[2018] UKUT 214 TCC
Appeal number: UT/2017/0095

VAT – repayment of VAT to non-EU trader under Thirteenth Directive – whether supplies used for taxable transactions – whether acting as a taxable person – consideration of Sveda and Iberdrola

UPPER TRIBUNAL
TAX AND CHANCERY CHAMBER

JDI INTERNATIONAL LEASING LIMITED **Appellant**

- and -

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE & CUSTOMS **Respondents**

TRIBUNAL: MR JUSTICE ROTH
JUDGE SARAH FALK

Sitting in public at The Royal Courts of Justice, Rolls Building, Fetter Lane, London EC4A 1NL on 15 May 2018

Raymond Hill, instructed by Baker McKenzie LLP, for the Appellant

Michael Jones, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents

DECISION

1. This is an appeal against a decision of the First-tier Tribunal ("FTT") (Judge Jonathan Richards) that the appellant, JDI International Leasing Limited ("JDI"), was not entitled to recover VAT of approximately £5.4m incurred on the leasing and purchase of equipment, on the basis that it did not use the equipment for taxable purposes and was not acting in the capacity of a taxable person for VAT purposes (the "FTT decision"). The FTT gave permission to appeal.

The facts

2. The full facts are set out in the FTT decision and what follows is a summary.

3. JDI is a Cayman Islands incorporated company which is a member of a group, referred to in the FTT decision as the Baker Hughes Group. JDI acquired a number of highly specialised oilfield drilling tools (the "Tools") and intellectual property rights relating to the Tools (the "Intellectual Property") pursuant to an intra-group reorganisation largely carried out in October 2012. The dispute relates to those Tools that were located in the UK at the time (the "UK Tools"). JDI leased the UK Tools to a Dutch company, Baker Hughes Nederland BV ("BHN"), which in turn subleased them to operating companies in the Baker Hughes Group (the "Operating Companies"). The Operating Companies make the Tools available to third parties engaged in oil exploration and production activities.

4. Ownership of the Intellectual Property entitles JDI to manufacture or procure the manufacture of further Tools, spare parts and other consumables relating to the Tools ("Spare Parts"). JDI procures the manufacture of Spare Parts from other group companies and supplies them to the Operating Companies.

5. The FTT decision describes the steps of the intra-group reorganisation at paragraphs [15] to [17]. Prior to its implementation, the Tools were owned by a variety of group companies. The UK Tools were owned by a UK company, Oilfield Tools Limited ("Oilfield Tools"). The Intellectual Property was owned by another Cayman Islands company, which had granted Oilfield Tools a licence to use it outside the US. The Baker Hughes Group decided that it would be more efficient for all its leasing activity outside the US to be centralised in a single entity, and chose JDI. The aim was that JDI would acquire outright ownership of all the Tools from other group members, but in some jurisdictions, including the UK, transfer of title to JDI was delayed and an interim leasing arrangement was put in place.

6. The first step in the reorganisation was to transfer the non-US Intellectual Property to JDI, with JDI taking over the licence to Oilfield Tools. JDI then served notice on Oilfield Tools to terminate the licence with effect from 1 October 2012. Oilfield Tools terminated the operating leases of the Tools to which it was party with effect from the same date. JDI entered into an agreement to acquire the Tools from Oilfield Tools on 1 October 2012, but the UK Tools were not transferred pursuant to this agreement until 22 November 2013 because the group was attempting to obtain

confirmation of the VAT treatment from HMRC (a confirmation which it did not ultimately obtain). In the interim Oilfield Tools leased the UK Tools to JDI under an equipment lease agreement dated 1 October 2012. Also on 1 October 2012, JDI leased the UK Tools to BHN (the "Headlease") and BHN subleased them to the Operating Companies. Oilfield Tools accounted for VAT on both the rentals received and the subsequent sale consideration in respect of the UK Tools. It is the right of JDI to repayment of this VAT that is the subject of the dispute.

7. The terms of the Headlease and the subleases are summarised at paragraphs [18] and [19] of the FTT decision. For reasons which were not explained, the Headlease did not provide for any monetary consideration for the use of the UK Tools. The Headlease was expressed to continue until such time as the parties agreed to cancel it or enter into another lease agreement, and BHN was entitled to terminate the lease in respect of any individual Tool at any time by redelivering it. Certain obligations were placed on BHN relating to the use and care of the Tools and the form of any sublease. JDI retained the risk of loss or damage, but any compensation received by BHN or any sublessee was required to be remitted to JDI.

8. The subleases to the Operating Companies had a number of similar provisions to the Headlease, but in contrast provided for a rental to be paid and also for either party to be able to terminate the agreement on 30 days' written notice.

9. As already mentioned, JDI supplies Spare Parts to the Operating Companies. Whilst it charges no rent under the Headlease it does charge the Operating Companies for Spare Parts, making a significant mark-up on the price it pays for their manufacture. The Tools are used in highly challenging environments, resulting in a need for Spare Parts both during use in the field and as part of the inspection and maintenance programmes undertaken once a Tool is returned by a third party or is otherwise being held within the Baker Hughes Group. The Spare Parts can only be used with the Tools and, because JDI has exclusive use of the Intellectual Property, in effect JDI is the sole supplier of the Spare Parts. Judge Richards accepted that access to the Intellectual Property is crucial to JDI's ability to manufacture the Spare Parts (paragraph [45]).

The legal background

The relevant legislation

10. Council Directive 86/560/EEC, known as the Thirteenth Directive, provides for Member States to refund VAT to taxable persons not established in the EU. Article 2(1) provides so far as relevant:

> "…each Member State shall refund to any taxable person not established in the territory of the Community, subject to the conditions set out below, any value added tax charged in respect of services rendered or moveable property supplied to him in the territory or the country by other taxable persons…in so far as such goods and services are used for the purposes of the transactions referred to in Article 17(3)(a) and (b) of Directive 77/388/EEC…"

11. Article 1(1) of the Thirteenth Directive defines a "taxable person" by reference to Article 4(1) of Directive 77/388/EEC (the Sixth Directive). Articles 4(1) and (2) of the Sixth Directive provide:

> "1. "Taxable person" shall mean any person who independently carries out in any place any economic activity specified in paragraph 2, whatever the purpose or results of that activity.
>
> 2. The economic activities referred to in paragraph 1 shall comprise all activities of producers, traders and persons supplying services including mining and agricultural activities and activities of the professions. The exploitation of tangible or intangible property for the purpose of obtaining income therefrom on a continuing basis shall also be considered an economic activity."

12. Articles 17(2) and (3) of the Sixth Directive provide so far as relevant:

> "2. In so far as the goods and services are used for the purposes of his taxable transactions, the taxable person shall be entitled to deduct from the tax which he is liable to pay:
>
> (a) value added tax due or paid within the territory of the country in respect of goods or services supplied or to be supplied to him by another taxable person…
>
> 3. Member States shall also grant every taxable person the right to the deduction or refund of the value added tax referred to in paragraph 2 in so far as the goods and services are used for the purposes of:
>
> (a) transactions relating to the economic activities referred to in Article 4(2), carried out in another country, which would be deductible if they had been performed within the territory of the country..."

13. The Sixth Directive was replaced by Directive 2006/112/EC in 2006 (the Principal VAT Directive or "PVD"), but the cross references in the Thirteenth Directive were not updated. The equivalent provisions of the PVD are however not materially different. Article 168 of the PVD, the equivalent of Article 17(2) of the Sixth Directive, provides:

> "In so far as the goods and 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 which 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…"

14. The relevant UK implementing legislation, contained in s 39 Value Added Tax Act 1994 and regulation 186 of the Value Added Tax Regulations 1995, is set out at paragraphs [21] and [22] of the FTT decision. There was no dispute that the effect of the Directives and the UK legislation is that, in order to succeed, JDI must establish that the VAT it incurred on the supply of the UK Tools to it would have been recoverable as input tax if JDI had been a taxable person carrying out its activities in the UK.

Sveda and Associated Newspapers

15. The FTT's legal analysis was based primarily on two cases, *'Sveda' UAB v Valstybine mokesčių inspekcija prie Lietuvos Respublikos finansų ministerijos* (Case C-126/14) [2016] STC 447 ("*Sveda*") and *Associated Newspapers Limited v HMRC* [2017] EWCA Civ 54, [2017] STC 843.

16. *Sveda* related to a claim to recover input tax on capital goods purchased in connection with the construction of a "Baltic mythology recreational and discovery path". The project was subsidised by the Lithuanian state to ensure that access was free of charge, but *Sveda* intended to carry on economic activities at the site in the form of the sale of refreshments and souvenirs. The Court of Justice of the European Communities ("CJEU") explained at paragraph [18] that it followed from Article 168 of the PVD that a taxable person is entitled to deduct input tax on supplies to it provided that (1) the taxable person is "acting as such" at the time of the receipt of the supplies and (2) it uses them for the purposes of taxed transactions.

17. The CJEU held that the findings of the referring court had determined the "acting as such" question in favour of *Sveda*, on the basis that the path was a means of attracting customers. On the second question, the CJEU held that the provision of the path free of charge was not a bar to recovery of input tax provided that a direct and immediate link was established between the expenses and Sveda's taxable transactions, or with its economic activity as a whole. The CJEU noted that there appeared to be a direct and immediate link between the expenditure and Sveda's planned economic activity as a whole, although that was a matter for the referring court to determine (paragraphs [35] and [37]).

18. *Associated Newspapers* related to a promotional scheme which involved the taxpayer purchasing vouchers from retailers which it supplied to its customers free of charge as part of a scheme to incentivise them to purchase newspapers. The taxpayer sought to reclaim input tax incurred on the purchase of the vouchers. The Court of Appeal held that the vouchers were acquired to increase circulation of the newspapers and facilitate associated sales of advertising, and that there was the necessary direct and immediate link with that activity, the cost of the vouchers being cost components of the taxable activities of the sale of newspapers and advertising.

The FTT decision

19. The FTT considered the two tests set out in *Sveda*, and concluded that neither test was satisfied. It was common ground that the leasing of UK Tools to BHN did not constitute an economic activity since it was for no consideration. Considering the second test first (use for the purposes of taxed transactions), the FTT decided that JDI had failed to establish that there was a "direct and immediate link" between its acquisition of the UK Tools and its overall economic activity of supplying Spare Parts.

20. The FTT decision notes that it is not necessary to show a link with a particular output transaction: a direct and immediate link is treated as arising with the economic activity as a whole where inputs are part of a taxable person's general costs and, as

such, components of the price of the goods or services supplied (paragraph [32], referring to *Sveda* at [28]). The test is an objective one and the link can be purely economic (paragraph [33] of the FTT decision). As *Sveda* demonstrated, the mere fact that immediate use did not involve receipt of consideration is not itself a bar to recovery, but a link can be severed where the goods or services acquired are used for the purposes of transactions that are exempt or do not fall within the scope of VAT (paragraph [35], referring to *Sveda* at [32] and [33]).

21. In applying these principles to the facts, the FTT concluded that in JDI's case there was no objective link between the acquisition of the UK Tools and the sale of Spare Parts. The market for Spare Parts was driven by the existence and use of the Tools rather than by the precise legal entity that owned them. Although once JDI had acquired the UK Tools its Spare Parts business did benefit from its decision to lease them to BHN, thereby putting them "into the market" and generating an increased requirement for Spare Parts, the terms of the Headlease meant that JDI's level of control was weak. There was no requirement about any level of use, BHN could terminate the lease of any Tool without notice, there were no obligations in relation to Spare Parts and JDI retained the majority of the risk of loss or damage to the Tools. (See paragraph [44] of the FTT decision.)

22. Although the FTT accepted that JDI was offered a package deal consisting of both the Tools and the Intellectual Property, and the Intellectual Property was crucial to its ability to manufacture Spare Parts, the perception that JDI may have had that it could not acquire the Intellectual Property if it did not acquire the Tools (and therefore could not sell Spare Parts) did not matter. The test was an objective one rather than a question of JDI's subjective purposes. (See paragraphs [45] to [48].)

23. That was sufficient to dispose of the appeal but the FTT also commented briefly on the first test at paragraph [50], concluding that JDI was not acting as a taxable person because it used the UK Tools in an uncommercial way by leasing them to BHN without charging a lease rental, and (as concluded in relation to the second test) there was no objective link between the acquisition of the Tools and JDI's economic activity of selling Spare Parts.

The parties' submissions

Submissions for JDI

24. Mr Hill, for JDI, submitted that JDI was entitled to deduct input tax on the UK Tools since they had a direct and immediate link with its economic activity as a whole, and JDI was acting as a taxable person in acquiring them. Without the purchase of the Tools JDI could not have bought the Intellectual Property, and that was necessary or essential to carry out its taxable business. The FTT appeared to have accepted that the purpose of the restructuring was for the Tools and Intellectual Property to be in the same company. The Spare Parts business directly related to the Tools rather than any other equipment, and JDI needed to get the Tools into the market to ensure that there was a demand for Spare Parts.

25. Mr Hill relied on the CJEU decision in *Direktor na Direktsia 'Obzhalvane i danachno-osiguritelna praktika' – Sofia v 'Iberdrola Inmobiliaria Real Estate Investments' EOOD* (Case C-132/16) [2017] All ER (D) 114 ("*Iberdrola*"), which was decided after the FTT's decision was reached. Mr Hill submitted that *Iberdrola* was authority for a "but for" test of causation. The Court had rejected the view of Advocate General Kokott in that case that a particular "use" for the purposes of taxable transactions was necessary, and instead held that it was sufficient that the relevant inputs were "essential" or "necessary" for the taxable person to carry out its economic activities. The FTT had incorrectly focused on how the Tools were used rather than on this test. It was essential for JDI to own the Intellectual Property and it was necessary for JDI to buy the Tools if it wanted to own the Intellectual Property. *Iberdrola* also demonstrated that it did not matter that the recipient of the element provided for no consideration (here, BHN) was different from the recipient of the supplies made for consideration (the Operating Companies). The FTT had wrongly focussed on the fact that in *Sveda* and *Associated Newspapers* the free inducements had been provided to the taxpayer's own customers.

26. The FTT was also wrong to conclude that the existence of the package deal requiring JDI to buy the Tools as well as the Intellectual Property was a subjective rather than objective matter that should be ignored. The intention of a taxable person in acquiring goods and services is relevant, as confirmed by *Sveda* and also by *Odvolací finanní editelství v Pavlína Bastová* (Case C-432/15) ("*Bastova*"), which required account to be taken of the "exclusive reason" for the transaction. Here the exclusive reason to buy the Tools was to obtain the Intellectual Property, enabling JDI to sell Spare Parts. The costs of that business included the cost of purchasing the Tools. The relevance of intention was further supported by a decision of the Inner House of the Court of Session, *Revenue and Customs Commissioners v Frank A Smart & Son Ltd* [2017] CSIH 77, [2018] STC 806 ("*Smart*").

27. Standing back, there was no risk of private use of the Tools. There was no risk of untaxed final consumption. Refusing deduction treated JDI as a final consumer, which it was not, and risked double taxation because JDI could only recover the increased cost of the Tools resulting from the irrecoverable VAT through the price charged for Spare Parts, which themselves attracted VAT. The Tools and Spare Parts activities were not separate. Allowing the deduction ensured neutrality of taxation.

28. The test for whether a taxable person is acting "as such" raised similar issues. Although it was accepted that the leasing of the Tools was non-economic, in the sense that no rent was charged, JDI bought the Tools for the purposes of its economic activity of selling Spare Parts. There was no distinct activity in respect of the Tools.

Submissions for HMRC

29. Mr Jones, for HMRC, submitted that the FTT reached the right conclusion for the right reasons. It was important to bear in mind that the critical phrase in Article 17(2) of the Sixth Directive (now Article 168 of the PVD) is "used for the purposes of". The case law has framed this test both in terms of the "direct and immediate link" formulation and the "cost component" formulation (the former being that there must

be a direct and immediate link with a particular output transaction or transactions giving rise to entitlement to deduct or with the taxable person's economic activity as a whole, and the latter being that the right to deduct VAT presupposes that the expenditure incurred in acquiring the goods and services is a component of the cost of output transactions giving rise to the right to deduct or is part of general costs and as such components of the price of goods and services supplied by the taxable person: see for example paragraphs [27] and [28] in *Sveda*). A "but for" link is insufficient, and *Iberdrola* is not authority for such a proposition.

30. There was no direct and immediate link between the leasing and purchase of the Tools and the sale of Spare Parts, nor were the leasing and purchase components of the cost of supplies of Spare Parts. JDI did not need to acquire the Tools to supply Spare Parts. Whilst the Spare Parts business benefited from the decision to lease the Tools rather than leaving them unused, that was insufficient. The causal link was a weak one: in reality the market for Spare Parts would exist for so long as the Baker Hughes Group carried on activities requiring the Tools.

31. Instead, the Tools were used for the purposes of leasing them free of charge to BHN. It was common ground that this activity was a non-economic one (paragraph [39]), and the FTT also found at paragraph [50] that JDI was acting otherwise than as a taxable person in acquiring the Tools. In effect, and despite recording at paragraph [37] that it did not propose to determine whether two separate activities were carried on, the FTT found that JDI did carry on two activities, an economic one of selling Spare Parts and a non-economic one of leasing Tools free of charge. That was a finding of fact with which the Upper Tribunal was not entitled to interfere.

Discussion

32. The basis for the FTT decision was that JDI had failed to establish a direct and immediate link between its acquisition of the Tools and its economic activity of supplying Spare Parts. That was sufficient for the FTT to dispose of the appeal. A further appeal to the Upper Tribunal can be brought only on a point of law (s 11 Tribunals, Courts and Enforcement Act 2007), so it is necessary to consider whether the FTT made an error of law in reaching that conclusion.

Iberdrola

33. Mr Hill placed significant reliance on *Iberdrola*, so it is necessary to consider that case in some detail. Iberdrola had purchased land in a holiday village in Bulgaria in order to construct around 300 apartments. It entered into a contract with the local municipality to undertake the reconstruction of a waste-water pump station owned by the municipality, and incurred expenditure in procuring the works from a third party. The municipality continued to own the pump station and operated it following reconstruction, so it directly benefitted from the works. Following completion of the works, the buildings which Iberdrola planned to construct could be connected to the pump station. Connection would have been impossible without the works being implemented, because the existing sewer system was inadequate.

34. The CJEU interpreted the questions referred to it as asking whether Article 168(a) of the PVD (see paragraph 13 above) confers a right to deduct input VAT in respect of the construction or improvement of property owned by a third party (the municipality) when that third party enjoys the results free of charge and where those services are used both by the taxable person and by the third party in the context of their economic activity (paragraph [24] of the judgment).

35. The CJEU went on to describe the principles to apply in the following terms (case citations omitted):

> "26 The deduction system is intended to relieve the trader entirely of the burden of the VAT payable or paid in the course of all his economic activities. The common system of VAT consequently ensures neutrality of taxation of all economic activities, whatever their purpose or results, provided that they are themselves subject in principle to VAT…
>
> 27 It follows from Article 168 of Directive 2006/112 that, in so far as the taxable person, acting as such at the time when he acquires goods or receives services, uses those goods or services for the purposes of his taxed transactions, he is entitled to deduct the VAT paid or payable in respect of those goods or services …
>
> 28 In accordance with settled case-law, the existence of a direct and immediate link between a particular input transaction and a particular output transaction or transactions giving rise to the right to deduct is necessary, in principle, before the taxable person is entitled to deduct input VAT and in order to determine the extent of such entitlement. 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…
>
> 29 A taxable person also 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…
>
> 30 On the other hand, where goods or services acquired by a taxable person are used for purposes of transactions that are exempt or do not fall within the scope of VAT, no output tax can be collected or input tax deducted…
>
> 31 It is apparent from the case-law of the Court that, in the context of the direct-link test that is to be applied by the tax authorities and national courts, they should consider all the circumstances surrounding the transactions concerned and take account only of the transactions which are objectively linked to the taxable person's taxable activity. The existence of such a link must thus be assessed in the light of the objective content of the transaction in question…"

36. The CJEU noted at [33] that it would have been impossible to connect the buildings to the pump station without the reconstruction, that the reconstruction was therefore "essential" for completing the project and that "…consequently, in the absence of such reconstruction, Iberdrola would not be able to carry out its economic activity". These circumstances were likely to demonstrate the existence of a direct and immediate link, since it appeared that the service was supplied to allow the construction project to be carried out, and provided that such link was established (a matter for the referring court) the fact that the municipality also benefited would not justify a denial of the right to deduct (paragraphs [34] and [35]).

37. There was an important qualification, however. The CJEU went on to say as follows:

> "37 That being said, it is also for the referring court to examine whether that service was limited to that which was necessary to ensure the connection of those buildings to the pump station at issue in the main proceedings or whether that service went beyond that which was necessary for that purpose.
>
> 38 In the first situation, it would be necessary to recognise a right to deduct the input VAT levied on all the costs incurred for the reconstruction of the pump station since those costs can be regarded as having a direct and immediate link with the general costs connected with all the economic activities of the taxable person...
>
> 39 By contrast, if the reconstruction works relating to that pump station exceeded the needs created solely by the buildings constructed by Iberdrola, the existence of a direct and immediate link between that service and the taxed output transaction by Iberdrola, consisting of the construction of those buildings, would be partially broken and a right to deduct would thus have to be recognised in respect of Iberdrola only for the input VAT levied on the part of the costs incurred for the reconstruction of the pump station which was objectively necessary to allow Iberdrola to carry out its taxed transactions."

38. We do not agree with Mr Hill that *Iberdrola* is authority for a "but for" test of causation, based on whether the inputs were "necessary" or "essential", rather than one based on use. Article 17 of the Directive and Article 168 of the PVD both require the relevant goods or services to be "used" for the purposes of taxable (or taxed) transactions. This has been expressed both in terms of a "direct and immediate link" and in terms of a cost component of output transactions, and the concept of direct and immediate link has been treated as applying to general costs which are components of the price of goods or services supplied rather than being linked to a specific output, but the underlying requirement is one based on use. This is reflected in paragraph [27] of the judgment in *Iberdrola,* and is entirely consistent with previous case law including *Sveda*.

39. The CJEU does use the term "essential" at paragraph [33], but that is to describe the fact that it would have been physically impossible for Iberdrola to complete its apartments project without reconstructing the pump station. The objective link is very clear: Iberdrola would be "using" the inputs in making its own taxable supplies.

40. What is particularly telling, however, is the terms of the qualification the CJEU went on to describe, namely that there was a right to deduct only insofar as the costs were "necessary" to ensure the connection of the buildings constructed by Iberdrola to the pump station. If the costs went beyond that, then only those "objectively necessary" to allow Iberdrola to carry out its taxed transactions could be deducted.

41. In our view, this is inconsistent with a "but for" test. It is not apparent from the judgment of the Court whether Iberdrola was required to undertake the pump station works as a condition of its own building permit (although there is a hint at paragraph 2 of the Advocate General's Opinion that it may have been). However, in contemplating that the expenditure might exceed what was needed to connect only the buildings that Iberdrola planned to construct, it seems to us that the CJEU must have had in mind that Iberdrola might be under an obligation to undertake additional or more extensive works as a condition of being permitted to build, since there would be no other obvious reason why a commercial undertaking would incur such apparently unnecessary expenditure. In any event, there is no indication that the CJEU considered that the position would be any different whether Iberdrola was or was not under any legal requirement to undertake additional works in order to build the apartments, and given the significance of the point we think it inconceivable that the CJEU would not have covered the point expressly if it considered that it did make a difference. Any requirement to undertake additional works as a condition of being permitted to build the apartments would clearly meet a "but for" test. In our view, the only rational conclusion to draw is that the CJEU was saying that a "but for" test is not sufficient. The statutory test is one of use, and the CJEU made clear that this test was satisfied only to the extent that the reconstruction allowed Iberdrola's own properties to be connected to the pump station, and thereby operate as viable dwellings.

42. Mr Hill attempted to meet this point by accepting that a condition which was not directly related to the taxpayer's activities would not be sufficient to meet the "but for" test. In that regard, he pointed to the close relationship between the Spare Parts and the Tools (with the former being designed for the latter). We do not accept this approach. The test to apply is one of use, as described in *Iberdrola* at paragraphs [26] to [31].

43. Mr Hill also referred to the Court of Appeal decision in *Revenue and Customs Commissioners v University of Cambridge* [2018] EWCA Civ 568 ("*University of Cambridge*") where Patten LJ, giving the judgment of the Court, referred at paragraph [45] to the CJEU in *Iberdrola* as having applied a "but-for test of causation" to the works. Whilst no doubt a convenient summary to apply in the context in which it was being considered, there was no reference to or consideration of the important qualification placed on recovery by the CJEU. That comment followed a detailed consideration of the other relevant case law, including *Sveda*, and Patten LJ regarded *Iberdrola* as expressing the same reasoning as *Sveda*: see at paragraph [44]. The significance of *Iberdrola*, as explained by the Court of Appeal, was only to determine that the fact that the services were provided free by the taxpayer to a third party and not to its customers did not in itself mean that the link was insufficient to the taxpayer's taxable activity. We do not consider that Patten LJ was intending to depart,

on the basis of *Iberdrola*, from the Court of Appeal decisions in *Customs & Excise Commissioners v Southern Primary Housing Association Ltd* [2003] EWCA Civ 1662, [2004] STC 209, and *Dial-a-Phone v Customs & Excise Commissioners* [2004] EWCA Civ 603, [2004] STC 987, which expressly held that 'but for' causation was not the relevant test (see the latter case at paragraphs [34]-[36]). In these circumstances, we do not think that the comment carries the weight placed on it by Mr Hill.

Relevance of subjective intention

44. Mr Hill's second principal criticism of the FTT's reasoning on the input tax issue was that it wrongly ignored the existence of the package deal requiring JDI to buy the Tools and the Intellectual Property, on the basis that it was a subjective matter. Mr Hill relied in particular on *Bastova* and *Smart* but noted that *Sveda* also refers to intention or intended use.

45. The paragraph of the FTT decision particularly criticised in this respect was paragraph [48] which states:

> "[48] Mr Smith explained in his witness statement the benefits that the Baker Hughes Group hoped would come from the Tools being owned by a single entity. The evident aim was to make efficiency and cost savings and that makes sense viewed objectively as, if all Tools were held by a single company, the need for a number of companies to have their own systems for dealing with, storing and maintaining Tools would be reduced. However, Mr Smith did not suggest that JDI's business of selling Spare Parts would be enhanced by all Tools being held by a single entity and nor is it objectively obvious why it should be enhanced. In those circumstances, I do not consider it matters that JDI's subjective purposes for acquiring the Tools might have included a perception that, if it did not acquire the Tools, it could not acquire the Intellectual Property and so could not sell Spare Parts. The jurisprudence of the CJEU, including *Sveda*, makes it clear that any 'direct and immediate link' must be established by means of objective evidence. For the reasons I have given, I do not consider that the objective evidence demonstrates the existence of such a link. I therefore reject Mr Hill's second argument…"

46. We agree with Mr Hill that intention is not irrelevant in determining whether goods or services supplied are used for taxed transactions, but it is clear from the cases that this must be established using objective evidence. There must be an objective link to the taxable activity. These cases include *Iberdrola*: see paragraph [31], cited above. The same point is referred to in *Sveda*, including at paragraph [29] and in the conclusion at [37], where the Court makes it clear that the question of a direct and immediate link is a matter for the referring court to determine on the basis of objective evidence. In *X v Staatssecretaris van Financiën* (Case C-334/10) [2012] STC 2288 ("*X*"), the CJEU stated at [22] and [23] that the question whether a taxable person acquires goods for the purposes of his economic activity, rather than with the intention of using them for private purposes, must be determined using objective evidence, including the nature of the goods concerned and the period between their

acquisition and use. In addition, there are a number of references in Patten LJ's judgment in *University of Cambridge* to the requirement for the link between inputs and taxable transactions to be established by objective means: see paragraph [20], the commentary on *Sveda* at [41], the rejection of a purpose test at [42], and the commentary on *Iberdrola* at [44].

47. The point is also considered in the Court of Appeal decision in *Associated Newspapers*, around a year before the *University of Cambridge* case. The background was that Patten LJ (with whose judgment Jackson and Black LJJ agreed) considered that earlier European case law, in particular *BLP Group plc v Customs and Excise Commissioners* (Case C-4/94) [1995] STC 424, illustrated an unwillingness to look beyond a direct and immediate link to a particular supply (there an exempt sale of shares) and take account of the broader effect of a transaction. After considering *Sveda* Patten LJ said the following (emphasis added):

> "47. It seems to me that the CJEU has clearly moved away in these recent decisions from any disregard of the ultimate economic purpose of the relevant expenditure in considering whether it should be treated as linked to the taxpayer's wider economic activities. *This is not a question of subjective intent but requires an objective analysis in terms of the taxpayer's identifiable economic activities of why the input supplies were acquired*. Although there must, I think, be some evidence that the cost of the input supplies was passed on as part of the cost of the supplies which the taxable person subsequently makes, the absorption of those costs as part of the expenditure of running the business is not to be ignored merely because they also facilitated the making of supplies which in themselves were either exempt or outside the scope of the PVD.
>
> 48. So in the present case the cost to ANL of acquiring the vouchers can be treated in purely causal terms as attributable to the onward supply of the vouchers. Without the purchase of the vouchers their free distribution could not have taken place. However, in economic terms, the cost of purchasing the vouchers was also part of ANL's overall expenditure in the production and sale of its newspapers which the vouchers were intended to promote. The fact that the vouchers were provided free to buyers of the newspapers merely serves to confirm that they were cost components of the business rather than the onward supply of the vouchers."

48. It is quite clear from this that the test is not one of subjective intention, but rather an objective one, requiring consideration of the taxpayer's economic activities to determine why the relevant input was acquired, and whether in economic terms the input can properly be regarded as a cost of taxable supplies. We do not consider that the FTT made an error in this respect. Paragraph [48] of the FTT decision refers clearly to the "evident aim…viewed objectively" of ensuring that the Tools were owned by a single entity, but goes on to say that it was not apparent how this would enhance the Spare Parts business.

49. Furthermore, we think that Mr Hill's criticism of the FTT decision is misplaced for another reason. In the context of input tax deduction, the question of intention can

only relate to the use or intended use of the goods or services. Judge Richards' comments about subjective purpose were not directly about what JDI intended to *use* the Tools for, but about what was the immediate motivation to *buy* them, which on the facts of this case was not the same thing. We agree with Mr Jones that the fact that the Intellectual Property may have only been available as a package with the Tools demonstrates, at most, that JDI would not have been able to carry on its Spare Parts business "but for" the acquisition of the Tools. It was simply a precondition to economic activity. As already discussed, a "but for" test is insufficient.

50. Turning to the cases relied on by Mr Hill, one of the questions in *Bastova* was whether a racehorse breeder and owner, who bred and trained his own horses as well as those of other owners, had a right to deduct input tax in respect of costs relating to the preparation for and participation in racing by his own horses. After making general comments about the concept of a direct and immediate link, including where general costs are treated as having a direct and immediate link with the overall economic activity, the CJEU said this:

> "45 Moreover, the fact that the existence of the direct and immediate link between a supply of services and the overall taxable economic activity must be determined in the light of the objective content of that supply of services does not preclude the exclusive reason for the transaction at issue from also being taken into account, since that reason must be considered as a criterion for determining the objective content. Where it is clear that a transaction has not been performed for the purposes of the taxable activities of a taxable person, that transaction cannot be regarded as having a direct and immediate link with those activities within the meaning of the Court's case-law, even if that transaction would, in the light of its objective content, be subject to VAT…
>
> 46 In the context of the assessment of the criterion of a direct and immediate link with the taxable person's overall economic activity, which the tax authorities and national courts must carry out, they should consider all the circumstances surrounding the transactions at issue…and take account only of the transactions which are objectively linked to the taxable person's taxable activity…"

51. The CJEU accepted that breeding and training the owner's own horses might have a link to economic activity, but made it clear that this was insufficient: there must be a direct and immediate link between the cost and the overall economic activity. To determine whether that link existed, the referring court needed to ascertain whether the horses were intended for sale or whether their participation in races was "from an objective point of view" a means of promoting the economic activity of operating stables. If that was the case there would be a direct and immediate link. In contrast, more indirect links, such as enabling the owner to improve and develop training methods and care given to the horses, and therefore the services provided to other owners, were insufficient. Any intention to promote the private interests of the owner would also mean that there was no direct and immediate link. (See paragraphs [48] to [51].)

52. Whilst the CJEU did refer to the "exclusive reason" for the transaction at paragraph [45], we do not consider that this supports JDI's case. It is clear that the CJEU was not displacing the requirement for objective evidence, but rather stating that notwithstanding that evidence, the actual reason for the transaction being undertaken (for example, promotion of private interests) might preclude recovery, on the basis that there would not then be a direct and immediate link with the economic activity. In other words, the goods and services would not be used for the purposes of taxed transactions. This is supported by the references in paragraph [45] to the exclusive reason "also" being taken into account, and to a non-taxable purpose preventing a direct and immediate link "even if" the objective content would otherwise mean that the transaction was subject to VAT.

53. *Smart* is a recent decision of the Inner House of the Court of Session, which post-dates both the FTT decision and *Iberdrola*. It relates to the deductibility of VAT incurred on the purchase of Single Farm Payment Entitlement ("SFPE") units issued by the Scottish government under the EU Single Farm Payment ("SFP") subsidy scheme. The question was whether the units were services used or to be used for the purposes of the taxpayer's taxable supplies. HMRC contended that on an objective analysis the inputs had a direct and immediate link with the receipt of SFP income, which was not an economic activity, whereas the taxpayer claimed that the units were purchased to raise capital to meet the requirements of its farming business and the future development of the business through the construction and operation of a wind farm.

54. The Inner House concluded that the units were acquired to finance the development and diversification of the business, and should be considered as part of its general overheads. The SFPE units were an investment and the SFP payments were simply a consequence of the acquisition of the units rather than a separate activity. Lord Drummond Young, delivering the opinion of the court, stated at paragraph [28]:

> "HMRC further contends that the intention of the taxpayer as to how the SFPs would be used for the benefit of the business is irrelevant. We have difficulty in understanding how intention could be irrelevant; the intention of the directors of a company is an objective fact, and it appears to us to be a factor that may properly be taken into account. If it is manifested in corporate documents, as occurred in the present case, ascertaining the state of mind should not be difficult. In this connection, as the judge of the Upper Tribunal points out at paragraph 20 of his opinion, section 24 of the Value Added Tax Act 1994 refers to goods and services "used or to be used" for the purposes of the taxable person's business. That clearly points to what may happen in future, and in that context the intention of the taxable person, or the directing mind of the taxable person, must be relevant. In any event, it is important to have regard to two further matters: the funds received by way of SFPs were paid into the company's bank account, and the directors' fiduciary duties required that those funds should be applied for the purposes of the company's business. This seems to us to be central to the analysis of the case. Finally, the findings of the First-tier Tribunal are clearly contrary to the argument for HMRC. As the judge of the Upper Tribunal indicates (paragraph 20) the First-tier Tribunal

> held (paragraph 42) on the basis of its primary findings in fact that the financing opportunity obtained through purchasing the SFPE units did not form a distinct business activity but was rather a wholly integrated feature of the farming enterprise. Like the judge of the Upper Tribunal, we consider that the findings of primary fact fully justify such a conclusion. For these reasons we reject HMRC's argument."

55. Clearly the Inner House did consider that intention was relevant, but as in *Bastova* that intention related to the use to which the goods or services would be put. Since the taxpayer had not yet made use of the units (or income from them) for the purposes of its farming business it was clearly relevant to consider evidence of intended future use. The acquisition of the units and receipt of income from them was a financing or investment transaction rather than amounting to the inputs being used. However, as is clear from paragraph [28] the court also relied on additional matters which provided further objective support for the company's position, namely the duty to use the SFPs receipts for the purposes of its business and the finding of fact that the acquisition of the units was integrated into the farming business, rather than being a separate business activity: in essence there was no use identified for the units other than the farming business.

56. In contrast, this is not a case where there is any room for doubt about the use to which the Tools were put by JDI. They were used by being leased to BHN, under a lease that gave JDI very limited control. JDI's perception that it needed to acquire the Tools to carry on the activity of selling Spare Parts was not an intention about how the Tools would be used by it in any sense, but an understanding that it would not be given the opportunity to carry on an economic activity unless it acquired them. Once it had acquired the Tools, it had no intention or objective in respect of them beyond leasing them to BHN for no consideration, under a Headlease that provided virtually no control over how the Tools were actually exploited, and in circumstances where the FTT had found that the market for Spare Parts did not depend on the precise legal entity that owned the Tools (paragraph [44(1)]). This is different to *Bastova* and *Smart*, where the dispute was over how the inputs would be used: whether for the purposes of selling horses or promoting the stable operation (in the case of *Bastova*), or for the purposes of the farming business (in the case of *Smart*), or instead for non-taxable purposes.

Conclusion that there was no direct and immediate link

57. In our judgment, the FTT's reasoning and conclusion that there was no direct and immediate link between the acquisition of the UK Tools and the sale of the Spare Parts, despite JDI being offered a package deal, discloses no error of law. The FTT correctly noted at [35] that the mere fact that immediate use does not involve receipt of consideration is not a bar to recovery. The FTT identified at [39] that, in order to succeed, JDI had to demonstrate a direct and immediate link between the acquisition of the UK Tools and JDI's activity of selling Spare Parts. We do not understand that to be disputed by Mr Hill, and in our view it must be correct. The leasing of the Tools was not by itself a taxable transaction, since no consideration was charged.

58. The FTT considered *Sveda* and *Associated Newspapers*, identifying that in *Sveda* the taxpayer's customers were allowed to use the path in the hope that they would purchase refreshments or souvenirs, and in *Associated Newspapers* that it was clear that the vouchers were part of a business promotion scheme designed to increase taxable sales of newspapers and advertising. The facts largely spoke for themselves. In contrast, the FTT found that that was not the case with JDI (paragraphs [41] and [42]). The FTT based its conclusion that a direct and immediate link was not established on the fact that on an objective basis there was simply no link between the acquisition of the Tools and the market for Spare Parts (see in particular paragraph [44]). That market was driven by the existence and use of the Tools rather than by their ownership, and any control JDI had through the Headlease was weak. JDI's witness accepted in cross examination that the market for Spare Parts would be the same whether JDI or anyone else owned the Tools. In those circumstances, whilst it is quite clear that the Tools were immediately "used" for leasing rent free to BHN, in our view the FTT was entitled to conclude, and indeed correct to conclude, that there was an insufficient basis to determine that they could also properly be regarded as used for the purposes of JDI's supplies of Spare Parts.

59. One of the bases on which Mr Hill criticised the FTT's reasoning was the fact that the FTT noted at paragraph [42] that in both *Sveda* and *Associated Newspapers* the taxpayers were offering free inducements to their own customers, whereas in this case it was BHN that received the free hire of the Tools. As Mr Hill pointed out, *Iberdrola* demonstrates that it is not necessarily a bar to recovery that a third party (there the municipality) receives a benefit. However, we do not think that the point was central to the FTT's reasoning, which was correctly based on the existence and extent of any link between the acquisition of the Tools and JDI's taxable transactions. The FTT had also correctly noted at [33] that a direct and immediate link can be purely economic, and not based on a particular legal or other relationship.

Taxable person "acting as such"

60. Given the FTT's conclusion on the absence of a direct and immediate link, it was not necessary for the FTT to comment on the first test considered in *Sveda*, namely that the taxable person must be "acting as such". Similarly, it is not strictly necessary for us to consider this issue, but since the FTT commented on it and both parties made submissions to us on the point it is appropriate for us to make some observations, particularly in relation to Mr Jones' argument that the FTT made a finding of fact which may only be interfered with on *Edwards v Bairstow* grounds.

61. At paragraph [37] in the FTT decision, Judge Richards considered an argument put forward by Mr Jones based on the High Court decision in *University of Southampton v Revenue and Customs Commissioners* [2006] EWHC 528 (Ch), [2006] STC 1389. That case related to a claim to deduct input tax relating to publicly funded research ("PFR") that did not involve taxable supplies. The question was whether the input tax was not recoverable at all because the supplies were used for the purposes of PFR, or whether the input tax was in principle recoverable as an overhead of the University's economic activities. The VAT Tribunal denied recovery on the basis that PFR was a "completely distinct" activity, carried out in its own right rather than to

support the University's other activities. This conclusion was the subject of an appeal to the High Court, where the University argued that it was inconsistent with the Tribunal's findings of primary fact and therefore that it could be challenged on *Edwards v Bairstow* principles. There appears to have been no suggestion that the finding that the PFR activity was distinct could have been challenged on other grounds, so the clear implication is that the conclusion that it was distinct was a finding of fact.

62. Although no doubt invited to do so by Mr Jones, Judge Richards expressly declined to make a finding of fact that JDI was conducting two separate activities. Despite stating this at paragraph [37] in clear terms, Mr Jones submitted that the FTT must in fact have made a finding to that effect. He referred to paragraph [39] which states that the activity of leasing the UK Tools was not an economic activity, whereas JDI's activity of selling Spare Parts was, as well as to paragraph [50] which contains the FTT's brief discussion of the "acting as such" issue and concludes that JDI was not acting as a taxable person when it acquired the UK Tools.

63. We do not accept Mr Jones' submission that the FTT made a finding of fact that there were two separate activities. The finding considered in the *University of Southampton* case was clearly a finding of fact, namely that the PFR and other activities were completely distinct. That finding did not depend on any legal test, although in that case it naturally led to the conclusion that the University's claim failed because the University then had no prospect of arguing that it was acting as a taxable person in conducting the PFR activities, because they were separate from its economic activities. In contrast, in this case the FTT did not find that the Tools and Spare Parts activities were distinct or separate as a matter of fact, but instead commented that leasing the Tools for no consideration cannot itself be described as an economic activity, whereas the Spare Parts business patently was economic in nature. This is not a comment that the activities are separate in fact, but simply a comment that the legal concept of economic activity does not extend to the provision of goods and services for no consideration.

64. *Sveda* provides a clear illustration of this. Constructing the path and making it available for free was not by itself an economic activity, but Sveda was acting as a taxable person because it intended to use the goods acquired for its taxable activities. What it did in relation to the path was not a distinct activity. The same applies to the reconstruction of the pump station in *Iberdrola*, and the point is also picked up in *University of Southampton*. At paragraph [80] Warren J commented that the Tribunal were aware that, viewed in isolation, the PFR activity would not be a VAT business, but did not base their conclusions simply on looking at it in isolation. Similarly, in *Associated Newspapers* Patten LJ commented at [51] that there was no dispute that the issue of the vouchers was not in itself an economic activity.

65. We also agree with Mr Hill that it is clear from the cases that the two questions, the input tax question (the existence of a direct and immediate link, or whether the inputs were cost components of output transactions) and whether the taxable person is acting as such, raise very similar issues. *Sveda* refers to both questions as requiring consideration of the taxpayer's intentions, supported by objective evidence (see

paragraph [20]). This is also confirmed by the *X* case referred to at paragraph 46 above, where the CJEU effectively amalgamated the tests by referring at [19] to the taxable person's intention, confirmed by objective evidence, to use an item or service for business purposes as making it "possible to determine whether, at the time when he carries out the input transaction, the taxable person is acting as such and must therefore be entitled to deduct the VAT payable or paid in respect of that item or services". It would be remarkable if the input tax question was accepted as a mixed question of fact and law (which it clearly is: see for example *Dial-a-Phone Ltd v Customs and Excise Commissioners* at [31]) and the "acting as such" test was an entirely factual question. The fact that the two questions raised similar issues is recognised in *University of Southampton* case itself: see paragraph [96].

66. We recognise that *Sveda* refers at paragraph [21] to the question of whether a taxable person acts as such for the purposes of an economic activity as being a question of fact for the referring court that must be assessed in the light of all the circumstances. However, in our view, this does not mean that it is purely a question of fact. The immediately preceding paragraph describes the legal test that must be applied, namely that a person must be regarded as a taxable person where they incur expenditure with the intention, confirmed by objective evidence, of engaging in economic activity within the meaning of Article 9(1) of the PVD (previously Article 4 of the Sixth Directive). Clearly, it is a matter for the referring court to determine whether the evidence supports such a conclusion. There is a similar statement at paragraph [37] in *Sveda* that the existence or otherwise of a direct and immediate link is a matter for the referring court to determine on the basis of objective evidence.

67. The FTT concluded that whilst the Tools were plainly designed for commercial exploitation, JDI's decision to lease them without charge, in circumstances where the FTT found no objective link between the acquisition of the UK Tools and JDI's taxable activities, meant that it was not acting as a taxable person when it acquired them. In our judgment, this was a conclusion that the FTT was entitled to reach, and indeed bound to reach given its findings on the absence of a link.

Disposition

68. For the reasons set out above the appeal is dismissed.

MR JUSTICE ROTH

JUDGE SARAH FALK

RELEASE DATE: 10 JULY 2018