arguably under any of the three tests for justifying that classification;
- the point just made means that fundamentally the Appellant could have elected to apply for costs under the old or new regimes, and when its case has the risk of falling down a rather unfortunate crack between the two regimes, it appears that we should be justified in seeking to avoid this result; and
- we are not troubled that the Appellant has made a last minute application for costs at a point when it considered that the case was likely to be decided in its favour, since the application was made in the Skeleton Argument, in which the Appellant was simply advancing points that it had been advancing with some confidence for three years.

110. The order for costs that we award in favour of the Appellant, and subject to paragraph 98 above, is in the form mentioned by HMRC in paragraph 96 above.

Right of Appeal

111. This document contains full findings of fact and the reasons for our decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) Tax Chamber Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

HOWARD M. NOWLAN
(Tribunal Judge)

Released: 5 March 2012