

## Partial exemption problems

### (Lecture B1159 - 22.09 minutes)

The lecture reviews a number of historical precedent cases on partial exemption and business/non-business activities to set out the principles that have been applied in three recent cases:

- BLP Group plc v C & E Commrs, ECJ Case C-4/94 [1995]: if input tax was directly and immediately linked to an exempt transaction (the sale of shares in a subsidiary company) it was blocked, and it was not permissible to recover it based on an indirect link to future taxable activities of the entity as a whole.
- Kretztechnik AG v Finanzamt Linz, ECJ Case C-465/03 [2005]: input tax incurred on the issue of new shares was not linked to an exempt transaction, because the issue of shares does not involve making a supply; the input tax was therefore linked to the activities of the business as a whole, and as the business was wholly taxable, it was wholly recoverable.
- HMRC v Mayflower Theatre Trust Ltd, CA [2007]: the link between the cost of putting on a theatrical production and the sale of refreshments was a mere 'but for' link that did not justify recovery under the rules of partial exemption – the cost of the production was not a cost component of the sale of ice cream. However, there was a link between the production cost and the sale of programmes, because the contract with the production company included the right to print photographs of the production in the programmes.
- Sveda UAB v Valstybin mokesi inspekcija prie Lietuvos Respublikos finans ministerijos, CJEU Case C-126/14 [2015]: the cost of building a tourist attraction was sufficiently linked to taxable supplies to be made by the trader to justify recovery, even though it would not charge for admission for the first five years and even though the cost was subsidised by a grant.
- Direktor na Direktsia Obzhalvane i danachno-osiguritelna praktika Sofia v Iberdrola Inmobiliaria Real Estate Investments EOOD, CJEU Case C-132/16 [2017]: the cost of upgrading a local authority's infrastructure, without charging the local authority for the work, was directly linked to the future taxable supplies of the trader because it was essential to those supplies.
- HMRC v Volkswagen Financial Services (UK) Ltd (No 3), CJEU C-153/17 [2018]: a company that supplied HP finance for cars was entitled to some recovery of input tax on overheads, because it made taxable supplies of the cars, even though it sold them on at cost and its overheads were therefore entirely financed by the exempt finance charges that it levied.

The three recent cases are described in detail below:

- Royal Opera House, a FTT decision that appears to go against the Mayflower judgment described above and may be appealed by HMRC;
- Cambridge University, a CJEU decision on the link (or absence of a link) between management of an endowment fund and taxable activities of a charitable institution;
- Glasgow School of Arts, an illustration of possible VAT planning in the area of partial exemption, in this case ineffective because it was not implemented early enough in a building project.

#### *Production costs*

HMRC refused a claim by the Royal Opera House to recover £530,000 of tax associated with the costs of staging productions between June 2011 and August 2012. It was common ground that the production costs were residual because of direct and immediate links to some taxable supplies that the ROH made (e.g. programme sales and production specific commercial sponsorship), while the ticket sales were exempt. HMRC considered that the standard method override significantly reduced the amount of recoverable input tax.

Before the hearing, ROH conceded that there was no direct link between the costs and third party commercial income, licensing income and service recharges, and sales of CDs etc. of non-ROH productions; while HMRC conceded that there was a direct link with backstage tours. What remained at issue were the following taxable supplies:

- (1) Catering income (bars and restaurants);
- (2) Shop income;
- (3) Commercial venue hire;
- (4) Production work for other companies; and
- (5) Ice cream sales.

Judge John Brooks listed a large number of precedent cases to which he was directed by counsel, but he noted from the Mayflower judgment of Carnwath LJ that the principles were well established:

(i) Input tax is directly attributable to a given output if it has a “direct and immediate link” with that 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; or whether the input is “essential” to the particular 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.

He added two more principles, one from College of Estate Management, and one from the A-G's opinion in Abbey National:

(vi) It may be necessary to determine whether, for tax purposes, a number of supplies are to be treated as elements in some over-arching single supply. If so, that supply should not be artificially split;

(vii) A transaction which is exempt from VAT will "break the chain" of attribution.

The judge examined the way in which the "direct and immediate link" test had been applied in a long string of cases, including Mayflower, Dial-a-Phone, Lok'n'Store, Roald Dahl Museum and Story Centre, Chester Zoo, Sveda and Associated Newspapers. The most recent cases cited were the Cambridge University case, where the CA has referred questions to the CJEU, and the CJEU decision in VW Financial Services. After quoting extensively from these precedents, the judge turned to the facts of the present case.

The production costs were those specific to each production, and not the costs of the ROH permanent staff or overheads. They included the fees for guest performers and conductors, creative teams, music copyright costs where relevant, the cost of sets, props, costumes, transportation, extras and actors. The costs varied considerably from one production to another, depending on the scale of the show and on whether it was an original production or a revival.

The essential argument for ROH was that the commercial and economic reality was that it could not incur production costs on the scale it did without those costs generating a level of income from the disputed sources. There was a "virtuous circle" that enabled the business to operate. HMRC dismissed this as the kind of "but for" link that was referred to in Mayflower Theatre Trust.

The judge listed a further ten points to apply in reaching a decision. Key among these were the need for an objective, fact-specific analysis of the extent of the link between the inputs and output supplies; a chain transaction that was exempt would "break the link" between inputs and outputs, but if there were separate chains linking to exempt and taxable outputs, there would be no break.

The judge considered that the link between the catering income and the production costs was similar to that between sales of ice cream and production costs in Mayflower. However, he was mindful of the more recent case law, in particular Sveda and Associated Newspapers, in which the question was whether there was a "necessary economic link between the initial expenditure and the economic activities which follow". The productions were central to everything that ROH did: they brought the customers into the bars and restaurants. This was, according to the judge, more than a mere "but for" link. The production costs were essential to the catering supplies; objectively, the purpose was not merely to sell tickets, but to enable ROH to maintain its catering income. The judge noted that Patten LJ had appeared to come to a similar conclusion when commenting on Mayflower in the Associated Newspapers decision; and this extended to the sale of ice cream as well as catering.

The same could not be said of the shop income, apart from sales of recordings of ROH productions. Similarly, venue hire was only to be taken into account where it specifically related to a production. For example, the Wimbledon Champions' Gala Dinner of 2014 was not sufficiently linked to any production. Production work for other companies was also not related to the costs of ROH productions.

The appeal was allowed in part; the financial effect of recalculating the standard method override, taking into account only the "linked" revenues, is not set out in the decision.

*First-Tier Tribunal (TC07157): Royal Opera House Covent Garden Foundation*

*Investment management costs*

The University of Cambridge has an endowment fund in which it invests donations. It pays professional fees to managers to look after this money, and the income and capital growth on the investments are used to support the various activities of the university, amounting to some 6% of its operational expenditure. As a charity, the university has activities that are business and non-business, and the business activities are taxable (mainly commercial research, sales of publications, consultancy and hire of facilities) and exempt (education).

The university generally claimed input tax in accordance with the 'CVCP guidelines' agreed between HMRC and higher education institutions. These enabled it to avoid preparation of detailed partial exemption calculations. For some years it did not include the investment management costs as residual input tax in the CVCP workings. It made a claim in 2002 which was refused and not pursued, but then claimed again in March 2009 following Fleming. The amount claimed was £182,500.

HMRC argued that the investment activity should be regarded as a 'free-standing activity' and therefore 'a supply made not by a taxable person acting as such', in line with the decisions in NSPCC and Wellcome Trust. Overheads relating to a non-economic activity undertaken for the purpose of an economic activity should not be regarded as recoverable.

The FTT (TC02836) did not agree. In line with the decision in Kretztechnik, something that did not involve the taxable person making a supply – whether the issue of shares, or in this case the receipt of dividends – should be related to the activities of the entity as a whole. As the endowment fund financed all the activities of the university, the management fees were residual, and the input tax was partly recoverable.

The FTT decision reviewed each of the major precedents in turn and comments on the reasons for following or not following them. In particular, HMRC's reliance on BLP Group was rejected: in that case, the sale of shares was held to constitute an economic activity, whereas the university was not engaged in such activity in relation to its investments.

HMRC appealed to the Upper Tribunal (Mr Justice Simon and Judge Sinfield, 2015). Their counsel's argument was summarised as follows in the decision:

*In order to be regarded as overheads, the costs incurred in acquiring the input transactions must be cost components (in the sense of being incorporated in the price) of all the taxable person's economic activities.*

*Putting it another way, the input transactions must 'burden' the cost of the taxable person's economic activity as a whole. Mr Singh contended that the costs of F&CM's investment management services do not burden the cost of all of the University's economic activities. He submitted that F&CM generates investment income from the Fund and that income subsidises the University's economic activities, thereby reducing the cost to the University of making supplies of education, research, catering, bar sales and conferencing services. He submitted that, in principle, the costs of generating investment income from the Fund do not have a direct and immediate link with and cannot be cost components of the price (or burden the cost) of the University's economic activity as a whole.*

*Mr Singh submitted that the correct analysis was that the costs of the investment management services are cost components of the price of the University's disposals of its investments for consideration and are thus directly and immediately linked with those disposals. He further contended that it is not permissible to 'look through' the disposals of investments for consideration in order to attempt to attribute the costs of the investment management services to the University's economic activity as a whole.*

By contrast, the taxpayer's counsel put forward a simple question based on Kretztechnik: for what purpose is the outside the scope activity carried out? He submitted that, in the present case, the answer was straightforward: the investment activity is not carried on for its own sake, but for the benefit of all the University's activities.

The Upper Tribunal reviewed BLP Group, Abbey National and Kretztechnik for authority on the treatment of overheads. The principle of BLP Group was that an exempt supply to which costs were directly attributable "broke the chain" between overheads and taxable activities of the business as a whole. Here, there was no such chain-breaking event, because the sale of investments was outside the scope investment activity rather than exempt economic activity.

The judges also considered Securenta and AB SKF for VAT on costs relating to investment activities and the sale of shares. The costs of the investment activity did not "burden the investment activity in the sense that fees were incorporated into the price of investments that were sold". According to AB SKF, then, they could be overheads of the business as a whole. HMRC's counsel tried to find a distinction between the raising of capital and the generation of income, but the judges considered that this only arose in the CJEU cases because of their facts, not as a principle of law.

The FTT had found that the investment activity was not carried out for its own sake but for the benefit of the University's economic activity in general. It followed that the costs associated with that investment activity were part of the University's overheads. HMRC's appeal was dismissed.

HMRC appealed again to the Court of Appeal. Patten LJ set out the leading judgment. He reviewed the facts, the law and the precedents. He summarised the issue as the need to choose between two different ways of looking at the attribution of inputs to taxable outputs: one, favoured by HMRC, that required a direct transactional link to a particular taxable output, and ruled out deduction for something that was directly linked to a non-taxable investment "activity"; and the other, which took a more general view of inputs that were associated with the business activity as a whole, and did not regard the investment transactions as an end in themselves.

He discussed the different lines of reasoning as set out in a number of CJEU cases, including BLP, Midland Bank and Abbey National. In the last, the CJEU had not ruled out deduction of VAT incurred in relation to the transfer of a business as a going concern, even though the law regarded it as a “non-supply”. That implied, even though it did not spell out, a distinction between something that was directly attributable to making exempt supplies (as in BLP) and something that was attributable to activities outside the scope of VAT. The Court’s decision in AB SKF also supported a distinction between the “magnetism and chain-breaking effect” of exempt outputs on the one hand and non-taxable activities on the other.

The judge accepted HMRC’s submission that a finding of a direct link to such a supply will render the input tax irrecoverable just as in the case of an exempt output supply. However, he considered that the appropriate question was whether one can link the expenditure to the ultimate economic activity by treating it as a cost component of a specific taxable supply or as an overhead of the business, i.e. are the costs incorporated in the cost of the taxpayer’s economic activities.

Finally, he noted the *Iberdrola* decision, and the fact that the CJEU had overruled the A-G’s view that the input tax incurred on a benefit provided to someone else without charge should be irrecoverable. He described the decision as the application of a “but-for test of causation to the works themselves”.

The university’s counsel sought to rely on the CA judgment in *Associated Newspapers*, which he contended related to a similar question. However, the judge said that in that case it was difficult to treat the purchase of an incentive to buy the newspapers as anything but part of the promotion of the taxpayer’s business. In this case he considered that the link in transactional terms was more remote and that the decisions in cases like *Kretztechnik* may have depended on a difference in tax treatment between exempt and non-taxable supplies which later CJEU decisions appear no longer to follow. There was some force in HMRC’s comparison with the *Wellcome Trust* case, in which the VAT on the costs of selling a large investment holding was held to be wholly consumed in the selling operation, rather than being capable of attribution to wider economic purposes of the charity concerned.

Overall, the law was not *acte clair*, and the Court of Appeal decided it was appropriate to make a reference to the CJEU. The questions referred were as follows:

*(1) Is any distinction to be made between exempt and non-taxable transactions for the purpose of deciding whether VAT incurred for the purposes of such transactions is deductible?*

*(2) Where management fees are incurred only in relation to a non-taxable investment activity, is it nonetheless possible to make the necessary link between those costs and the economic activities which are subsidised with the investment income which is produced as a result of the investments, so as to permit VAT deduction by reference to the nature and extent of downstream economic activity which carries an entitlement to deduct VAT? To what extent is it relevant to consider the purpose to which the income generated will be put?*

*(3) Is any distinction to be drawn between VAT that is incurred for the purposes of providing capitalisation for a business and VAT that produces its own income stream, distinct from any income stream derived from downstream economic activity?*

The CJEU gave a relatively brief answer to the question. The judgment notes that it is possible for VAT incurred in relation to a non-business activity to be linked to the activities of a business as a whole (as in *Kretztechnik*); however, the key paragraph states:

*"In the present case, it is apparent from the documents before the Court that, first, costs relating to the management of donations and endowments invested in the fund concerned are not incorporated into the price of a particular output transaction. Second, as it is apparent from the documents before the Court that (i) the University of Cambridge is a not-for-profit educational establishment and (ii) the costs at issue are incurred in order to generate resources that are used to finance all of that university's output transactions, thus allowing the price of the goods and services provided by the latter to be reduced, those costs cannot be considered to be components of those prices and, consequently, do not form part of that university's overheads. In any event, as there is no direct and immediate link in the present case either between those costs and a particular output transaction or between those costs and the activities of the University of Cambridge as a whole, the VAT relating to those costs is not deductible."*

The answer to the question is very specific to the facts of the case (relating to management of investment funds and use of the money to subsidise operations), but it seems likely that HMRC will see this as a significant victory in showing that a link between costs and taxable outputs has to be more specific than some people have argued since *Sveda* and *Iberdrola*.

*CJEU (Case C-316/18): HMRC v Chancellor, Master and Scholars of the University of Cambridge*

*One building or two?*

TC06506 was concerned with a repayment return for 01/16 submitted by Glasgow School of Arts (GSA) claiming £405,301, and a Form 652 submitted at the same time applying for £65,778 in respect of costs of a building project. HMRC rejected both claims and replaced them with an assessment for £96,525.

GSA had carried out construction works at its Garnethill campus. There was a difference of opinion as to whether there were two buildings involved, the Reid Building and the Assembly Building; to start with, GSA had referred only to the Reid Building, but later it argued that there were two buildings, while HMRC's position was the opposite of this.

The Tribunal explained that the decision would use "the Assembly Building" to refer to an area of the site occupied by the Students' Union, and "the Reid Building" as an area occupied by GSA itself. However, the whole site had frequently been referred to by both parties as "the Reid Building".

The judge considered the history of the refurbishment project, which involved substantial amounts of demolition and reconstruction. The Assembly Building is an older sandstone structure which shares a party wall with the Reid Building, a modern steel-and-glass construction opposite the historic Mackintosh Building which has recently been destroyed by a second fire in a short period. They were functionally separate, with minimal shared facilities (sprinkler and air handling systems and heating), and access from one building to the other only used for maintenance purposes. The buildings are classified separately for rates, with the Assembly Building classified as a business and the Reid Building as a charity.

The Assembly Building was leased to the Students' Union. The judge noted that the agreement is in reality a Service Level Agreement rather than a lease; the rental is £5,000pa plus VAT. This was at an effective rate of 45p per square foot at a time when the market rate for a city centre bar or restaurant was £7.62 and office space was £12 to £15.

The construction company had originally tendered for the whole refurbishment and reconstruction project as a single contract, and had rendered combined invoices. GSA asked for separate invoices to identify the VAT element of the Assembly Building refurbishment, when it had decided that it ought to be possible to reclaim it. The VAT on the costs had initially been treated as residual, and had recovered it according to an agreed combined PESM (business/non-business and partial exemption) that had operated since August 2009.

GSA's tax agent wrote to HMRC in December 2013 in an attempt to agree a new "capital item special method" based on the floor area of the whole Reid Building site. This suggested that 16.28% of the combined building was used for wholly taxable purposes. On 14 August 2014 the agent submitted an option to tax covering the whole building. In October 2014, the agent submitted a capital goods scheme adjustment working which produced an overall taxable percentage of 29.98%; the taxable areas included the Assembly Building (rented to the Students' Union), a refectory (operated by a company as agents for GSA) and a retail shop (operated by a commercial subsidiary).

HMRC refused the claims on the basis that the outputs of £102,500 did not fairly represent the economic use of the building costs and did not justify the recovery of £2.1m of input tax.

In correspondence during 2015, the tax agent explained that GSA now maintained that the Assembly Building was a separate building from the Reid Building; although the option to tax had referred to the Reid Building, the clear intention had been to opt the Assembly Building. VAT had been charged and accounted for on all rental income; the Assembly Building had been used for wholly taxable purposes. The agent stated that there was no internal link between the buildings, in spite of supplying plans which clearly showed that such a link existed. Further investigation and correspondence ensued about the nature and possible use of the access doors, which were now only to be used as an emergency fire exit from the Assembly Building.

HMRC's argument was summarised as follows:

*(a) There was a single supply which had not been altered by the issue of the credit notes and invoices outwith the accounting system.*

*(b) VAT had been charged at the time of the supply and deducted using the PESM and BNB then in place.*

*(c) The supply was properly attributable to all of the appellant's activities so the VAT on the construction services was residual and it is not possible years later to re-attribute part of that supply to fully taxable.*

*(d) The cost component on the supply of construction of the Assembly Building relates to all of the appellant's activities not just the lease so the deduction should not be limited to the Assembly Building alone.*



*(e) The cost component test relates to whether there is a “direct and immediate link” between the input and the output tax.*

*(f) Whilst it is accepted that a business does not require to be profitable to deduct its input tax, and that deduction is not being denied by HMRC, the attribution solely to the lease does not reflect the economic reality.*

*(g) One should look objectively at purpose and funding when considering the economic use of costs and the grant of a lease at an almost notional cost was not the sole or even principal purpose of the refurbishment funded by the Scottish Funding Council.*

GSA’s argument was that the separate identity of the two buildings was a question of fact, which necessarily determined that the VAT was incurred on two separate sets of costs; and the VAT incurred on the Assembly Building was then fully recoverable, because it was used for wholly taxable purposes.

The judge considered precedents on whether buildings can be regarded as separate, in particular Cantrell. The internal access provisions of Sch.8 Group 5 Notes 16 and 17 only relate to the question of whether something is an “annexe”, which had no relevance here. There were factors favouring both possible outcomes, but overall the judge was satisfied that the Reid Building was a single structure with a self-contained area within it. It was “one building constructed as such”. The changes to restrict the internal access were made as a result of the HMRC enquiry, not as part of the original plans.

It was still necessary to consider whether there was one supply, on which the input tax would be residual, or two, on which one part was wholly used for taxable supplies. The judge was satisfied that the intention at the time had always been for a single project; in effect, the VAT consideration after the event had led to the “artificial dissection of the transaction”. The request for replacement invoices and credit notes did not change the nature of the supply. Even if there were two buildings, there was only one building supply.

The judge also accepted HMRC’s argument that the letting of the Assembly Building to the Students’ Union did not constitute an economic activity. Although a low rent did not preclude such activity, the judge noted that it would take GSA 500 years to recoup its capital outlay, not allowing for the fact that it bore the insurance and some other costs. It provided the lease and the facilities as part of its necessary support of the Students’ Union.

In effect, HMRC won on every argument. The appeal was dismissed.

The school appealed to the Upper Tribunal. The judge summarised the FTT’s findings, and in particular identified the key points: the FTT had concluded that the edifice was more akin to a semi-detached building with an internal link than separate buildings; however, the key question was whether there was one supply or two, which it had considered using the principles derived from CPP and Levob. The conclusion was supported by the following findings of fact:

- A single price was charged (although this was not decisive);
- The project had a single procurement strategy encompassing both buildings;

- It was a condition of funding that BREEAM rating (concerning sustainability) be achieved, which meant that the buildings had to be constructed together and physically linked;
- Planning applications were for both buildings;
- The economic and commercial reality was that the appellant intended to, and did, develop the site as a whole;
- Separate invoices were not provided until after the VAT issue arose.

The FTT had also concluded that the letting of the Assembly Building to the Students' Union was not an economic activity, on the grounds that the rent would not recoup the costs of the outlay for 500 years. The lease and facilities were provided as part of the school's necessary support of the Union, and not as an economic activity.

The UT's decision is rather briefer than its review of the decision below. It could see no error of law in the FTT's conclusion that the two structures were in essence a single building, but also agreed with the FTT that it was not a particularly significant finding. As regards the question of a single supply, the FTT had applied the correct test, and an appellate Tribunal should be reluctant to overturn a finding of this kind. Although the appellant wanted and obtained two separate premises with different functions, that did not raise an inference that there were separate supplies. The original invoicing arrangement appeared to reflect the economic and commercial reality of the project more accurately than the amended arrangement that was substituted after the VAT issue had been identified.

For those reasons the appeal failed; for completeness, the UT also considered the question of a separate supply in relation to the Assembly Building. The judges applied the principles of Wakefield College and held that the lease was within art.2 PVD (a supply for consideration) but was not within art.9 (economic activity) because of the nominal rent. The school was therefore not making taxable supplies to the Union, and it was not possible to recover input tax charged on the basis of such supplies being taxable.

*Upper Tribunal: Glasgow School of Art v HMRC*