[2012] UKUT 394 (TCC)
Appeal number: FTC/85/2011

VAT – partial exemption special method - hire purchase transactions - taxable supplies of motor vehicles and exempt supplies of credit - whether residual cost inputs have a direct and immediate link with and are cost components of taxable supplies of motor vehicles - whether a methodology which attributes 50% of residual input tax to taxable supplies is fair and reasonable

IN THE UPPER TRIBUNAL
TAX AND CHANCERY CHAMBER

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE & CUSTOMS	**Appellant**
- and -	
VOLSWAGEN FINANCIAL SERVICES (UK) LIMITED	**Respondent**

Tribunal: Mr Justice Vos
Judge Timothy Herrington

Sitting in public in London on 23 and 24 October 2012

Mr Owain Thomas, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Appellant, the Commissioners of Her Majesty's Revenue and Customs ("HMRC")

Ms Nicola Shaw QC and Mr Michael Jones, instructed by KPMG LLP, for the Respondent, Volkswagen Financial Services (UK) Limited ("VWFS")

DECISION

Introduction

1. This is HMRC's appeal from a decision of the first-tier tribunal (tax) (the "FTT") allowing VWFS's appeal (the "Decision") against an assessment to VAT in the sum of £498,886 issued by HMRC on 16th June 2008 (the "Assessment") and a decision letter dated 30th September 2008 upholding the Assessment.

2. The appeal concerns the Partial Exemption Special Method ("PESM") to be adopted by VWFS in determining the proportion of residual input tax (i.e. VAT on its overheads) that it can recover, specifically in relation to VWFS's hire purchase ("HP") transactions.

3. The appropriate proportion of recoverable input tax can be arrived at either by use of the standard method or by agreeing a PESM with HMRC. For a trader like VWFS making both exempt supplies and taxable supplies, the standard method applies a fraction determined by reference to the ratio of taxable turnover to total turnover.

4. In this case, the parties have agreed to operate a PESM which divides VWFS's business into six sectors: retail, wholesale, insurance services, securitisation, contract disposals and catch-all. It is only in relation to the retail sector and specifically in relation to the most numerous HP transactions that this dispute has arisen.

5. So far as the financing transactions undertaken by VWFS (apart from HP transactions) namely leasing transactions, fixed price servicing transactions and fixed cost maintenance transactions are concerned, it is agreed that these are taxable supplies, and that the proportionate part of the residual input tax on overheads attributable to these transactions is deductible. It is the treatment of the residual input tax on overheads attributable to HP transactions that is in dispute.

6. The residual input tax in question is accepted to be in respect of overheads that are attributable in part to exempt outputs (supplies) and in part to taxable outputs (supplies). In relation to HP transactions, the vehicle is bought in by VWFS from a vehicle dealer and is then invoiced to the customer at cost without any mark up. The purchase of the vehicle is agreed to be a deductible input, and the supply of the vehicle is agreed to be a taxable output. The financing charges (including interest charges, an acceptance fee and an option to purchase fee) are a mixture of exempt outputs and taxable outputs. The largest part of the financing charges is an exempt output since it comprises interest charges (and also an acceptance fee), but smaller parts are accepted to be taxable outputs (for example, the option to purchase fee and the settlement charges sometimes levied). We shall refer in this decision to the financing part of the HP transactions as being exempt outputs; but it should not be forgotten that that designation is not entirely accurate because small parts of the financing costs are accepted as being taxable outputs.

7. The issue between the parties before the FTT was as to what was a fair and reasonable apportionment of residual input tax on costs incurred by VWFS's retail sector.

8. VWFS's preferred methodology, endorsed by the FTT, was to regard each HP transaction as one taxable transaction (the sale of the vehicle at cost price) and one exempt transaction (the finance element) and to split the residual input tax in proportion to the ratio of taxable transactions to the whole. That has the effect of splitting the residual input tax 50/50 for HP transactions, which make up the most significant part of VWFS's retail business.

9. HMRC, on the other hand, argued unsuccessfully before the FTT that, as a matter of law, the residual input tax attributable to the HP transactions was largely not deductible. HMRC submitted that allowing 50% of the residual input tax attributable to exempt HP transactions to be deducted would be contrary to the whole scheme of VAT, which requires fiscal neutrality. If VWFS were right, it would be perpetually recovering rather than paying VAT. HMRC's preferred method was to apportion the residual input tax between the value of the taxable and exempt outputs in each aspect of the HP financing transaction, ignoring the sale of the vehicle itself.

Chronological background

10. On 1st April 2007 HMRC issued its Revenue and Customs Brief 31/07 (which was re-issued on 12th January 2010, and is referred to in either form as the "Brief"). The Brief included the following:

> "***VAT recovery for HP transactions***
>
> *Normally it is clear when VAT on costs is recoverable. This is because goods and services are either sold independently, each priced to reflect the costs incurred or if they are supplied together, the price of each item reflects both direct costs and overheads.*
>
> *In most HP transactions, the goods are resold at cost without any margin to cover overhead costs. As there is no margin on the HP goods, the cost of the overheads will normally be built into the price of the supply of credit.* ***In this scenario, HMRC's view is that the overheads are purely cost components of the exempt supply****. Otherwise the business would continually enjoy net VAT refunds despite:*
>
> - *Making no zero-rated or reduced rate supplies and*
> - *Charging a total consideration under the HP agreement that fully recovers its costs and an element of profit.*
>
> *Where overheads are used to make both HP transactions and other supplies on which VAT is charged (such as taxable purchase option fees or sales of repossessed goods), then some VAT on overhead costs is recoverable. In this scenario the partial exemption method should reflect the extent to which the overhead costs are a cost component of the prices of the supplies in question*" (emphasis added).

11. On 1st October 2007, HMRC wrote to VWFS approving its proposed PESM. Paragraph 7 relating to apportionment calculations indicated as follows in relation to

the retail sector: "*[t]he deductible element of the non-attributable input tax allocated to each sector shall be quantified by multiplying that input tax by the following formulae: "A. Retail Non-attributable input tax allocated to this sector is deductible to the extent that it is incurred on goods or services which are used or to be used to make taxable supplies, expressed as a proportion of the whole use or intended use*".

12. On 16th June 2008, HMRC issued a notice of the Assessment of VAT to VWFS in the total sum of £498,866 for the periods from October 2007 to March 2008.

13. On 30th September 2008, HMRC wrote to VWFS providing its reconsideration of the Assessment, but refusing to alter it. HMRC's reasons are summarised in the following paragraph: "*HMRC's Brief outlines that in most HP transactions, goods are resold at cost without any margin to cover non-attributable overhead costs. Therefore the overhead costs must become "cost components' of the charge made for the supply of credit. HMRC's Brief explains that where overhead costs are used in making both HP transactions and other transactions, then some VAT on overhead costs is recoverable. The PESM should reflect the extent to which the overhead costs are a cost component of the value of the supplies*".

14. The FTT sat to hear VWFS's appeal between 20th and 23rd June 2011

15. On 18th August 2011, the FTT released its decision allowing VWFS's appeal.

16. On 14th October 2011, HMRC applied for permission to appeal from the FTT's decision and provided its grounds of appeal.

17. On 19th October 2011, the FTT released its decision notice declining to undertake a review of the decision, but granting HMRC permission to appeal to the Upper Tribunal.

18. On 3rd November 2011, HMRC filed its Notice of Appeal from the FTT.

Agreed facts and evidence

19. The most significant agreed facts relied upon by the FTT were as follows:-

> "*1. … [VWFS] is a wholly owned subsidiary of Volkswagen Financial Services AG, which is ultimately owned by Volkswagen AG.*
>
> *2. The Volkswagen AG Group owns a number of brands or marques of vehicle ("Group Brands"): these include Volkswagen Cars, Volkswagen Commercial Vehicles, Audi, SEAT and Skoda.*
>
> *3. In the course of its business, [VWFS] makes a number of taxable and exempt supplies. [VWFS] is, therefore, a partially exempt trader. …*
>
> *5. In the course of its business, [VWFS] incurs input tax, some of which is directly attributable to the making of either taxable or exempt supplies and some of which is not directly attributable to the making of taxable or exempt supplies (i.e. is residual input tax).*

> *6. The residual input tax in question relates to everyday overhead expenditure, such as: (i) temporary staff, staff training and recruitment; (ii) hotel accommodation, staff meals and drinks; (iii) travel, parking, road tolls and car hire, service and repairs; (iv) marketing and corporate hospitality; (v) IT maintenance and enhancement; (vi) heating, lighting, cleaning, security and other premises costs; (vii) furniture leasing; (viii) couriers, stationary, printing, photocopying and archiving; and (ix) legal, tax and accounting expenses. …*
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> *14. … For VAT periods 10/07 to 07/08 the Appellant applied its preferred method to Retail and HMRC raised assessments based on its preferred method. The Appellant appealed against those assessments.*
>
> *15. From VAT period 10/08 onwards, the Appellant has applied HMRC's preferred method to Retail and has submitted voluntary disclosures for under-claimed input tax. HMRC has rejected those voluntary disclosures and the Appellant has appealed against those rejections.*
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> *16. HMRC's preferred method for Retail is to allocate input tax between HP transactions, leasing transactions and service and maintenance on a contracts count basis and then to apportion the tax using the value of taxable and exempt outputs in each sub-sector. In relation to HP transactions, however, no account is taken of the value of the vehicle.*
>
> *17. The Appellant's preferred method for Retail is to quantify the ratio of taxable transactions to total transactions, where every HP agreement is counted as two transactions (one taxable, one exempt), every leasing agreement is counted as two transactions (both taxable) and every fixed price service and maintenance contract is counted as one transaction (taxable)*".

20. Paragraphs 9-20 of the Decision include the FTT's further findings of fact, in addition to those that were agreed. The parties have each referred to various findings upon which they place specific reliance. Ms Nicola Shaw QC and Mr Michael Jones, Counsel for VWFS, place reliance on paragraph 11 of the Decision which emphasised VWFS's obligations to its customers as follows:-

> "*In respect of each of the purchase products VWFS purchases the vehicle from the retailer and supplies it to the customer on deferred payment terms under an HP agreement. Under the HP contracts title to the vehicle does not pass to the customer until all payments due under the terms of the agreement have been paid. This business is fully regulated, including under the Consumer Credit Act 1974.* ***VWFS is deemed to be the supplier of the vehicle under the HP agreement and as such a number of terms are implied by law into the HP agreement for the protection of the customer, including a condition that the vehicle is of satisfactory quality****. Although VWFS would nevertheless have its own recourse to the retailer in this respect,* ***this liability has the effect that the service provided by VWFS is not limited to the provision of funding, but extends to the provision of support in terms of the vehicle itself, such as dealing with complaints regarding quality***" (emphasis added).

21. Both sides relied on the crucial findings of fact at paragraphs 13-19 of the Decision as follows:-

> "*13. We were shown copies of typical HP agreements regulated by the Consumer Credit Act 1974. Such an agreement sets out the cash price of the vehicle, which is equal to the price paid by VWFS to the retailer, with no mark up. From this there is deducted any advance payment (such as a deposit), leaving an amount of credit to be financed over the relevant period. The total amount payable (which includes the advance payment) is specified, along with details of the monthly and other payments to be made. The difference between the cash price and the total amount payable is the total charge for credit, which is broken down in the agreement between interest charges, and acceptance fee and an option to purchase fee. The option to purchase fee and the acceptance fee are set at market rates.*
>
> *14. The market or advertised rate of interest is determined by VWFS. It does this by applying a margin for overheads, a profit margin and an allowance for bad debts to its own cost of financing the vehicle. However, the VW brands use a range of incentives to make their cars more attractive to consumers, including discounts and free specification upgrades. The incentives also extend to the finance options, including offers of low or zero rate finance and low deposit requirements. If the VWFS market rate is higher than the VW brands wish to offer to their customers, the brands can subsidise the difference by making subvention payments to VWFS. The brands pay the difference to VWFS up front out of their marketing budgets. The commercial risk of these incentives is therefore borne by the VW brands.*
>
> *15.* ***From the evidence we find that the overheads that are the subject of this appeal are built into the interest rate, the option to purchase fee and the acceptance fee****. There is no separate fee charged to cover overheads.* ***Overheads do not form part of the cash price for the vehicle, as that merely reflects the price paid by VWFS to the retailer****.*
>
> *16. We accept that the primary purpose of VWFS's finance packages is to aid the sale of Volkswagen brand cars. VWFS is an in-house finance arm that does not provide any finance other than in respect of VW brands. We also accept that the availability of finance packages forms an integral element to the sales of cars to consumers, by the VW brands and by the retailers. This is supported by VWFS in a number of ways, including by training of retailers' sales forces, and the use of an e-Learning system that retailers can access as part of the marketing and sale of VW brand vehicles. No separate charge is made by VWFS to VW brands or to the dealerships for its involvement and support of marketing campaigns, although some charges, principally for accommodation and out-of-pocket expenses, may be made for participation in e-Learning. In general the cost is amortised across VWFS's whole operating budget.*
>
> *17. We heard, and we accept, that these systems, which VWFS has designed and implemented, are designed for the following purposes:*

a) to train, monitor and incentivise the retailer's sales force;

b) to enable the retailer to configure a vehicle for his customer and to provide a series of quotes based on the different purchase products offered by VWFS (namely, hire purchase, Solutions and lease purchase); and

c) to allow the retailer to prepare and submit a proposal to VWFS once the customer has selected a particular vehicle and finance package and, once the proposal has been accepted, to print out the customer agreement in the showroom

18. However, we also find that those sales activities, although supported by VWFS, are carried on by separate businesses to that which is the subject of this appeal. The same applies to the collection of data to encourage customer retention. Those separate businesses, even within the VW group, are not part of the same VAT registration as VWFS.

19. The involvement of VWFS in the sale of vehicles is limited to those cases where VWFS provides the finance. VWFS is not a car dealership, and does not sell cars for cash. VWFS only acquires the vehicle as part of the financing arrangements, at a time when a customer has agreed to buy the car on those terms from the dealer" (emphasis added).

22. In paragraph 20 of the Decision, the FTT described the processes and functions undertaken by the 8 departments of VWFS's business. There is no need for us to set out the details of these findings, but it should be recorded that they include marketing and development, sales, new business, customer services, risk and IT departments.

23. Paragraph 15 of the statement of Mr Graham Wheeler (of VWFS) underlay the FTT's findings of fact:-"*The Brands use a range of sales incentives to make their cars more attractive to consumers, including offering discounts and free additional items of specification on their cars. As the finance options are such an integral part of selling the cars, these incentives also include offers of low or zero rate finance and low deposit requirements. In working out the specific detail of any given incentive, the Brands take the market (advertised) rate as determined by VWFS.* ***VWFS does this by applying a margin for overheads, a profit margin and an allowance for bad debts to the cost of financing the vehicle****. If that market rate is higher than the Brands wish to offer the vehicles to their customers, then the Brands can subsidise the difference between the market rate and their preferred advertised rate by making subvention payments to VWFS. The Brands pay the difference to VWFS up front out of their marketing budgets*" (emphasis added).

24. The FTT also found that VWFS's accounts described the principal activities of the company as: "*the provision of retail, business user and fleet finance to the customers of the Volkswagen Group United Kingdom Limited franchised dealer networks. In addition to this the company provides various insurance and service and maintenance products, along with business development activities to the retailer networks*". VWFS's 2005 strategic review had decided that it should strengthen its position as an automotive captive finance supplier to the VW group

brands, and closer relationships had been developed with the VW group to achieve common goals as a result. Turnover included interest income, but no part of the capital payments made under HP contracts for the purchase of vehicles.

The Decision of the FTT

25. At paragraph 42 of the Decision, the FTT stated the essence of the dispute as follows:

> "*At its essence the dispute is on whether any part of the overhead costs with which this appeal is concerned represent cost components of the supply of the vehicles under the HP agreements. That must be considered against the background of the clear fact, which we have found, that overhead costs are built into the price (namely the interest charge) for the supply of credit, and fees, such as the acceptance fees and the option to purchase fees, and are not factored into the cash price of the sale by VWFS of the vehicles, for which there is no mark up on the price paid by VWFS to the retailer*".

26. The FTT then explained a dispute, which has not been repeated before us, as to whether or not VWFS was at liberty to mark up the price of the vehicles under applicable consumer credit regulations. The FTT held that the dispute was irrelevant because it had to consider the nature of the actual supply, not the reasons for its particular characteristics.

27. The FTT then continued by considering the authorities. In summary, its reasoning was as follows:-

i) It was common ground that the right to deduct input tax arises only in respect of goods and services which have a direct and immediate link with taxable transactions (see BLP Group plc infra).

ii) The intention of the taxable person is not material. Regard must be had, instead, to the objective character of the transaction in question. Thus, VWFS's purpose in increasing sales of VW brand cars and the reasons why the cars are sold at cost price can play no part in the analysis.

iii) The requirement for a direct and immediate link with taxable transactions presupposes that the expenditure incurred is part of the cost component of the taxable transaction. But where there is no direct and immediate link, but the cost components of the services in question form part of the taxable person's overheads, those are as such cost components of the products of the business as a whole (see Abbey National infra and Midland Bank plc infra and Mayflower Theatre Trust infra).

iv) The FTT then repeated HMRC's argument that the references to 'costs components' emanated from article 2 of the First Directive infra, and was picked up in paragraph 31 of Midland Bank plc infra and paragraph 36 of Kretztechnik infra. It discussed the French texts of certain decisions, and paragraphs 60-62 of Skatterverket infra, in an attempt to evaluate HMRC's reliance on authorities that showed that deductible inputs must be cost components of the price of taxable outputs.

28. The FTT then concluded at paragraph 64 that: "*when one is looking at overhead costs, what the cases say is that because these are overhead, or general, costs, they are, by virtue of that fact, cost components of the price of the taxable person's products. There is no separate test or hurdle of incorporation into price that has to be met or overcome. Those costs are then directly and immediately linked with the taxable person's economic activity as a whole*". That reasoning is then slightly expanded in paragraph 68.

29. The FTT's conclusions are then encapsulated in paragraphs 69-71 to the effect that the overhead costs are cost components of both the exempt supply of the finance and the taxable supply of the vehicle as follows:-

> "*69. There is no direct attribution of any part of the input tax in question to either the taxable or exempt supply components of the HP transactions. The costs are, to the extent attributable to those transactions, cost components of that economic activity as a whole. It is accepted that the input tax incurred by VWFS on its acquisition of a vehicle from a dealer is directly and immediately linked to the onward supply of that vehicle under the HP transaction, and is accordingly recoverable.* ***But overhead costs are****, to the extent that they are apportioned to the HP transactions,* ***used for those transactions as a whole****. It follows therefore, in our view, that the overhead costs are cost components of each of the supplies that make up those transactions. We agree therefore with Miss Shaw that the* ***individual supplies comprised in the HP transactions must be respected so as to allow recovery to the extent that a cost component of the whole transaction can be regarded as a cost component of a taxable supply****.*
>
> *70. Accordingly, in our view, any method that has the effect of treating the overhead costs as solely cost components of a particular element, or elements, of the transactions, to the exclusion of another element, or other elements, cannot be fair and reasonable. The relevant economic activity is the carrying out of the HP transactions. This is simply a reflection of the way in which the business of VWFS is carried on.* ***We do not agree with Mr Thomas when he seeks to apply the label "finance business" to VWFS****, pointing to the way in which VWFS accounts for the HP transactions, to argue that such a business ought not to recover the vast majority of its input tax. The observable features of the HP transactions are that they comprise not only exempt supplies of finance but also taxable supplies of the vehicles.*
>
> *71. What HMRC's argument amounts to, in essence, is that there is a limit to the amount of cost that can be a cost component of a supply, and that because the supply of the vehicle is at cost, and so reflects only the price paid by VWFS to the dealer, and input tax on the acquisition of the vehicle by VWFS is directly attributable to that supply, the cost component capacity of the vehicle supply has been exhausted, with the result that no other costs can be cost components of that supply. We consider that to be wrong in principle.* ***The mere fact that only particular costs are recovered by a supplier in the price he charges for the making of a particular supply does not lead to the conclusion that no other costs are cost components of that***

> ***supply***. ***Unrecovered costs not directly attributable to a particular supply, or such costs recovered in other ways, for example by marking up other supplies, are nonetheless cost components of transactions of the business in general***, *and to the extent that those transactions include taxable supplies, the input tax incurred on those costs is deductible*".

30. The FTT then considered the principle of fiscal neutrality and held that the conclusion that overhead costs are cost components of the economic activity as a whole is itself an expression of the principle of fiscal neutrality; it would not be right for a trader who has incurred costs in making taxable supplies not to be able to deduct input tax because the price of the taxable supplies did not reflect that input tax.

31. In paragraph 75, the FTT did not accept that the purpose of the supply of the vehicle in an HP transaction is a supply of credit. The fact that the supply of the vehicle cannot take place without the supply of the credit did not change the essential economic characteristics of an HP transaction, objectively ascertained, namely that it was one indivisible transaction that comprised, for VAT purposes, two supplies, one taxable and one exempt.

32. Finally, the FTT rejected HMRC's argument that it was objectionable that VWFS would be consistently reclaiming input tax on HP transactions

33. The FTT's conclusion was that a partial exemption special method that provided for the partial attribution of the residual input tax incurred by VWFS to the taxable supplies of vehicles that it makes under the HP transactions, and therefore, VWFS's methodology, were fair and reasonable. This was on the basis that the issue was "*the only dispute on methodology*".

HMRC's arguments

34. Mr Owain Thomas, counsel for HMRC, opened HMRC's appeal by submitting that the critical question for the Upper Tribunal was to identify the fair and reasonable recovery of input tax for costs that have been incorporated into the price of exempt supplies of finance. We suggested that this formulation of the issue begged the legal question that we had to decide. Be that as it might, Mr Thomas placed central reliance on the FTT's factual finding that VWFS's residual input costs had been built in to the price of the exempt supplies of finance. His essential submission was that nowhere in the case law was there any authority for the proposition that there could be any recovery of input tax that has been incorporated into the price of an exempt output supply.

35. In reply, Mr Thomas's submissions changed a little in that he put the matter as follows:-

    i) The authorities in the Court of Justice of the European Union ("CJEU") show that the test for deductibility is met where the cost component requirement is satisfied (i.e. where the residual input costs are a cost component of the price of the taxable output);

ii) Where the cost component test is not satisfied (i.e. where the residual input costs cannot be shown to be a cost component of the price of a taxable output), the residual input tax can in some cases still be deductible. These are cases such as Rompleman infra (as to business set up costs) or Abbey National (as to business termination costs), where the cost inputs cannot be traced to taxable outputs.

iii) In this case, the cost component test is satisfied, and that determines deductibility, because the FTT found as a fact that the entirety of the residual input costs were cost components of exempt outputs (the finance charges).

iv) The FTT was in error in saying that just because the cost component requirement is not always a necessary requirement, it is irrelevant. That is what strikes at the heart of the way the tax works.

VWFS's arguments

36. Ms Shaw argued that the FTT was right for the reasons that it gave. In answer to Mr Thomas's approach, however, she argued that:-

i) There was no difference between the test of a direct and immediate link between residual input costs and taxable outputs, and the test of the one being a cost component of the other (see Jonathan Parker LJ in Dial-a-Phone infra).

ii) The cost component test does not require the residual input costs to be a cost component of the price of the outputs, and there is no need to be able to show that the residual input costs are built in to a particular output.

iii) The key question is whether the residual input costs are used for a business supplying cars as well as a business supplying finance, or whether, looked at economically, they are used just for a business supplying finance. Here, the two businesses are inextricably linked. If it were otherwise, a loss-making business making taxable supplies alongside a profitable exempt business would never be allowed to deduct residual input tax, yet such a business was allowed to do so in London Clubs Management infra.

iv) In this case, there is one indivisible transaction: sale and finance. The one cannot exist without the other.

Relevant legislative background

37. The primary instrument concerning VAT is now the Council Directive 2006/112/EC of 28th November 2006 on the common system of value added tax (the "Principal Directive"). The Principal Directive, in effect, replaced the Sixth Council Directive (77/388/EEC) of 11th April 1967 on the Harmonisation of the Laws of the Member States relating to Turnover Taxes (the "Sixth Directive"), which had itself replaced much of the First Council Directive (67/227/EEC) of 11th April 1967 on the Harmonisation of Legislation of Member States concerning Turnover Taxes (the "First Directive").

38. Article 2 of the First Directive is often cited as providing the principle underlying VAT as follows:-

> "*The principle of the common system of value added tax involves the application to goods and services of a general tax on consumption exactly proportional to the price of the goods and services, whatever the number of transactions which take place in the production and distribution process before the stage at which tax is charged.*
>
> *On each transaction, value added tax, 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 value added tax borne directly by the various cost components****.*
>
> *The common system of value added tax shall be applied up to and including the retail trade stage*" (emphasis added).

This provision was repeated in Article 1 of the Principal Directive.

39. Article 14(2)(b) of the Principal Directive provides that an HP transaction is to be regarded as a supply of goods by saying the following shall be regarded as a supply of goods: "*the actual handing over of goods pursuant to a contract for the hire of goods for a certain period, or for the sale of goods on deferred terms, which provides that in the normal course of events ownership is to pass at the latest upon payment of the final instalment*".

40. Article 168 of the Principal Directive provides for the deductibility of input tax on supplies to the trader of goods and services "*used for the purposes of the taxed transactions of a taxable person*".

41. Article 173 of the Principal Directive then deals with proportional deduction where goods and services are used by the trader both for taxable transactions and for exempt transaction, saying that the deductible proportion is to be determined in accordance with articles 174 and 175. Article 173(2) authorises Member States to take the following measures:- "*(a) authorise the taxable person to determine a proportion for each sector of his business, provided that separate accounts are kept for each sector; … (c) authorise or require a taxable person to make the deduction on the basis of the use made of all or part of the goods and services*".

42. The predecessors of the Principal Directive were given effect in the UK by the Value Added Tax Act 1994 (the "VATA").

43. Paragraph 5 of Schedule 4 to the VATA reflects Article 14(2)(b) of the Principal Directive by providing, in effect, that an HP transaction is to be regarded as a supply of goods.

44. Section 31 of the VATA provides that a supply of goods is an exempt supply if it is of a description for the time being specified in Schedule 9. Item 3 of Group 5 of Schedule 9 specifies that the following is exempt:-

> "*The provision of the facility of instalment credit finance in a hire-purchase, conditional sale or credit sale agreement for which facility a separate charge is made and disclosed to the recipient of the supply of goods*".

45. Section 24(1) of the VATA reflects Article 168 of the Principal Directive by providing that "*input tax*" in relation to a taxable person means VAT on the supply to him of any goods or services "*used or to be used for the purpose of any business carried on or to be carried on by him*". Section 26(1) of the VATA provides that the amount of input tax for which a taxable person is entitled to credit at the end of any period shall be so much as is allowable under regulations "*as being attributable to supplies within subsection (2) below*". Section 26(2) then refers to "*taxable supplies*", and section 26(3) says that HMRC "*shall make regulations for securing a fair and reasonable attribution of input tax to supplies within subsection (2) above …*".

46. The Value Added Tax Regulations 1995 (1995/2518) (the "VATR") provides methods to achieve the apportionment contemplated by section 26. Paragraph 101 sets out the standard method, to which we have already referred. Paragraph 102 relates to "*other methods*" and provides in paragraph 102(1) that HMRC may approve or direct the use of another method. Paragraphs 102(9) and (11) provide for a mechanism to ensure that an alternative method "*fairly and reasonably represents the extent to which goods or services are used by or are to be used by him in making taxable supplies*".

47. This analysis of the statutory background leads to the conclusion that the statutory test for deductibility is simply that input tax on supplies of goods and services to the taxable person must be used by him for the purposes of his taxed transactions. The VATR make regulations to secure a fair and reasonable attribution of input tax to taxable supplies, and the PESM adopted must fairly and reasonably represent the extent to which goods or services are used by or are to be used by him in making taxable supplies.

Chronological treatment of the authorities

48. It is, in our judgment, hard to understand the true principles that are to be derived from the authorities without looking at them in chronological order in order to see how the jurisprudence has developed.

49. D.A. Rompleman and another v. Minister van Financien Case 286/83; [1985] ECR 655 is still frequently cited. In that case, the CJEU considered the purpose and objective of the VAT system. The CJEU had to decide whether the acquisition of a right to the future transfer of ownership of part of a building, yet to be constructed, with a view to letting such premises, might be regarded as an 'economic activity' within the meaning of Article 4(1) of the Sixth Directive. The CJEU considered the general characteristics of the VAT system and the rules on deductibility of set-up costs, and said this at paragraph 16:-

> " … *[A] basic element of the VAT system is that VAT is chargeable on each transaction only after deduction of the amount of the VAT borne directly by*

the cost of the various components of the price of the goods and services …".

50. Mr Thomas relies on this passage as showing that input tax is deductible only so far as it is a cost component of the price of the goods. The CJEU also made an important reference to fiscal neutrality in paragraph 19 where it said: "*the common system of value-added tax therefore ensures that all economic activities, whatever their purpose or results, provided that they are themselves subject to VAT, are taxed in a wholly neutral way*".

51. In BLP Group plc v. Customs and Excise Commissioners Case C-4/94; [1995] STC 424, BLP sought to deduct input tax on invoices for the professional services it had used in connection with the sale of shares in its subsidiary company (an exempt output). BLP appealed against the Commissioners' refusal to allow the deduction, contending that the purpose of the share sale was to raise funds to pay off debts which had arisen from its taxable transactions, so that the professional services should be treated as having been 'used for' the purposes of its taxable transactions.

52. Advocate General Lenz considered the principles of deductibility in paragraphs 30-37 of his Opinion. He said this:-

> "*31. On the question whether the goods or services supplied to taxable person, on which input tax has been charged, can be attributed to a transaction by the taxable person in such a way that deduction of input tax is justified, the Community legislature decided on a criterion corresponding to the system: the amount which is to be deducted as input tax must have been 'borne directly by the various cost components' (see art 2 of the First Directive). …*
>
> *33. Those details logically do not change the fact that input tax can be deducted only to the extent that the goods or services on which it has been paid are 'cost components' of a taxable transaction …*
>
> *36. With respect to the present case, the High Court found … that the services in question on which input tax had been paid were 'used … for an exempt transaction' by the taxable person … It is thus established that those services form a cost component precisely of the exempt supply (effected by the sale of the shares).*
>
> *37. That is not affected by the argument put forward by BLP at the hearing that the costs of the services on which input tax has been paid … are ultimately incorporated into the price of the goods and services which it sells by means of its taxable transactions. … That circumstance does not make the services in question into cost components of the taxable transactions and cannot therefore alter the attribution stated above*".

53. The CJEU said this in BLP Group at paragraphs 18-25:-

> "*18. Paragraph 2 of art 17 of the Sixth Directive must be interpreted in the light of para 5 of that article.*

> *19. Paragraph 5 lays down the rules applicable to the right to deduct VAT where the VAT relates to goods or services used by the taxable person "both for transactions covered by paragraphs 2 and 3, in respect of which value added tax is not deductible".* ***The use in that provision of the words "for transactions" shows that to give the right to deduct under para 2, the goods or services in question must have a direct and immediate link with the taxable transactions****, and that the ultimate aim pursued by the taxable person is irrelevant in this respect.*
>
> *20. That interpretation is confirmed both by art 2 of the First Directive and by art 17(3)(c) of the Sixth Directive [Article 169 of the Principal Directive]. …*
>
> *25. It is true that an undertaking whose activity is subject to VAT is entitled to deduct the tax on the services supplied by accountants or legal advisers for the taxable person's taxable transactions … However,* ***that is a consequence of the fact that those services, whose costs form part of the undertaking's overheads and hence of the cost components of the products, are used by the taxable person for taxable transactions***" (emphasis added).

54. Thus, in BLP, the CJEU decided that the professional services were used for an exempt output, the sale of the shares. BLP was not able to deduct the input tax even though the ultimate purpose of the transaction was the carrying out of taxable outputs. The direct and immediate link was with the exempt output.

55. In Midland Bank plc v. Customs and Excise Commissioners Case C-98/98; [2000] STC 501, Samuel Montagu & Co Ltd ("Samuel Montagu") was a merchant bank and part of the Midland Bank Group ("Midland"). Samuel Montagu provided financial services to Quadrex Holdings Inc ("Quadrex"). Quadrex then sued Samuel Montagu alleging negligent misrepresentation. Samuel Montagu retained solicitors who invoiced them in respect of work relating (i) to the provision by Samuel Montagu of its services to Quadrex and (ii) the subsequent litigation. Midland sought to deduct all the VAT charged on the solicitors' fees. The CJEU decided that the solicitors' fees relating to the litigation were attributable to Samuel Montagu's business generally and that the business comprised both taxable and non-taxable transactions. The input tax relating to the litigation, therefore, needed to be apportioned in accordance with article 17(5) of the Sixth Directive (Article 173 of the Principal Directive). When considering the issue of a 'direct and immediate link' the CJEU referred to BLP at paragraph 20, and then continued at paragraph 24 as follows:-

> "24. *…art 2 of the First Directive and art 17(2), (3) and (5) of the Sixth Directive [Articles 168, 169 and 173 of the Principal Directive] must be interpreted as meaning that, in principle, the existence of a direct and immediate link between a particular input transaction and a particular output transaction or transactions giving rise to entitlement to deduct is necessary before the taxable person is entitled to deduct input VAT and in order to determine the extent of such entitlement*".

56. At paragraphs 30-32, the CJEU considered the 'cost component' test as follows:-

> "*30. It follows from that principle as well as from* ***the rule enshrined in the judgement*** *[in BLP], para 19* ***according to which, in order to give rise to the right to deduct, the goods or services acquired must have a direct and immediate link with the taxable transactions, that the right to deduct the VAT charged on such goods or services presupposes that the expenditure incurred in obtaining them was part of the cost components of the taxable transactions****. Such expenditure must therefore be part of the costs of the output transactions which utilise the goods and services acquired. That is why those cost components must generally have arisen before the taxable person carried out the taxable transactions to which they relate.*
>
> *31. It follows that, contrary to what the Midland claims, there is in general no direct and immediate link in the sense intended in BLP Group, between an output transaction and services used by a taxable person as a consequence of and following completion of the said transaction. Although the expenditure incurred in order to obtain the aforementioned services is the consequence of the output transactions, the fact remains that it is not generally part of the cost component of the output transaction, which art 2 of the First Directive none the less requires. Such services do not therefore have any direct and immediate link with the output transactions.* ***On the other hand, the costs of those services are part of the taxable person's general costs and are, as such, components of the price of an undertaking's products. Such services therefore do have a direct and immediate link with the taxable person's business as a whole, so that the right to deduct VAT falls within art 17(5) of the Sixth Directive and the VAT is, according to that provision deductible only in part***".

57. The Midland Bank case, therefore, introduced the concept of the 'direct and immediate link' being either directly between the input expenses and a particular output supply, or with the taxable person's business as a whole. The CJEU indicated that such a link existed if the inputs were a cost component of either the specific taxable supplies or of the price of the taxable person's products generally.

58. In Abbey National plc v. Customs and Excise Commissioners Case C-408/98; [2001] STC 297, Abbey National sought to deduct input tax on professional services it had employed in relation to a transfer of its rights under a lease and sublease. The transfer was not a taxable transaction. Abbey National's insurance business effected both taxable and non-taxable transactions. It was held that the input professional costs were part of the Abbey National's overheads and therefore had a direct and immediate link with the whole of its economic activity, so that it could deduct the proportion of VAT attributable to its taxable transactions.

59. Advocate General Jacobs said this about overheads in his Opinion:-

> "*42. According to a broader approach, where a taxable person pursues an economic activity in which he makes wholly taxable supplies, all the goods and services supplied to him for the purposes of that activity are cost components of his outputs and all the VAT borne by them should be deductible. The fact that, from a strict bookkeeping point of view, inputs are not attributed to or even apportioned among particular outputs is of no import here. Clearly not all goods and services consumed by a taxable*

> *person will be incorporated directly into an identifiable output. Some will be of the nature of general overheads and, to the extent that those overheads are components of taxable supplies, VAT levied on them may be deducted (see [BLP supra], para 25). Many types of overhead may be absorbed by the business as a whole, simply influencing indirectly the range of profit margins sought*".

60. The FTT cited paragraph 35 of the CJEU's decision, where it held that the professional services used to effect the transfer were overheads that were costs component of the products of a business. In paragraph 36, the CJEU decided that "*in principle the various services used by the transferor for the purposes of the transfer … have a direct and immediate link with the whole economic activity of that taxable person*".

61. The CJEU continued as follows:-

> "*38. However, as the Court held in paragraph 26 of the Midland Bank judgment,* ***a taxable person who effects transactions in respect of which VAT is deductible and transactions in respect of which it is not may nevertheless deduct the VAT charged on the goods or services acquired by him, where those goods or services have a direct and immediate link with the output transactions in respect of which VAT is deductible****, without it being necessary to differentiate according to whether Article 17(2), (3) or (5) of the Sixth Directive applies.*
>
> *39.* ***That rule must apply also to the costs of the goods and services which form part of the overheads relating to a part of a taxable person's economic activities which is clearly defined and in which all the transactions are subject to VAT****, since those goods and services thus have a direct and immediate link with that part of his economic activities.*
>
> *40. So if the various services acquired by the transferor in order to effect the transfer of a totality of assets or part thereof have a direct and immediate link with a clearly defined part of his economic activities, so that the costs of those services form part of the overheads of that part of the business, and all the transactions relating to that part are subject to VAT, he may deduct all the VAT charged on his costs of acquiring those services.*
>
> *41. It is for the national court to determine whether those criteria are satisfied in the case in point in the main proceedings*" (emphasis added).

62. In Dial-a-Phone Limited v. Customs and Excise Commissioners [2004] STC 987, the Court of Appeal considered the CJEU decisions that we have already mentioned.

63. Jonathan Parker LJ (with whom Dyson and Waller LJJ agreed) expressed the view that there was no material difference between the 'direct and immediate link' test and the 'cost component' test. He said this at paragraph 28 of his judgment:-

> "*Hence, on the authority of BLP and Midland Bank, in applying the "used for" test prescribed by art 17(2) of the Sixth Directive the relevant inquiry is whether there is a "direct and immediate link" between the input costs in*

> *question and the supply or supplies in question; alternatively whether the input cost is a "cost component" of that supply or those supplies. It is clear from the judgements of the ECJ in BLP and Midland Bank, as I read them, that there is no material difference between these alternative ways of expressing the basic test*" (original emphasis).

64. In Kretztechnik AG v. Finanzamt Linz Case C-465/03; [2005] STC 1118, the taxpayer's ("KAG") main business was the development and distribution of taxable supplies of medical equipment. KAG applied for admission to the Frankfurt Stock Exchange and was subsequently listed. Its capital was increased by the issue of shares, an exempt transaction. The tax authority refused to allow KAG to deduct input tax paid on the services it had used in relation to the admission to the stock exchange. The CJEU decided that these services had a direct and immediate link with KAG's whole economic activity, so that it was entitled to deduct the input tax charged. The CJEU said this:

> "*36. In this case, in view of the fact that, first, a share issue is an operation not falling within the scope of the Sixth Directive and, second, that operation was carried out by Kretztechnik in order to increase its capital for the benefit of its economic activity in general,* ***it must be considered that the costs of the supplies acquired by that company in connection with the operation concerned form part of its overheads and are therefore, as such, component parts of the price of its products****. **Those supplies have a direct and immediate link with the whole economic activity of the taxable person** (see BLP Group, paragraph 25; Midland Bank, paragraph 31; Abbey National, paragraphs 35 and 36, and Cibo Participations, paragraph 33).*
>
> *37. It follows that, under Article 17(1) and (2) of the Sixth Directive, Kretztechnik is entitled to deduct all the VAT charged on the expenses incurred by that company for the various supplies which it acquired in the context of the share issue carried out by it, provided, however, that all the transactions carried out by that company in the context of its economic activity constitute taxed transactions. A taxable person who effects both transactions in respect of which VAT is deductible and transactions in respect of which it is not may, under the first subparagraph of Article 17(5) of the Sixth Directive, deduct only that proportion of the VAT which is attributable to the former transactions (Abbey National, paragraph 37, and Cibo Participations, paragraph 34)*" (emphasis added).

65. It will be observed that the CJEU decided that the overheads in question were "*component parts of the price of [KAG's] products*".

66. In Halifax Plc and others v. Customs and Excise Commissioners Case C-255/02; [2006] STC 919, Advocate General Poiares Maduro (with whom the CJEU appeared to agree) said this about the entitlement to deduct input tax on supplies received for exempt output transactions:-

> "*93. … VAT is, in effect, an indirect general tax on consumption meant to be borne by the individual consumers. Correspondingly the same principle requires that a taxable person must not be entitled to deduct or recover the*

input VAT paid on supplies received for its exempted transactions. As long as no VAT is charged on the goods or services provided by taxable persons, the Sixth Directive necessarily seeks to prevent them from recovering the corresponding input VAT…".

67. In St Helen's School Northwood v. Revenue and Customs Commissioners [2007] STC 633, Warren J had to consider the deductibility of input VAT on the cost of building a school swimming pool and sports hall. The facilities were used by the school pupils (exempt for VAT purposes), but also commercially outside school hours by parents and others (a taxable output). The commercial use of the complex was contemplated in the application for planning permission. The school sought to recover a proportion of the VAT on the building of the complex by reference to a comparison between the hours of use for school and commercial purposes. Warren J decided that the provision of the exempt supply of education was the primary purpose of the complex, and the taxable supplies were a secondary use. Accordingly, the Revenue's proposed application of the standard method was preferable to the school's PESM. He said this at paragraphs 75-79:-

> "*[75] I agree with Mr Thomas [counsel for the school] that the search in the present case is for a fair and reasonable proxy for the 'use' of the sports complex in making the exempt and taxable supplies made by the School. However, I also agree with Miss Simor [counsel for HMRC] that the physical use of the complex is not necessarily a fair and reasonable proxy for that use.* ***I consider that her use of the phrase 'economic use' is a helpful approach to establishing what the search is for****.*
>
> *[76]* ***In that context, it is instructive, I consider, to look at the position had the School not granted the licence at all and had not allowed any out-of-hours use. In those circumstances, there would have been no taxable supply at all****. In consequence, none of the input tax would fall to be attributed to taxable supplies as a result of regs 101(2)(b) and (c), reg 101(2)(d) not applying. However, the sports complex is used for the purposes of the School's (exempt) business. It is so used not because there is a supply to parents of the physical use (by their daughters) of the sports complex to their children, but because the availability of the complex is part of the package of benefits which is acquired by parents for the fees they pay and which constitutes the exempt supply by the School. The use made by the School, for VAT purposes, of the sports complex is its use in providing that package of services, a single supply. There is, of course, no need to identify a proxy for use when there is only an exempt supply since questions of allocation under reg 101(2)(d) do not then arise. Nonetheless, one can see that the 'use' referred in reg 101 (as elsewhere) is not physical use but some special VAT use. It is, I think, the same as what Miss Simor terms 'economic use'.*
>
> *[77] On the facts of the present case, it seems to me that the overwhelming economic use of the sports complex by the School is in relation to the provision of educational services. In that context, I agree with Miss Simor that the source of funds and the purpose of constructing the sports complex are relevant considerations. To regard those factors as relevant is not, in my judgment, to fall into the error, as Mr Thomas would say it is, of*

> *categorising the nature of a supply by reference to the purpose or motive in making it. There is no doubt that in the present case, the supplies are distinct and readily identifiable, that is to say the taxable supply of the licence to [the company] and the exempt supply of education. Nor, in my judgment, is there any question, in taking those factors into account of treating a taxable supply as an exempt supply or vice versa. The question is what 'use' is being made of the inputs in producing the outputs. It seems to me that the purpose of the School, objectively ascertained, in constructing the sports complex is a highly relevant factor in attributing cost components between the relevant outputs and is an entirely different issue from identifying the nature of the output by reference to purpose or motive (which is inadmissible), the issue addressed by Patten J in Customs and Excise Comrs v Yarburgh Childrens Trust [2002] STC 207*" (emphasis added).

68. In Investrand BV v. Staatssecretaris van Financien [2008] STC 2298, the input tax in question was VAT on the cost of advisory services paid by Investrand in relation to arbitration proceedings to establish the amount of a claim that formed part of its assets, but which arose before Investrand became liable to VAT. The CJEU held that Investrand did not have the right to deduct the input tax saying this:-

> "*23. According to settled case-law, the existence of a direct and immediate link between a particular input transaction and a particular output transaction or transaction giving rise to entitlement to deduct is, in principle, necessary before the taxable person is entitled to deduct input VAT and in order to determine the extent of such entitlement (see Midland Bank, paragraph 24, Abbey National, paragraph 26, and Case C-32/03 Fini H [2005] ECR I-1599, paragraph 26). The right to deduct VAT charged on the acquisition of input goods or services presupposes that the expenditure incurred in acquiring them was a component of the cost of the output transactions that gave rise to the right to deduct (see Midland Bank, paragraph 30; Abbey National, paragraph 28; and Case C-16/00 Cibo Participations [2001] ECR I-6663, paragraph 31).*
>
> *24. It is however also accepted that a taxable person has a right to deduct even where there is no direct and immediate link between a particular input transaction and an output transaction or transactions giving rise to the right to deduct, where the costs of the services in question are part of his general costs and are, as such, components of the price of the goods or services which he supplies. Such costs do have a direct and immediate link with the taxable person's economic activity as a whole (see, inter alia, Midland Bank, paragraphs 23 and 31, and Kretztechnik, paragraph 36)*".

69. This seems to have been a clear reiteration of the principles previously espoused in the cases we have cited above – without any significant elaboration.

70. In Mayflower Theatre Trust Limited v. Revenue and Customs Commissioners [2007] STC 880, the Court of Appeal looked again at the principles of the CJEU cases. Carnwath LJ (with whom Chadwick and Auld LJJ agreed as to the result) adopted counsel's summary of the main principles to be derived from the cases at paragraph 9 of his judgment as follows:-

> "*… (i) input tax is directly attributable to a given output if it has a 'direct and immediate link' with the output (referred to as 'the BLP test'); (ii) that test has been formulated in different ways over the years, for example: whether the input is a 'cost component' of the output. Such formulations are the same in substance as the 'direct and immediate link' test; (iii) the application of the BLP test is a matter of objective analysis as to how particular inputs are used and is not dependent upon establishing what is the ultimate aim pursued by the taxable person. It requires more than mere commercial links between transactions, or a 'but for' approach; (iv) the test is not one of identifying what is the transaction with which the input has the most direct and immediate link, but whether there is a sufficiently direct and immediate link with a taxable economic activity; and (v) the test is one of mixed fact and law, and is therefore amenable to review in the higher courts, albeit the test is fact sensitive*".

71. The CJEU considered the overall economic activity of the taxable person in Skatteverket v. AB SKF Case C-29/08; [2010] STC 419, where it said this:-

> "60. *It follows that whether there is a right to deduct is determined by the nature of the output transactions to which the input transactions are assigned. Accordingly, there is a right to deduct when the input transaction subject to VAT has a direct and immediate link with one or more output transactions giving rise to the right to deduct.* ***If that is not the case, it is necessary to examine whether the costs incurred to acquire the input goods or services are part of the general costs linked to the taxable person's overall economic activity****. In either case, whether there is a direct and immediate link will depend on whether the cost of the input services is incorporated either in the cost of particular output transactions or in the cost of goods or services supplied by the taxable person as part of his economic activities. …*
>
> *62. … In order to establish whether there is such a direct and immediate link,* ***it is necessary to ascertain whether the costs incurred are likely to be incorporated in the prices of the shares [in its subsidiary – an exempt supply] which SKF intends to sell or whether they are only among the cost components of SKF's products [taxable supplies]***" (emphasis added).

72. In Revenue and Customs Commissioners v. London Clubs Management Limited [2012] STC 388, the Court of Appeal had another opportunity to consider the principles applicable where a taxpayer made both taxable and exempt supplies. The taxpayer casino sought to apportion its input tax according to a PESM that was based on the relative use of the floor space for taxable (restaurants and bars, for example) versus exempt (gambling) purposes. The catering services were hugely loss making. HMRC argued that apportionment based on a turnover method was more fair and reasonable. The Court of Appeal ultimately found in favour of the taxpayer, on the basis of a critical finding of fact made by the First Tier Tribunal to the effect that, although the catering business was not currently profitable, it was a business in its own right and not merely ancillary to the gaming business (see paragraph 69 in the judgment of Etherton LJ, with whom Pitchford and Ward LJJ agreed).

73. At paragraph 33, Etherton LJ made clear that the need for a process of attribution only arose when an item is a cost component of both taxable and exempt supplies, so that if the standard method does not result in a fair and reasonable attribution, the search is for a more fair and reasonable method.

74. Etherton LJ continued:

> *"34. A fair and reasonable attribution to a taxable supply must, for the purposes of Article 17(2) and (5) of the Sixth Directive and regulation 101(2)(d) of the Regulations, reflect the use of a relevant asset in making that supply. In assessing that use, and its extent, consideration is not limited to physical use. The assessment must be of the real economic use of the asset, that is to say having regard to economic reality, in the light of the observable terms and features of the taxpayer's business*"

75. Etherton LJ then endorsed the passages in Warren J's judgment in St. Helen's School Northwood, which we have set out above, and cited the CJEU in Baxi Group Limited v. Revenue and Customs Commissioners C-53/09 and C-55/09; [2010] STC 2651, where it had said that: "*[i]t must be recalled that consideration of economic realities is a fundamental criterion for the application of the common system of VAT* …". He continued at paragraph 41 as follows:-

> "*41. That case [St Helen's Scool Northwood] and the reasoning of the Tribunal, with which I agree, is illustrative of three points of principle. First, it shows the importance in these cases of close attention to the facts in order to understand the economic or commercial reality underlying the use of the relevant VAT inputs. Secondly, identification of the source or potential source of profit in a business may be an important feature of a business throwing light on whether or not the standard method or a PESM is a more fair, reasonable and accurate method of attribution. It all depends on the facts of each case: cf. Banbury Visionplus Ltd v Revenue and Customs Commissioners [2006] STC 1568 at [68]. Thirdly, depending again on the precise factual situation under consideration, the approach of the Tribunal in Aspinall's Club at [49] may well be appropriate in a case where the taxable supplies are not, in themselves, a source of profit:*
>
> *"Those costs are funded by the gaming. That in itself does not make them cost components of those exempt supplies. But in this case it is additional proof, if any is needed, that gaming is the foundation of the business and it is the furtherance of that gaming which causes and is seen as justifying commercially the decisions to incur the expenditure""*.

76. Etherton LJ also considered what the position would have been without the critical finding of fact. He concluded that he was very doubtful if it would have been possible to uphold the FTT's decision (paragraph 83), because, in looking at economic reality "*profit may be an important factor*" (though profit might in some cases be irrelevant). He held that the absence of a realistic expectation that the catering business would be profitable in the foreseeable future would have been likely to have been a critical factor against the proposed floor area PESM. He concluded that he found it difficult to see how in the absence of such an expectation: "*as a matter of economic reality, any significant weight in support of the proposed*

PESM could legitimately be given to the avowed strategy of the respondent to run the catering activity as a separate business, making a positive contribution towards overheads". Finally, Etherton LJ referred to the "*startling consequence*" that the loss-making activity would serve to boost the respondent's profits as a result of payments from HMRC (paragraph 88).

77. The FTT's decision in Aspinall's Club Limited 29th April 2002 (VTD 17797) arose from similar factual circumstances to London Clubs Management Limited. The taxpayer ran a casino with catering facilities and the dispute concerned a floor space PESM. The Tribunal decided that the catering facilities were so heavily funded by the exempt and profitable gaming activities that a PESM based on floor use was not fair and reasonable. The distinguishing factor between the two cases was the finding of fact in London Clubs Management Limited that the catering business was a business in its own right and was carried on independently of the gaming activities.

78. In TETS Haskovo AD v. Direktor na Direktsia 18th October 2012; Case C-234/11 is the CJEU's most recent decision on this issue. It reiterated the position as follows:-

> "*32. Moreover, the Court has consistently held that for there to be the direct and immediate link required by the Court,* ***the costs incurred in acquiring the input transactions must be part of the cost components of the taxable output transactions, that is to say they must be incorporated into their price****. The Court has also made it clear that this also covers the input transactions attributable to the taxable person's general overheads. In the case of such input transactions the required link exists not with certain output transactions but rather with the taxable person's economic activity as a whole, that is to say all of his output transactions*" (emphasis added).

Discussion

79. The burden of the FTT's Decision was that it did not agree with Mr Thomas's characterisation of VWFS's business as a 'finance business'. Instead, it started from the proposition that the residual or overhead input costs were, by their very nature, costs components of both VWFS's taxable and exempt outputs. Accordingly, it held that any method that treated those overheads as solely cost components of the exempt supply could not be fair and reasonable, even allowing for the fact that it had held that, as a matter of fact, all the overhead costs in question were built in to the price of the exempt financing outputs as opposed to the taxable vehicle sales outputs.

80. The FTT's key reasoning is then contained in paragraph 71 where it said that: "*[t]he mere fact that only particular costs are recovered by a supplier in the price he charges for the making of a particular [taxable] supply does not lead to the conclusion that no other costs are cost components of that supply*". This led to the conclusion that the overhead input costs were directly attributable to, and cost components of, the transactions of the business in general including the essential taxable supply of the vehicle, which was part of one indivisible transaction for the supply of vehicles (taxable) on hire purchase terms (exempt). As Ms Shaw put it,

without the supply of the vehicles, there would be no business at all, let alone an exempt one.

81. The essential question for us is whether the FTT made an error of law in following this simple, and if we may say so, attractive, reasoning. This depends, as we see it, on two supplemental questions namely:-

i) Was Mr Thomas right to submit that the FTT should have held that, where the residual input costs in question are in fact a cost component of only the exempt output (i.e. the financing in this case), the input tax will never be deductible?

ii) If Mr Thomas was not right about that, was the FTT right in its characterisation of the economic reality of VWFS's business, so as to hold that it was engaged upon the sale of vehicles on HP terms rather than upon simply a finance business?

82. In answering both questions, one needs to keep very carefully in mind the statutory exercise upon which the FTT was engaged. As we have said already, both article 168 of the Principal Directive and section 24(1) of the VATA provide that deductibility depends on the input goods and services being "*used for the purposes*" of taxable outputs. Mr Thomas places emphasis on the decisions that refer to the need for the residual cost input to be a cost component of the price of the taxable output, because he says, if it is not, it cannot be used for the purposes of a taxable output. The FTT said expressly that there was no such rule (see paragraph 68 of the Decision).

83. Mr Thomas accepts that there is no authority which has expressly held that where the residual input costs in question are only built in to the price of exempt outputs, they cannot also be a cost component of taxable outputs, but he says that this follows from the dicta we have cited above.

84. In our judgment, the way that the CJEU has dealt with these issues, now over many years, does not give rise to a rule of the kind that Mr Thomas contends for. This is because of the way the CJEU has approached the application of the statutory test. One is looking for a fair and reasonable attribution of input costs to taxable supplies – so as to see whether the input supplies are used for taxable outputs. That is achieved, in the case of overheads, by adopting a twin approach: first by looking to see whether the residual inputs have a direct and immediate link with the taxable transactions, and secondly by looking to see whether the residual inputs are a cost component of the taxable transactions. We do not think that there is a meaningful difference between asking whether residual inputs are a cost component of the taxable outputs, and asking whether they are a cost component of the price of the taxable outputs. The concepts are identical, as the cases show by using the terms interchangeably.

85. Likewise, it has been repeatedly explained by the Court of Appeal in Dial-a-Phone and in Mayflower Theatre Trust and in London Clubs Management that these twin approaches are alternative ways of expressing the same basic test.

86. But when it cannot properly be said (as is normally the case with overheads properly so-called) that a residual cost input has a direct and immediate link with

any particular output, one applies these twin tests objectively from the broader economic standpoint. One asks whether the residual cost inputs have a direct and immediate link with or are cost components of the taxable part of the taxable person's entire economic activity.

87. It is, in our view, conceivable, though not likely, that a residual cost input that was never part of the cost component of a taxable output might be regarded as deductible. Taking the example of the London Clubs Management case, the food and drink was loss-making and so must have been charged at below cost. Nonetheless the residual cost inputs were, on one analysis, part of the cost component of the taxable supply. If one assumes that the cost price of the food was £10 and the relevant overhead was £2, and the whole was charged at £8, a loss of £4 was made on each taxable supply. But the overhead was still a percentage component of that loss-making price of £8 – just a smaller one than was necessary to make a profit.

88. Here, of course, no part of the overhead is in fact attributed to the price of the taxable sale of the vehicle. But that does not mean that a part of the overhead could not, in theory, be attributable to the taxable sale. Whether or not it is so attributable depends, on the clear authority of the Court of Appeal cases and the CJEU cases, on whether the residual input costs in question have a direct and immediate link with, or are cost components of, the taxable part of the taxable person's entire economic activity.

89. Thus, in our judgment, the answer to the first question we have posed is that Mr Thomas is wrong to say that there is a rule that will in every case mean that, where the residual input costs in question are in fact a cost component of only the exempt output, the input tax will never be deductible. It is likely that, in practice, Mr Thomas will be right in many, if not most, cases. But the outcome of any particular case turns in our judgment on the answer to the second question that we have posed: was the FTT right in its characterisation of the economic reality of VWFS's business, so as to hold that it was engaged upon the sales of vehicles on HP terms rather than upon simply a finance business? If the economic reality is that VWFS is engaged in finance alone, then the residual input costs in question will have neither a direct and immediate link with, nor be cost components of, VWFS's entire economic activity.

90. Before seeking to answer this second question, it is as well to remind ourselves of the parameters of the debate. We found most help in Etherton LJ's judgment in London Clubs Management where he reminds us that a fair and reasonable attribution to a taxable supply must reflect the use of a relevant asset in making that supply, and must be of the real economic use of the asset, that is to say having regard to economic reality, in the light of the observable terms and features of the taxpayer's business. Close attention must be paid to the facts in order to understand the economic or commercial reality underlying the use of the relevant cost inputs, and the identification of the source or potential source of profit in a business may be an important feature. As the Tribunal said in Aspinall's, the overhead costs "*are funded by the gaming. That in itself does not make them cost components of those exempt supplies. But in this case it is additional proof, if any is needed, that gaming is the foundation of the business and it is the furtherance of that gaming which*

causes and is seen as justifying commercially the decisions to incur the expenditure".

91. Here the FTT formed a very clear view of the nature of the economic reality of VWFS. It thought that it was not simply to supply credit, but to supply vehicles on hire purchase terms. It was the single whole transaction, and the indivisibility of that transaction that seems to have impressed the FTT.

92. We think that the FTT took too far the suggestion in paragraphs 67 and 68 that profitability was irrelevant. As Etherton LJ held in London Clubs Management, in looking at economic reality "*profit may be an important factor*", and the absence of a realistic expectation that the catering business would be profitable in the foreseeable future would have been likely to have been a critical factor.

93. We have in mind also Ms Shaw's submission that we should apply Warren J's approach in St. Helen's School Northwood to the effect that it was instructive to "*look at the position had the School not granted the licence at all and had not allowed any out-of-hours use*". In this case, if there had been no sale of the vehicle (therefore, no taxable supply), there would have been no finance (therefore, no exempt supply). That was unlike the position before Warren J where if there had been no taxable supply, none of the input tax would have been deductible, because the sports complex would have been used for wholly exempt supplies. As it seems to us, however, that is only one aspect of the matter, and it does not detract from the need to look at the overall economic position as the cases explain.

94. We much regret that we are unable to agree with the FTT on this issue. It seems to us that the observable terms and features of VWFS's business start with the fact that it is the finance arm of Volkswagen AG. It exists in order to provide finance to those purchasing Volkswagen's brands of vehicle, and will only be involved in any transaction when the purchaser requires such finance. Specifically, in VWFS's retail sector, VWFS provides credit to enable the customers of Volkswagen's dealers to pay for the vehicles they want – whether by way of HP terms or other credit arrangements.

95. The residual cost inputs with which this case is concerned are normal overheads for a sales or a finance business, including temporary staff expenses, hotel, travel and training expenses, marketing expenses, IT and legal and accountancy expenses. It is true that the marketing expenses appear to be shared in some respects between dealers and the finance arm. But it is the way that HP transactions are universally invoiced and processed that gives a clear clue to the objective economic reality of VWFS's business. It is true also that, in every case, VWFS will buy and sell the vehicle in question, but it does so at whatever cost the dealer has in fact agreed with the ultimate consumer without any mark-up, and the transaction is not even shown in its statutory accounts. VWFS does not appear to have any say in the price. Indeed, the price is irrelevant to its finances because it is always put through without any mark-up, and is not even shown in its statutory accounts. The price of the vehicle and indeed the sale of the vehicle have no economic impact on VWFS's business whatsoever. It simply does not matter to VWFS what the price of the vehicle is.

96. The question of profit also points against the real economic activity of VWFS being the sales of vehicles. No profit is or will ever be made by VWFS in respect on vehicle sales. All VWFS's profits will always, for whatever reason (and the reason does not seem to us to matter), be made from the finance transactions that are predominantly exempt.

97. We feel that the FTT may have been misdirected by looking at the matter purely through VAT-tinted spectacles. What is required is a focus on economic realities. It is true that VWFS's transactions will always involve a taxable transaction and an exempt transaction inextricably intertwined. But the finance transaction is, to put the matter colloquially, the 'main event' for VWFS. It is what VWFS is all about. Without it, VWFS would be a wholly unnecessary intervener.

98. We have taken into account the fact that, notionally at least, VWFS is the vendor of the vehicle and receives complaints about quality and maintenance. But in reality, it must pass those complaints on to the dealer to process, since it has no workshops or vehicle service facilities itself.

99. As in the St. Helen's School Northwood case, the economic reality of the school's new sports hall was to provide facilities for the pupils, not to provide an income from incidental after-hours usage by parents or third parties.

100. It is not the case, in our view, that residual input tax can never be deductible when the taxable part of the trader's business is loss-making or cost-neutral, but in this case it seems really quite obvious to us that a proper application of the correct tests shows that there is no direct or immediate link between the residual input costs in question and the taxable sales of vehicles by VWFS. The direct and immediate link is between the residual input costs and the finance supplies which are predominantly exempt outputs. Likewise, the residual input costs are not, properly regarded, cost components of the taxable part of VWFS's entire economic activity. They are cost components, as the FTT correctly found, of the financing part of VWFS's business. That is the economic reality of VWFS. Its overheads are used for its financing business, which is exempt from VAT.

101. For these reasons, by an application of the statutory "*used for*" test and of the explanation of that test reflected in both the CJEU and English cases, the residual input tax is not deductible against VWFS's taxable sales of vehicles. For these reasons, a PESM which attributes 50% of the residual input costs to the taxable outputs would not be a fair and reasonable apportionment. Accordingly, we think the appeal must be allowed.

102. Finally, we should mention that HMRC submitted that, in the event we were in doubt as to whether the decision of the FTT was contrary to the provisions of the Principal Directive and the CJEU case law concerning the 'direct and immediate link' test and the 'cost component test', we should refer the matter to the CJEU for a preliminary ruling. In the result, we do not think that there is any lack of clarity in the CJEU case law. Moreover, a series of the cases have made clear that the decision on the application of the tests is for the national court. In these circumstances, where we have differed from the FTT only on the application of the test, we see no need for a reference to be made.

Ground 2

103. HMRC also raised a second ground of appeal based upon the FTT's failure to address its submission that, even if it was wrong on its main points, VWFS's method was not fair and reasonable, and a lesser figure than 50% should have been attributed to the taxable supplies. This ground of appeal is not relevant in the light of what we have now held. But we will deal with it briefly in any event.

104. It seems fairly clear that Mr Thomas did, in fact, make a submission to this effect, despite the FTT's apparent understanding (reflected in paragraph 77 of the Decision) that he did not. The submission is clearly recorded on page 94 of Judge Berner's manuscript notes of the FTT hearing. It also appears that Mr Thomas challenged Ms Norma Doherty's evidence on the point. Moreover, we do not read Mr Jonathan Cannon's evidence as conceding the point on behalf of HMRC.

105. Accordingly, the FTT should have dealt with this submission. But the detail has not been argued before us, and we were only asked to send the matter back to the FTT if we found in favour of HMRC on the point. Thus, if we had not reversed the decision of the FTT as to the fair and reasonable attribution, we would have sent the matter back to the FTT to deal with ground 2.

Conclusions

106. In our judgment, the statutory test for deductibility is simply that input tax on supplies of goods and services to the taxable person must be used by him for the purposes of his taxed transactions. The PESM adopted must fairly and reasonably represent the extent to which goods or services are used by or are to be used by the taxable person in making taxable supplies.

107. The FTT was right to find that there is no rule to the effect that, where residual input costs are in fact a cost component of only an exempt output, the input tax will never be deductible. That will normally be the case, but on authority, a twin approach is appropriate in the case of overheads: one looks to see whether the residual cost inputs have a direct and immediate link with the taxable transactions, and whether the residual cost inputs are a cost component of the taxable transactions. The concepts of asking whether residual inputs are a cost component of the taxable outputs, and asking whether they are a cost component of the price of the taxable outputs are substantially identical. These twin approaches are alternative ways of expressing the same basic test.

108. When it cannot properly be said (as is normally the case with overheads properly so-called) that a residual cost input has a direct and immediate link with any particular output, these twin tests are to be applied objectively from the broader economic standpoint. The question is whether the residual cost inputs have a direct and immediate link with or are cost components of the taxable part of the taxable person's entire economic activity.

109. We have concluded that the FTT was wrong in its characterisation of the economic reality of VWFS's business. It should have held that, for these purposes, the economic reality was that VWFS is engaged in a finance business and not in the business of selling cars on finance terms. VWFS sells vehicles at a price fixed by

the dealer. It has no say in the price, and the price is irrelevant to its finances. Moreover, no profit is or will ever be made by VWFS in respect of vehicle sales. Accordingly, the economic reality of VWFS's business is that it is running a finance business from which it makes all its profits.

110. Accordingly, the residual cost inputs in this case have no direct and immediate link with and are not cost components of the taxable part of VWFS's business, save for the small taxable elements of its finance business. For this reason, VWFS's PESM which attributes 50% of the residual input costs to the taxable outputs would not be a fair and reasonable apportionment.

111. HMRC's appeal must, for the reasons we have given, be allowed. We will deal with any application for costs in the usual way.

Tribunal Judges

Mr Justice Vos **Timothy Herrington**

Release Date: 12 November 2012