Neutral Citation: [2023] UKFTT 855 (TC)

Case Number: TC08956

FIRST-TIER TRIBUNAL
TAX CHAMBER

Alexandra House, Manchester

Appeal reference: TC/2020/02240

VAT, attribution issue (direct and immediate link) and apportionment issue (fair and reasonable) considered in the context of an Appellant who makes both exempt (equity release mortgages) and standard rated supplies.

Heard on: 19-23 June 2023
Judgment date: 05 October 2023

Before

HIS HONOUR JUDGE MALEK
MS SUSAN STOTT

Between

KRS FINANCE LTD

Appellant

and

THE COMMISSIONERS FOR HIS MAJESTY'S REVENUE AND CUSTOMS

Respondents

Representation:

For the Appellant: Ms Amanda Brown KC, solicitor, instructed by KPMG Law

For the Respondents: Ms Isabel McArdle, of counsel, instructed by the General Counsel and Solicitor to HM Revenue and Customs

DECISION

INTRODUCTION

1. This decision concerns itself with four related appeals. It has, therefore, been necessary to set out a little of the procedural background. In addition, a preliminary issue arose on the first day of the hearing in relation to which we gave our decision with reasons to be provided or expanded upon in writing. It appeared to us to be logical to deal with this issue straight after setting out the procedural background. The remainder of this decision takes each appeal in turn.

2. In this decision, we have cited authorities only where clearly necessary and sought to summarise the position at law wherever possible. Neither do we think readers would find it helpful if we reproduced large parts of the evidence verbatim (save where absolutely necessary to give clarity) and we have, therefore, confined ourselves to pertinent, useful and summary findings of fact. Whilst taking this approach does not necessarily mean that the time taken for consideration and writing the decision is shortened (in fact it sometimes increases it) it has, we hope, resulted in a significantly shorter and more focussed decision.

PROCEDURAL BACKGROUND

3. The Appellant is a representative member of a VAT group (which included at all material times Key Retirement Solutions Ltd ("**KRS**"), More 2 Life Ltd ("**M2L**") and KRS Services Limited ("**Services**") and brings these appeals on behalf of that group.

4. KRS is in the business of offering advice and related services (including Equity Release Mortgages ("**ER**") and Estate Planning ("**EP**") to members of the public aged over 55 years about to enter into or during retirement. It is not in dispute that ER services are, save for a small proportion, exempt for the purposes of VAT and EP services are standard rated. In addition, KRS receives fees from solicitors in connection with the ER business.

5. M2L is an "ER originator". It identifies capital funders (such as life insurance companies and pension schemes) who wish to offer ER loans to package the loans to customers through brokers and Independent Financial Advisors. The loans are made by M2L which retains legal title to the loan and the associated property charge, but M2L sells the beneficial interest (and thereby all associated risk as well as the benefit) to the funder. M2L is paid to take on the role of originator/trustee and the consideration received is the Loan Sale Premium ("**LSP**").

6. Services operates as the corporate group's central support function providing the head office, human resource, finance, compliance, IT, legal etc. functions, and it incurs all central overhead costs on behalf of the group. Services recharges these overhead costs to the group entities by an allocation of accounting via the management accounts prepared for each entity.

7. It is common ground that the Appellant is a partially exempt trader for the purposes of VAT and it is further common ground that the Appellant used the Standard Method ("**SM**") for recovery of input tax, save where costs were directly attributable to its exempt or standard rated supplies.

8. The SM results, for the Appellant, in the recovery of residual input tax at a rate of approximately 10%. This was felt by the Appellant to be too low, or to put it in more statutory language (about which more later) the Appellant's view was that the SM did not give rise to a "fair and reasonable" rate of recovery for input tax. As a result, the Appellant instructed KPMG LLP to carry out a review of its business to see if a Partial Exemption Special Method ("**PESM**") would produce a better result and could be used instead.

9. The procedural history resulting in these appeals is both protracted and far from straightforward. However, of relevance for present purposes, are the following matters:

(1) On 1 November 2018 KPMG LLP, on behalf of the Appellant's VAT group, submitted a proposal to the Respondents for a PESM. This proposed, broadly, that the Appellant operate a sectorised method on a trading entity basis and that a transaction count proxy be used to attribute residual costs incurred by each entity to taxable or exempt supplies (the "**Transaction Count Method**"). After considerable exchange of correspondence and information the Respondents rejected the Transaction Count Method by review letter dated 12 June 2020. This resulted in the Appellant appealing this decision on 7 July 2020 (the "**Transactional Count Method Appeal**").

(2) On around 17 December 2019 the Appellant proposed an alternative PESM using, again, a transaction count approach, but on an adjusted income basis (the "**Income Adjusted Method**"). Again, following exchange of information and correspondence this too was rejected by the Respondents by review letter dated 25 May 2021. This resulted in the Appellant appealing this decision on 22 June 2021 (the "**Income Adjusted Method Appeal**").

(3) On various dates between 1 November 2018 and 30 April 2021 the Appellant submitted four Error Correction Notices ("**ECN**") seeking to amend earlier returns based upon use of the Transaction Count Method. By letter dated 11 March 2022 the Respondents rejected the ECNs. The Appellant appealed that decision on 18 March 2022 the "**ECN Appeal**"). It is common ground that the outcome of the ECN Appeal turns on our decision in relation to the Transaction Count Method Appeal and the Income Adjusted Method Appeal.

(4) On 22 March 2022 the Respondents carried out a review of the marketing expenditure and concluded that VAT incurred on equity release advertising was directly attributable to the equity release services provided by KRS- ultimately leading to assessments for over-recovered input tax. That decision was appealed on 28 March 2022 (**the "Marketing Expenditure Appeal**").

PRELIMINARY ISSUE- CONFIDENTIAL INFORMATION

10. By notice dated 17 May 2023 the Appellant made an application pursuant to Rule 5(3) of the First Tier Tribunal (Tax Chamber) (Tribunal Procedure) Rules 2009 that confidential information (as defined and set out in an annex to the application) be:

(1) Redacted, prior to publication, if referred to in our judgment, and

(2) The subject of similar redaction in the event of an application by any third party for disclosure of documentation in the event that such documentation contains or contained confidential information (as defined).

11. We considered the application as a preliminary issue at the start of the hearing and decided to grant the application with written reasons to follow.

12. It is, of course, helpful that the Respondents consented to the application. However, that is not (as sometimes may be the case for other types of applications) sufficient to dispose of applications of this nature. This is because this sort of application engages not only the rights and interests of the parties, but also the general public who may have an interest in observing the proceedings (see for example the decision of the Court of Appeal in *JIH v News Group Newspapers Ltd (rev 1)* [2011] EWCA Civ 42).

13. The starting point is that the principle of open justice is a fundamental aspect of English law and represents the very foundation upon which a free, open and democratic society is built. The general rule, therefore, is that all hearings must be in public (see *Scott v Scott* [1913] A.C. 417). This extends to both decisions or judgments of the Courts and Tribunals and any documents referred to or used in the hearing.

14. However, the principle of open justice is not absolute. For example, Civil Procedure Rule ("**CPR**") 39 .2(3)(c) provides that hearings can be in private where they involve confidential information, publicity would likely damage that confidentiality and it is necessary in the interest of justice to have the hearing in private.

15. Applying these principles (by analogy if necessary) to the facts it is clear to us that (a) the information sought to be protected is confidential and commercially sensitive financial and business information and its publication would likely damage its confidentiality, (b) the information sought to be protected is limited in scope, (c) maintaining the confidentiality of the information sought does not detract from this Tribunal's ability to provide a fully reasoned decision and (d), the balance, therefore, favours granting the application and it is in the interest of justice (or the overriding objective) to do so.

16. We intend to give appropriate directions relating to any confidential information at the end of this judgment.

THE EVIDENCE

17. In addition to seeing a large amount of documentary evidence we had the benefit of hearing orally from a number of witnesses for the Appellant. Each witness produced a witness statement which stood as their evidence in chief. Each witness who was tendered for oral evidence was cross-examined and there was an opportunity for us to ask questions. These witnesses included Mr. Chris Bibby (the Appellant's Group Chief Marketing Officer), Mr. Andrew Parkinson (who manages and supervises the Appellant's EP business), Mr. Simon Drew (the Appellant's Chief Financial Officer) and Mr. William Hale (the Appellant's Chief Executive Officer of Key Advice business).

18. We have been asked to, and do, take particular care when coming to our findings of fact. This is because whilst the relevant legal tests can be simply stated their application to the facts can, and has in other cases, given rise to particular difficulty. Cases such as the present are highly fact sensitive and even small modifications of the facts can give rise to different answers to the same question.

19. It goes without saying that in coming to our findings we have had in mind the relevant burden and standard of proof and our findings (set out below) are made after the Appellant has demonstrated each fact to us on the balance of probabilities.

20. In order to aid understanding the relevant findings of fact are set out separately in relation to each issue / appeal.

THE MARKETING EXPENDITURE APPEAL

Introduction

21. VAT is a tax on consumption and, therefore, intended to be neutral for taxpayers making taxable supplies. However, where the person making supplies is making both taxable and exempt supplies problems can arise in identifying the input tax used in making taxable supplies so as to determine the recoverable proportion of input tax in order to maintain the tax neutrality of the tax for suppliers. The problems that can occur can either be because of

attribution or apportionment. The Marketing Expenditure Appeal is concerned with the attribution problem.

The law

22. The basic relevant principles were not in dispute. They derive from the EU legislation applicable to VAT, which in the present case is Council Directive 2006/112/EC, often called the Principal VAT Directive (the "**PVD**"), as interpreted by the Court of Justice of the European Union ("**CJEU**") and by our domestic courts. Effect is given to the PVD by national legislation. Whilst the timeframe of the dispute straddles the UK's departure from the EU there was no dispute that the relevant principles to be applied remain matters of retained EU law.

23. Art 1(2) of the PVD provides that:

> "'… On each transaction, VAT, calculated on the price of the goods or services at the rate applicable to such goods or services, shall be chargeable after deduction of the amount of VAT borne directly by the *various cost components*.' (emphasis added)

24. Art 168 gives the right to deduct input tax as follows:

> (1) "In so far as the goods or services are used *for the purposes* of the taxed transactions of a taxable person, the taxable person shall be entitled, in the Member State in which he carries out these transactions, to deduct the following from the VAT he is liable to pay:
>
> > (a) the VAT due or paid in that Member State in respect of supplies to him of goods or services, carried out or to be carried out by another taxable person …' (emphasis added)

25. As Richards, LJ neatly summarised in the Court of Appeal's decision in *Revenue and Customs Commissioners v Royal Opera House Covent Garden Foundation* [2021] EWCA Civ 910 ("**ROH**"):

> (1) The right to a deduction arises because the goods or services supplied to the taxable person are used "for the purposes of" the taxed supplies made by the taxable person and need not be reflected in the price charged for the relevant output supplies made by the taxable person [17].
>
> (2) The taxable person's purpose is to be objectively ascertained from the facts and circumstances of the transactions, not by investigating the subjective intentions of the taxable person [17].
>
> (3) By its decisions, the CJEU has established that for an input supply to be made 'for the purposes of' an output supply, there must be 'a direct and immediate link' between them, as confirmed by the reference to 'cost components' in art 1(2) of the PVD: see *BLP Group plc v Customs and Excise Comrs* (Case C-4/94) EU:C:1995:107, [1995] STC 424, [1996] 1 WLR 174 ('BLP') at [19]–[21]. On the basis of the CJEU's judgment in *Revenue and Customs Comrs v Chancellor, Master and Scholars of the University of Cambridge* (Case C-316/18) EU:C:2019:559, [2019] STC 1523, [2019] 4 WLR 126, Lord Hodge said in *Revenue and Customs Comrs v Frank A Smart & Son Ltd* [2019] UKSC 39, [2019] STC 1549, [2019] 1 WLR 4849 ('Frank A Smart') at [65] (ii) that a direct and immediate link exists 'if the acquired goods and services are part of the cost components of that person's taxable transactions which utilise those goods and services' [18].

(4) Where the direct and immediate link is not with a particular supply by the trader but with the whole of its economic activity, (in other words, it is an overhead cost), the input tax on the supply to the taxable person is deductible from the output tax on the taxable supplies made by it in the course of its economic activity [19].

(5) In the case of a taxable person making both taxable supplies and supplies which are exempt or fall outside the scope of VAT then if the direct and immediate link is exclusively with the taxable supply on the one hand or with the exempt supply or the supply falling outside VAT on the other hand, the input tax will be respectively fully deductible or not deductible at all. Where the link is with both types of supply, arts 173–175 of the PVD provide for an apportionment of the input tax [22].

(6) While it is straightforward to state the general principles or tests of a direct and immediate link and cost component, their application can be difficult [39].

(7) Identifying whether there is a direct and immediate link is a question of mixed fact and law but will be determined by reference to the particular facts of each case [40].

Findings of fact

26. Our findings of fact in relation to the Marketing Expenditure Appeal are as follows:

(1) The Appellant exclusively sells its ER and EP services through advisors. This influences the marketing strategy adopted by the Appellant. The strategy is to funnel all enquiries through to an appointment with an advisor.

(2) The funnel or customer journey starts with broadcast communications aimed at priming customers or making them aware of how the Appellant can meet their needs (for e.g. how the customer can repay their mortgage). The next stage is to educate the customer by providing information (in the form of press adverts, social media adverts, direct mail, magazines and online videos) about the Appellant's products. Following the education stage it is hoped that the customer will make an enquiry (typically about an ER product). If a customer makes an enquiry this will be progressed to booking an appointment with an advisor. This final stage is the "nurture stage" and can take a number of years. This stage involves providing the customer with the Appellant's detailed 'guides' to later life finance and sending emails, direct mail and magazines to the customer.

(3) The Appellant's marketing aim is to build a lasting brand in addition to simply driving leads or enquiries. The aim is to build a trusted brand offering customers access to cash in retirement, help with planning their retirement and providing the financial and legal tools to secure it.

(4) The Appellant uses a "hero product" strategy for marketing. A "hero product" is a product which is easier to market than other products, but from which there is the opportunity to establish the brand name of the business as a whole. In the case of the Appellant there is no doubt that its hero product is ER and that is where the vast majority of its marketing efforts are focussed. As Mr. Bibby says in his witness statement at paragraph 33 "*We know that ER is a category where we can tap into more emotional needs states with consumers which allow us to market cost effectively on a much bigger scale. Such as, 'Staying in your home for longer and not having to downsize' or 'settling your mortgage so you can settle into retirement' or 'helping out your family whilst you are still around to see it', are all very emotional areas that our Equity Release products can provide solutions for. Where we lead our marketing*

activities with ER it is so that we can tap into these big emotional drivers of consumer demand and then sell our full suite of services once initial interest has been created."

(5) The Appellant uses different marketing channels to create a marketing campaign. The decision as to which channel to use is a function of both the effectiveness and the cost of the channel. The two largest channels are TV and Pay-Per-Click ("**PPC**"). TV advertising generally raises brand awareness and trust, but does not drive direct sales.

(6) PPC involves the advertiser paying a fee each time a customer clicks on a search term served up by a search engine (such as Google). Advertisers are invited, by the likes of Google, to bid on "key words" in an online auction. The Appellant might bid on key words such as "equity release" or "Key later life finance". The price will vary from day to day and key word to key word. Once a customer clicks on a key word s/he is directed to the landing page relevant to their search. This landing page will not only contain information relevant to the customer's search, but will also allow the customer to provide their contact details to enable the customer to be "nurtured" through to an appointment with an advisor.

(7) The Appellant also engages in Search Engine Optimisation ("**SEO**") work or marketing. In addition to paid advertising, search engines, such as Google, also serve up natural or unpaid results to enquiries. In order to do this Google uses an algorithm which is designed to rank sites based on content relevance, the quality of the website, speed and site performance and links to other sites. SEO work involves dealing with as many of these hygiene factors as possible so as to promote a higher ranking by Google.

(8) The Appellant has a significant marketing budget – in the low tens of millions in 2021/22. It sets this budget by reference to the forms of income received (e.g. ER, solicitor's marketing fee ("**SMF**"), EP) and the costs of marketing and delivering that business. This enables a return on marketing investment to be calculated.

(9) The Appellant measures the effectiveness of its marketing activity by reference to advisor appointments made and conversion of these appointments into sales of ER or EP products (with the former including fees from solicitors). To track the effectiveness of its marketing the Appellant uses direct linear measurements and econometric analysis. Direct linear measurement, effectively, involves tracking (using the Appellant's CRM system) each enquiry through to its sale. To give an example a customer might click on an advert served up by a search engine which leads to a telephone call, a subsequent advisor appointment and the sale of an ER product. This highly granular linear measurement can show, for example, which key word or advert is effective for the Appellant. However, this form of measurement does not give the Appellant an understanding of the bigger relationship between the various channels. So, for example, the person who clicked on a search engine advert might have been prompted to make the search because s/he had seen a TV advert. This would not be captured by the linear measurement undertaken by the Appellant. In order to address this issue the Appellant engages a third party to carry out an econometrics analysis (essentially a regression analysis aimed at estimating the relationship between media spend levels and sales). This analysis shows, for example, that TV advertising has a much larger impact on sales than might be apparent from a simple linear measurement.

(10) The contents of the ER advertising material refer only to ER and makes no reference to EP or any other service provided by the Appellant.

(11) The Appellant derives income from firms of solicitors on terms which are set out in writing in the "Key Retirement Panel Appointment" letter. A sample of the latter shows the key terms are as follows:

(a) The purpose of the appointment is so that the solicitor can provide "legal advice" to the Appellant's "Customers in relation to their equity release transactions".

(b) The solicitor must pay a "quarterly marketing fee" in consideration of the Appellant "marketing and promoting" to its customers the services the solicitors "provide in relation to equity release transactions" (the "**SMF**").

(c) The amount of the fee payable will be notified to the solicitor for the forthcoming quarter and may vary from quarter to quarter.

(d) The Appellant will "endeavour to use" not less than seventy five percent of the Marketing Fee "for the purpose of marketing and promoting equity release mortgages and the public awareness thereof generally" with the solicitor being entitled to require the Appellant to "produce accounting and financial information to verify the expenditure".

(e) The Appellant is entitled to a "referral fee" of 50% of the fee paid to the solicitor by the Appellant's customers for EP services.

(f) The Appellant is entitle to an "introduction fee" of 25% of the fee paid to the solicitor by the Appellant's customers for any other service.

(12) The SMF is calculated by reference to the number of referrals of ER cases that a solicitor is expected to receive and then undertake.

Discussion

27. The Appellant's primary position is that the contested marketing expenditure was incurred by the Appellant for the purposes of marketing the KRS business as a whole and it is properly, therefore, overhead expenditure. That is to say that this expenditure has no direct or immediate link with any particular supply, but does have such a link with the whole of the economic activity carried on by the Appellant. Accordingly, such overhead expenditure is deductible and in the case of businesses making both taxable and exempt supplies (such as the Appellant) the overhead expenditure falls to be apportioned between the two types of supply.

28. In support of this the Appellant argues that:

(1) The Appellant adopted a marketing strategy that used a "funnel approach" using both "brand" and "acquisition" expenditure and a "hero product approach". However, it is submitted, the sale of EP is in no way subservient to ER and neither are ER services a necessary precondition to the purchase of EP services. They stand side by side, meeting independent needs of the customer, and are synergistic rather than interdependent. Generally, only at the first advisor appointment will it be established whether the customer will proceed with either, both or neither service.

(2) The marketing strategy then drives the budgeting process which is in turn informed by a detailed "linear" and "econometric" analysis. Whilst the linear and econometric analysis establishes a "but for" link (which by itself, it is accepted, would be impermissible) that is not the critical or relevant question. The point is that the Appellant uses, in particular, the econometric analysis to make budgetary decisions, which are ruthlessly focused on return on the investment made in marketing in achieving a first appointment and the success of such appointments in terms of written sales and issued value which incorporates income from both ER and EP services.

(3) The customer journey, for either ER or EP or both, demonstrates that once a potential customer has identified a perceived need for any of the Appellant's services or

simply an interest in engaging with later life planning generally, they will be informed and encouraged to consider both categories of service in parallel and not sequentially. As such, there can be no question of the ER supply having a chain breaking effect. Many clients will contract for both and some for only one. This is not a case where a customer can only engage for EP services if they have already contracted for or even intend to contract for ER services.

(4) On this basis the Appellant contends that, as the contested marketing expenditure is incurred for the same purpose of driving a customer into the funnel, it is all properly considered to be an overhead of the business, incurred to promote the business as a whole and secure the first appointment from which all income streams are then derived.

29. In the alternative, the Appellant contends that there is also a sufficient and direct link to both EP and SMF income. It is argued that a sufficient link may exist despite it not being the closest link and the basis of the link to EP services is rooted in the objectively determined purpose underpinning the marketing strategy, the basis on which the budget is set and how the return on investment is measured.

30. With regards to the link to SMF income the Appellant argues that the obligation to "endeavour to use not less than seventy five (75%) of the Marketing Fee for the purposes of promoting equity release mortgages and public awareness thereof" (with a right to audit), the fact that the SMF is in addition to the Referral Fee and Introduction Fee both point to a direct and immediate link with ER only marketing expenditure. This is similar to the situation in *Town and County Factors Limited v The Commissioners for Her Majesty's Revenue and Customs* [2006] UKVAT V19616 ("***T&C"***) whereby the Appellant is committed to marketing as a consequence of the contract with the solicitors.

31. The Appellant further emphasises the point that when considering the question of a specific link that it is the use of the costs which is relevant and not whether and to what extent the costs may, or may not, be incorporated into the price of the product.

32. The starting point, it seems to us, is firstly to properly define the "contested" marketing expenditure. This was because there was some confusion, at least on the part of some of the witnesses, as to what that expenditure, exactly, comprised. The Appellant say that the "contested" marketing expenditure, for these purposes, includes expenditure (in so far as it does not reference EP services) incurred on: TV, radio and press advertising, direct mail, paid social media advertising, and pay per click. This is, in our judgment, the same as ER only advertising as referred to in the Respondents' skeleton argument. In this judgment we will use the phrase contested marketing expenditure or ER only advertising interchangeably. They mean the same thing.

33. The logical way in which we approach the central question is to consider whether, firstly, the contested marketing expenditure has a direct and immediate link with ER, EP, SMF or a combination of the three supplies. We need only consider whether there is a direct and immediate link with the whole of the economic activity carried on by the Appellant if we find that there is no direct and immediate link with any of the three supplies identified. Succour for this approach can be found in the speech of Carnwath LJ in *Mayflower Theatre Trust Ltd v HMRC* [2007] STC 880 at paragraph 33.

34. We were referred to a number of first instance decisions (in particular *N Brown Group Plc v HMRC* [2011] UKFTT 172 (TC) and *Sofology Ltd v HMRC* [2022] UKFTT 153). These cases were, in our judgment, of passing interest only given that they are neither binding upon us nor serve to establish any points of principle. Nevertheless, they served as useful illustrations as to how the relevant principles had been applied in other cases with some comparable (but nevertheless different) facts.

35. We agree with the Respondents that the marketing material relating to the contested marketing expenditure, viewed objectively, is designed to attract those customers who are looking for ER services. The evidence clearly shows this to be the case: the advertising material focusses on ER supplies and makes no refence to EP services or the SMF. However, whilst the content of marketing material is an important factor it is not, by itself, determinative in establishing a direct and immediate link.

36. The evidence also shows that the typical customer journey for a customer who views ER advertising starts when an interest is shown in the Appellant's ER product by the customer contacting the Appellant (typically either by telephone or by filling in an online contact form). Following initial contact the customer is then booked into their first meeting with an advisor. It is at this point that the Appellant's EP services are introduced, for the first time, to the customer. Therefore, whilst a customer may end up purchasing ER, EP, both or neither service and the purchase (or failure to purchase) one service is not dependant on the other; it is fair to say that the customer only booked the initial appointment with an advisor because s/he wished to purchase an ER product or, at the very least, enquired about one. To that extent any subsequent sale of an EP service is dependent upon and subservient to the ER product/service. More than that, the selling of EP services takes place at the initial advisor meeting. It cannot have been any earlier because, as already set out, the ER only advertising did not refer to any EP services at all. This, again, seems to us to be an indicator that there is a direct and immediate link between the contested marketing expenditure and ER services.

37. The marketing strategy adopted by the Appellant uses a "funnel" approach and what is described as a "hero" product approach. The "hero" product in this case is clearly the ER product or suit of products. This strategy is grounded in the Appellant's belief, as shown by the evidence, that its ER services provide the main emotional drivers for the purchase of the Appellant's services by consumers. This requires the Appellant's marketing efforts to be focussed on ER products in order to create an initial interest to, eventually, enable other services (such as EP) to be cross-sold. Whilst we accept that general advertising expenditure (of say a brand name) would tend to make it difficult to establish a direct link with a particular product and or service and, therefore, such expenditure would tend to be better categorised as residual overhead, the same cannot be said where the advertising expenditure in question relates to a prominent (or hero) product or service. The natural inference must be that the expenditure is directly linked to the product or service that is the feature of the advertising. The subjective motive of the advertiser (to enable cross-selling whether or not by using a "funnel approach" or increase footfall for example) seems to us to be irrelevant. The fact that the Appellant couches its argument in terms of "the objectively determined purpose" of the marketing strategy does not assist it.

38. Nor is the Appellant helped by looking at the budget process. We accept that the Appellant's marketing strategy drives the budgeting process. It may also show how marketing is used by the Appellant. However, all that can be said on that score is that marketing is concentrated on ER services or products with a view to enable the cross-selling of EP services.

39. After taking a holistic view of all the circumstances and taking into account the facts as we have found them, we come to the conclusion that the contested advertising expenditure has a direct and immediate link with ER products and services. Further and for the reasons already given no direct link can be established between the contested marketing expenditure and EP products or services.

40. It is, of course, possible that the contested marketing expenditure has a direct and immediate link with ER products and services as well as the SMF. It is to this possibility that we turn next.

41. There was some argument about whether the SMF had been "rebranded" in the Appellant's skeleton argument (from initially being described as a Solicitor's Referral Fee ("**SRF**") to a Solicitor's Marketing Fee. We entirely accept Ms. Brown's submissions that this was done simply in order to more accurately reflect the Appellant's position and what was said on the face of the document. There was nothing nefarious or underhand in the way the Appellant's case was advanced or put by Ms. Brown. In any event, it is the substance of the documents or agreement that lead us to conclusions as to their nature or characteristics which in turn enable us to categorise them. The descriptors used by the parties (helpful as they are when there is consensus) must play second fiddle to that analysis when there is a dispute. To that end we prefer the Respondents' analysis. We agree, applying the test in *Card Protection Plan Ltd v CCE (No2)* [2002] 1 AC 202, that the essential feature or dominant purpose of the agreement was to be appointed to the Appellant's panel for the purpose of receiving referrals of clients. It was not to advertise ER products or services without more. This is clear when one reads the agreement as an objective whole. In particular, the evidence shows that the consideration payable by solicitors for appointment onto the panel is calculated by reference to the number of referrals anticipated to be made to the solicitors. We use the term SMF in this judgment because that is the term used in the solicitors' panel appointment letter, but, as we have made clear, it can properly and more accurately be described as a referral fee.

42. Whilst we accept that the Appellant has an obligation under the panel agreement to use its best endeavours to use not less than 75% of the SMF to promote ER products we do not think that this provides a direct and immediate link. Firstly, the Appellant's obligation extends only to using its best endeavours and in that sense there is no binding requirement for it to use the fees for ER marketing (the only binding requirement being to use its best endeavours to do so). Secondly, and most compelling, the referral to the solicitor in relation to ER takes place once the customer has already bought or committed to buying an ER product or service from the Appellant. The direct and immediate link with the SMF exists as between the SMF and the process of referral not the disputed marketing expenditure. At the point that disputed marketing expenditure is taking place there is in no sense a promotion of the services provided by the solicitors. That comes later. Any link between the disputed marketing expenditure and the SMF is tenuous at best, at least one step removed and, therefore, not immediate or direct.

43. For the reasons given we conclude that the contested expenditure has a direct and immediate link solely with ER products and services (or supplies to be more accurate). Given that conclusion, and for the reasons already given, we do not need to go on to consider whether the contested expenditure is general overhead expenditure. Accordingly, the Marketing Expenditure Appeal must be dismissed.

THE APPORTIONMENT ISSUE

44. As set out earlier in this decision where input tax is attributable to both taxable transactions and those for which there is no entitlement to recover VAT, it becomes necessary to consider how the input tax incurred is to be apportioned.

The law

45. Article 173 of the PVD provides that "...In the case of goods or services used by a taxable person both for transactions in respect of which VAT is deductible pursuant to

Articles 168, 169 and 170, and for transactions in respect of which VAT is not deductible only such proportion of the VAT as is attributable to the former transactions shall be deductible. The deductible proportion shall be determined, in accordance with Articles 174 and 175, for all the transactions carried out by the taxable person".

46. Articles 174 of the PVD provide that, subject to certain exceptions, the deductible proportion is to be determined by a fraction of which the numerator is the turnover, exclusive of VAT, attributable to taxable transactions and the denominator is the turnover, exclusive of VAT, attributable to taxable transactions and the turnover attributable to exempt transactions.

47. These principles have been enacted into domestic law by virtue of sections 24-26 of the VATA. Section 26(3) provides the Respondents with the power to "*make regulations for securing a fair and reasonable attribution of input tax*".

48. Regulation 101(2)(d) of the Value Added Tax Regulations 1995 (the "Regulations") provides that "*there shall be attributed to taxable supplies such proportion of the residual input tax as bears the same ratio to the total of such input tax as the value of taxable supplies made by him bears to the value of all supplies made by him in the period*," thereby, essentially, establishing the standard method of assessment of VAT.

49. Regulation 102(1) provides for special methods as follows:

> "(1) Subject to paragraphs (2) and (9) below and regulations 103, 103A, 103B, 105A and 106ZA, the Commissioners may approve or direct the use by a taxable person of a method other than that specified in regulation 101".

50. In the version in force prior to the start of the transitional period Regulation 102(1A) of the Regulations states:

51. "1A) A method approved or directed under paragraph (1) above—

(a) shall be in writing,...

(d) may be based on sectors provided that the method reflects the use made of the goods and services in the business and each sector reflects—

(i) the use made of the goods and services in that sector,

(ii) the structure of the business, and

(iii) the type of activity undertaken by that sector..."

52. In summary, then, the combined effect of the legislation set out above is that the standard method results in attribution of input tax to taxable supplies, as a percentage, based upon the value of those taxable supplies using the residual inputs in comparison to the total value of supplies using those residual inputs. The Respondents, however, can approve or direct the use of a special method (including one based on sectors).

53. The various authorities establish the following principles:

(1) The discretion enjoyed by the Respondents in respect of the approval or direction of a special method serves to achieve the statutory objective of securing a fair and reasonable apportionment of input tax to taxable supplies [*Banbury Visionplus Ltd v Revenue and Customs Commissioners and other appeals [2006] EWHC 1024* (Ch) ("**Banbury**")].

(2) The special method proposed must be more fair and reasonable "that is to say more accurate" than the standard method in reflecting the use of the relevant costs in making taxable supplies [par 33-34 *Revenue and Customs Commissioners v London Clubs Management Ltd* [2011] EWCA Civ 1323 ("**London Clubs**")], but it need not be

the most precise possible [par 53 *Volkswagen Financial Services (UK) Ltd v Revenue and Customs Commissioners* (C-153/17) ECLI:EU:C:2018:845 (***"VWFS"***)].

(3) When considering "use" it is the "economic use" (or put another way the "economic reality") that is relevant. Economic use may or may not reflect physical use and profit may or may not be an important factor [par 34-41 & 77-88 of London Clubs].

The Transactional Count Method Appeal or PESM1

Findings of fact

54. The evidence shows that:

(1) The Appellant does not operate a cost-plus method of pricing. The Appellant's prices are ultimately determined by the market, but in the case of ER products there is a correlation with the value of the loan.

(2) However, where ER products are concerned there is no correlation with the size of the loan and the costs associated with it. Costs associated with the brokering of an ER transaction are driven by the vulnerability of the customer and/or difficulties associated with matching their requirements to appropriate ER products.

(3) The basis of the Transaction Count Method is as set out in the PESM proposal letter and associated calculations dated 1 November 2018 as refined and explained in the letter of 10 June 2019. In summary, the method provides for the Appellant to be divided into 6 sectors by reference to trading entity/activity and a catch all sector (sector 7). Input tax is allocated to each sector by reference to whether the input tax in question is used exclusively within that sector, and by reference to the annual recharge from Services identified in the management accounts. Input tax used centrally (i.e., that remaining as a cost in Services) is allocated to sector 7. The recoverable proportion of input tax is then determined by reference to the number of taxable transactions divided by the total number of transactions. In sector 1 (KRS) each engagement is counted as an individual taxable transaction and each loan as an individual exempt transaction. For sector 2 (M2L) newly originated transactions are counted individually as a transaction and, in respect of the servicing activity, each loan serviced in the period is treated as a transaction. Whilst for sectors 3 – 6 the calculation is proposed on the basis of taxable and exempt transactions in reality each of those sectors has either taxable or exempt activity, though the Tied Sector (sector 4) may have reversionary transactions. Sector 7 input tax is apportioned on the basis of total transactions in all sectors.

(4) Sector 1 transactions include the following:

(a) "…the act of intermediating and advising upon the most appropriate ER product for the customer…",

(b) Solicitor referrals,

(c) "Drafting of Wills, Lasting Power of Attorney (LPAs), trusts and living Wills…",

(d) "…bereavement services to executors in partnership with the law firm, Co-operative Legal Services, whereby we provide estate management and probate services to next of kin and/or friends of the customer (deceased)…", and

(e) "…act[ing] as professional executors…".

(5) The relevant residual inputs include:

(a) Marketing;

(b) Staff;

(c) Printed material and storage;

(d) Mobiles, travel, accommodation;

(e) IT;

(f) Stationery;

(g) Property;

(h) Telephones;

(i) Training;

(j) Sundry (e.g. fuel, legal fees, subscriptions);

(k) Services travel;

(l) Services consultancy;

(m) Key consultancy;

(n) Recruitment;

(o) Call centre; and

(p) IT services- infrastructure.

(6) PESM1 assumes that EP transactions, on average costing the customer £398, consume the same inputs as ER transactions, on average costing the customer £3,619.

Discussion

55. The Respondents contend that PESM1 is not fair and reasonable and does not produce a result guaranteed to be more accurate than the SM when considering the economic credibility of the method. Fundamentally, it is argued, the Appellant, uses a transaction count method grouping together a range of diverse supplies without persuasive objective evidence that those supplies use the same amount of residual inputs.

56. We tend to agree with the Respondents' submissions in this regard. Firstly, looking at Sector 1 ("Key") of PESM1, it is clear to us that there is a range of very disparate transactions grouped together under this heading. This would tend to suggest an inherent likelihood that the transactions concerned are not broadly similar, and, therefore the costs attributable to these transactions will differ (or put slightly differently these transactions are unlikely to consume similar amounts of residual input).

57. Secondly, we agree that there is no objective evidence to support the contention that, in particular, Sector 1 transactions consume, broadly, the same amount of residual input. This part of the Appellant's case is based upon evidence offered up by way of, what amounts in our view, to assertion or opinion contained in witness statements filed on behalf of the Appellant. It seems to us to be self-evident that where it is sought to be asserted that two transactions take similar amount of staff hours or consume similar amounts of IT resource then these are matters which are capable of being objectively evidenced through use of software or manually recording activity. The Appellant could and ought to have produced such evidence.

58. Thirdly, we agree that the marketing analysis produced by the Appellant to show that different categories of supplies consume similar marketing costs does not, in fact, do so. The analysis concerns itself with measuring how many transactions have come from a particular

piece of advertising. It takes no account of how much input cost was spent in the exercise or how the residual inputs have been utilised.

59. Fourthly, and more fundamentally, it appears that the marketing analysis also includes those customers who initially saw ER only marketing. Given that we have already concluded that there is a direct link between ER only marketing and ER supplies any special method must also attribute ER only marketing solely to ER supplies before we can hold that it is fair and reasonable. PESM1 makes no attempt to do so.

60. Lastly, the Respondents argue that PESM1 should be tested against normal operations and that the Appellant's position on EP supplies lack economic credibility. By economic "credibility" we assume the Respondents to be saying economic "reality". PESM1 assumes that EP transactions, on average costing the customer £398, consume the same inputs as ER transactions, on average costing the customer £3,619. This renders EP transactions vastly less profitable. Profitability is, in our judgment, an important factor in the context of the present case acting, as it does, like gravity on unrealistic assumptions. Whilst we accept that a business might decide to engage in the sale of services or products which are less profitable as a means, for example, of selling other more profitable services this was not the Appellant's strategy. Mr. Bibby's evidence was that EP was not, in fact, used as loss-leading product or service. On the whole there was no cogent explanation or evidence available to show, in the face of the disparity in profit, why it was economically realistic to assume that EP and ER transactions consume the same inputs.

61. There was some argument before us about whether the Respondents took into account irrelevant considerations and whether or not, in fact, these considerations were in fact irrelevant or misguided. Whether or not the Respondents took into account irrelevant considerations when coming to a decision to refuse to apply PESM1 is not, in our view, germane to this appeal. We are hearing this appeal *de novo* and not exercising a review only function. That is to say we are not considering the merits of the decision-making process adopted by the Respondents, but rather the decision itself. Put another way, the decision could have been arrived at by the Respondents after carefully considering only the relevant matters and yet still be wrong in the sense that we are compelled to allow the appeal because the decision came to the wrong conclusion. Likewise, the decision could have taken into account all sorts of irrelevancies (and/or not considered any relevant matters) and yet still be the right decision in the sense that we agreed with the outcome and we would be required not to disturb it on appeal.

62. In summary, we agree that the Appellant has failed to show that PESM1 is fair or reasonable and is guaranteed to produce a more precise determination of the deductible proportion of the input VAT than that arising from the application of the standard method.

The Income Adjusted Appeal or PESM2

63. The basis of calculation of PESM2 is set out in the proposal dated 8 March 2021. The proposal continues to take a transaction based approach but seeks, it is said, to remove the distortion arising from the disconnect between the value of the income calculated by reference to the value of the advance and the costs used to originate (M2L) and broker (KRS) the advance. The distortion is removed by assuming that each advance generates the same LSP for M2L and procuration fee/customer fee for KRS. The income for each being determined by reference to the minimum transaction permitted by funders and a median average LSP, procuration and customer fee as relevant.

64. We agree with the Respondents when they say that the adjustments made to PESM2 do not cure any of the fundamental defects identified with PESM1 and set out above. For example, PESM2 continues to use a transaction based approach grouping together a diverse

range of transactions absent any objective evidence that the transactions in each sector consume broadly the same inputs.

65. PESM2 is also criticised by the Respondents, rightly in our view, for adding an economically unrealistic gloss by using the £10,000 minimum release amount as the value of the mortgage when calculating ER income. This runs counter to the evidence that the bulk of the mortgages are for £30,000-£150,000 with an average of £63,677 and does not reflect economic reality.

66. It was also suggested that in approaching the economic use element of their decision in the way that the Respondents had they had fallen into error and failed to apply the test in *London Clubs*. For the reasons set out at paragraph [61] above we do not concern ourselves with whether or not the Respondents have fallen into error, but confine ourselves to properly applying the test to the facts as we have found them. The precise profitability of a transaction might not be possible to calculate, but it must be self-evident that using a figure of £10,000 as opposed to, say, £64,000, for the value of the mortgage in the transaction is going to have a significant (distortive) effect on profitability where the income achieved for ER transactions is calculated as a percentage of the value of the mortgage.

VARIATIONS TO THE PESMS, THE ECN APPEAL AND QUANTUM

67. In so far as there any variations proposed to the PESMs (whether through witness statements or via skeleton arguments) we take the view that these are more than very minor and ought, therefore, to be properly put directly to the Respondents first. Only after the Respondents have had adequate time and opportunity to consider them and made a decision would it be appropriate for this Tribunal to consider these variations on appeal.

68. We further trust that our decision in relation to the main issues before us disposes of both the ECN Appeal and any quantum issue that might have arisen. If, for any reason, it does not do so then we direct that the parties attempt to agree suitable directions for the disposal of such outstanding issues and failing agreement the parties be at liberty to apply for further directions.

CONCLUSION, DISPOSAL AND DIRECTIONS

69. For the reasons given we dismiss the appeals.

70. We have taken care, given our ruling on the preliminary issue, to try and not to refer to any commercially sensitive information in this decision. However, we have had to make some reference to certain commercial information in order to ground our reasoning in the relevant facts. It may be that it is appropriate to further redact some of that information before publication of this judgment. Before taking a decision on that point we think it only fair that the parties (and the Appellant in particular) be able to make submissions on that point. To that end we direct that a draft of this judgment be circulated to the parties in advance so that written submissions can be made, if necessary, about further redaction of our judgment.

71. Last, but not least, we would like to take this opportunity to publicly thank Ms. Brown and Ms. McArdle (as well as their respective teams) for the helpful and professional way in which they have sought to present their respective cases and assist this Tribunal in coming to a decision.

RIGHT TO APPLY FOR PERMISSION TO APPEAL

72. This document contains full findings of fact and reasons for the 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.

HHJ MALEK
SITTING AS A TRIBUNAL JUDGE

Release date: 05th October 2023