Case No: A3/2013/0076

Neutral Citation Number: [2015] EWCA Civ 832

IN THE COURT OF APPEAL (CIVIL DIVISION)
ON APPEAL FROM THE UPPER TRIBUNAL (TAX AND CHANCERY CHAMBER)
MR JUSTICE VOS AND JUDGE TIMOTHY HERRINGTON
[2012] UKUT 394 (TCC)

Royal Courts of Justice
Strand, London, WC2A 2LL

Date: 28 July 2015

Before :

LORD JUSTICE PATTEN
LADY JUSTICE SHARP
and
LADY JUSTICE KING

- -

Between :

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

- -
- -

Nicola Shaw QC and **Michael Jones** instructed by **KPMG LLP** for the Appellant
Owain Thomas instructed by the **General Counsel and Solicitor to HM Revenue and Customs** for the Respondent

Hearing dates : 16 and 17 April 2015

- -

Judgment

Lord Justice Patten :

Introduction

1. Volkswagen Financial Services (UK) Limited ("VWFS") is the representative member of the VWFS VAT group. It is a wholly owned subsidiary of Volkswagen Financial Services AG which is itself ultimately owned by Volkswagen AG. The Volkswagen Group owns and manufactures cars and commercial vehicles under the well-known VW, Audi, SEAT and Skoda marques. Many of the sales are financed through captive finance houses of which VWFS is one.

2. For the purposes of VAT, the business of VWFS is divided into a number of different sectors which are summarised in the agreed statement of facts prepared for the purpose of these proceedings. They are:

   (1) Retail – (i) entering into hire purchase ("HP") agreements with customers in respect of Group Brand vehicles; (ii) entering into leasing agreements with customers in respect of Group Brand vehicles; and (iii) fixed price service and maintenance contracts on Group Brand vehicles;

   (2) Wholesale – providing funding to dealers of Group Brand vehicles for the purchase of demonstrator vehicles and stock (new and used cars);

   (3) Volkswagen Insurance Services ("VIS") – the arrangement of insurance for owners of Group Brand vehicles and dealers of Group Brand vehicles;

   (4) Asset Backed Securitisation ("ABS") – servicing (and reporting on) securitised hire purchase contracts;

   (5) Contract Disposals – the disposal of previously leased and/or repossessed Group Brand vehicles; and

   (6) Catch All – miscellaneous items, such as the provisions of training programmes or the rental of signage to dealers of Group Brand vehicles.

3. VWFS does not operate a car dealership or sell cars for cash. When a customer of a VW dealership wishes to purchase a vehicle using finance from VWFS the vehicle is acquired by VWFS as part of the finance arrangements from the dealer and then supplied by it to the customer on deferred payment terms under an HP contract. The customer does not acquire title to the vehicle until all the payments under the agreement have been made. For the purposes of the Consumer Credit Act 1974, VWFS is deemed to be the supplier of the vehicle under the HP agreement and the customer has the benefit of various statutory warranties including the terms that the vehicle is of satisfactory quality and fit for purpose implied under s.10 of the Supply of Goods (Implied Terms) Act 1973. It is therefore primarily liable to the customer in this respect although with a secondary right of recourse to the dealer from whom it purchased the vehicle.

4. For VAT purposes VWFS is treated as making two separate supplies to a customer who purchases a car on finance. The first is a taxable supply of the car or other vehicle on which VWFS must account for output tax on the full price of the vehicle at the date of the contract. The second is an exempt supply of finance. In economic

terms this has the effect that VWFS is required to account to HMRC for output tax on the price of the vehicle when sold but can only recover the VAT from the customer as part of the monthly payments made under the HP contract. The vehicles are sold on to the customer at the same price as they are purchased from the dealer. Nor is any finance provided by VWFS except in respect of VW Group brands.

5. In the course of its business VWFS incurs input tax as part of its expenditure. Some of this expenditure is directly attributable to the specific supplies made in the various sectors of its business described earlier. In those cases the input tax is deductible in the case of a taxable supply but irrecoverable if the supply is exempt: see VATA 1994 s.26. But other expenditure is not directly attributable to particular supplies (whether taxable or exempt). This includes expenditure on overheads 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.

6. The issue on this appeal is whether any of the residual input tax paid by VWFS in respect of the general overheads of the business is deductible against the output tax paid on the taxable supply of vehicles to customers. In short, HMRC contend that the correct tax treatment of the residual input tax on overheads in this case is that the overheads are all attributable to the exempt supplies of finance and the input tax is therefore irrecoverable.

7. The statutory context in which this issue arises is not a matter of dispute. Article 2 of the First Council Directive of 11 April 1967 (67/227/EEC) ("the First Directive") states that:

> "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.
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> The common system of value added tax shall be applied up to and including the retail trade stage."

8. Article 168 of the Principal VAT Directive (2006/112/EC) (which replaces Article 17 of the Sixth Directive 77/388/EC) confirms the right of the taxable person to deduct input tax on expenditure "insofar as the goods and services are used for the purposes of the taxed transactions". Where the relevant goods and services are used for both taxable and exempt transactions then Article 173 provides that "only such proportion of the value added tax as is attributable to [taxable] transactions shall be deductible".

9. The standard method of making this apportionment prescribed by Article 173(1) is by reference to the ratio of taxable turnover to total turnover. But Article 173 permits member states to derogate from the standard method in particular cases. The provisions of the Principal VAT Directive in relation to the deduction of input tax have been implemented in the UK by s.26 VATA 1994 and regulations 101 and 102 of the Value Added Tax Regulations 1995 (SI/1995/2518). Section 26 provides for the amount of allowable input tax to be determined by regulations which are to secure "a fair and reasonable attribution of input tax to [taxable] supplies". Regulation 101 (so far as material) provides:

> "(1) … the amount of input tax which a taxable person shall be entitled to deduct provisionally shall be that amount which is attributable to taxable supplies in accordance with this regulation.
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> (2) … In respect of each prescribed accounting period—
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> …
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> (b) there shall be attributed to taxable supplies the whole of the input tax on such of those goods or services as are used or to be used by him exclusively in making taxable supplies,
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> (c) no part of the input tax on such of those goods or services as are used or to be used by him exclusively in making exempt supplies, or in carrying on any activity other than the making of taxable supplies, shall be attributed to taxable supplies, and
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> (d) there shall be attributed to taxable supplies such proportion of the residual input tax as bears the same ratio to the total of such input tax as the value of taxable supplies made by him bears to the value of all supplies made by him in the period,
>
> (e) the attribution required by subparagraph (d) above may be made on the basis of the extent to which the goods or services are used or to be used by him in making taxable supplies, …"

10. The derogation from the standard method prescribed by regulation 101(2)(d) which is permitted by Article 173 is provided for by regulation 102 which allows HMRC to approve a special method of determining the allowable proportion of residual input tax. Between 1984 and 2000 HMRC and the Finance Houses Association operated an agreed partial exemption special method ("PESM") for the valuation of the proportion of residual input tax attributable to HP transactions. Under this PESM the finance houses were entitled to recover (in respect of HP transactions) all of the input tax incurred on the goods plus 15% of the residual input tax. In August 2000 VWFS agreed its own PESM with HMRC which also restricted the residual input tax recoverable in respect of the HP sector of its business to the 15% allowed for under

the 1984 FA agreement. After various meetings to discuss the updating of the PESM, VWFS suggested, on 2 February 2007, a new PESM which apportions residual input tax between sectors 1-5 of its business (as described in [2] above) in proportion to the turnover of each sector but then applies the following methodologies to determine the recoverable input tax for each sector:

(i) for Retail, the proportion of recoverable input tax is quantified by reference to the total number of taxable transactions to total transactions; and

(ii) for Wholesale, VIS, ABS and Contract Disposal, the proportion of recoverable residual input tax is quantified by reference to the ratio of taxable income to total income in the sector.

11. HMRC agreed the new PESM except in relation to the retail sector where, as I have mentioned, HMRC maintain that none of the residual input tax referable to that sector should be treated as attributable to the taxable supplies of vehicles. To allow the new PESM to function pending the resolution of this dispute, the parties therefore agreed to adopt the following formula for retail, namely:

> "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. The operation of the new PESM with effect from 1 October 2007 has therefore resulted in VWFS accounting for VAT for the VAT periods 10/07 to 07/08 according to its preferred method of calculating the amount of deductible residual input tax and HMRC raising assessments for under-claimed VAT which have been appealed. For the VAT periods 10/08 onwards VWFS has adopted HMRC's methodology but has then submitted voluntary disclosures for underpaid tax which have been rejected and are now also the subject of appeals.

13. The issue therefore on this appeal is whether any part of the residual input tax apportioned to the retail sector under the new PESM is attributable to the taxable supplies of vehicles. The position of HMRC is that none of this input tax was incurred in the making of taxable supplies of motor vehicles. If they are wrong about that then an issue arises as to whether they can maintain a secondary position that the formula for partial attribution contained in the proposed PESM is not fair and reasonable. The First-tier Tribunal ("FtT") proceeded on the basis that the only dispute about methodology was whether any part of the residual input tax was attributable to and could be set-off against the taxable supplies of vehicles made in the retail sector of VWFS's business. But HMRC contend that they did challenge the apportionment formula contained in the proposed PESM on wider grounds and that a lower figure than 50% should be attributed to the taxable supplies of vehicles as part of the hire purchase contracts in terms of the use made of the allocated inputs.

The facts

14. As mentioned earlier, the price of the vehicle supplied to customers as part of the HP arrangements remains the same as the price paid by VWFS to the dealer. After deducting any deposit which the customer pays, the balance of the purchase price is

financed on credit and the total charge for the credit is divided between the interest payable, an acceptance fee and an option to purchase fee. The acceptance and the option to purchase fees are set at market rates but the calculation of the rate of interest is more complicated. The FtT found:

> "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. Perhaps most critically for the purposes of this appeal the FtT made specific findings about how VWFS recovers the cost of the overheads which account for its residual input tax:

> "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. The dispute about the recoverability of residual input tax in relation to the taxable supplies of vehicles centres on the fact that none of the relevant portion of overheads attributable to the retail sector is recovered as part of the price of the vehicle. It is now part of HMRC's published policy (see Revenue & Customs Brief 82/09) not to allow the recovery of input tax in respect of vehicles and other goods that are re-sold under hire purchase contracts without any increase in price to cover the cost of overheads. In such cases where the overheads are recovered as part of the cost of the finance, HMRC's view is that the economic use of the overheads lies solely in the financing of the purchase and that they cannot be cost components of the taxable supply of vehicles where the consumer of that supply bears none of the cost of the overheads and VWFS (as the supplier in this case) is able to recover all of the relevant overheads as part of the price charged for the exempt supply of finance in respect of which the recovery of the residual input tax is not permitted. The principle of fiscal neutrality requires the recovery of input tax to be limited to those cases in which the maker of the taxable supply passes on to the ultimate consumer the cost of the overheads as part of the price and with it the VAT on that increased price which it recovers by the deduction of input tax. This correspondence is lacking in the present case where none of the cost of the relevant overheads is added to the price of the vehicle.

17. If this is right then the subsidiary issue of whether the identification of the recoverable proportion of residual input tax under the new PESM is fair and reasonable does not arise. But, if they are permitted to argue this point, HMRC also take issue with the weighting of transactions used by VWFS as its method of identifying the proportion of recoverable input tax. Under its preferred method, the ratio of taxable transactions to total transactions is determined by weighting each transaction within the retail sector in order to reflect the extent to which the transactions in question use the overheads to which the residual input tax relates. Hire purchase contracts are treated as two transactions (the taxable supply of the vehicle and the exempt supply of finance); contract hire transactions as two transactions (both taxable); and service contracts as one (taxable) transaction. The amount of residual input tax allocated to the retail sector which is deductible is then calculated by applying the fraction representing the proportion which the number of taxable transactions (using the weighting described above) bears to the total number of transactions carried out in the relevant accounting period. The supply of cars is therefore included in the calculation of taxable transactions. By contrast, under HMRC's preferred methodology, hire purchase contracts are treated as one transaction along with contract hire and service contracts and an equal amount of input tax is attributed to each. This is then apportioned between taxable and exempt supplies within each transaction based on the value of those supplies. But for hire purchase contracts, the value of the vehicle is excluded so that the recovery of input tax is limited to settlement charges and option to purchase fees which account in practice for less than 1% of the value of the transaction.

<u>The authorities</u>

18. The FtT (Judge Roger Berner and Mrs Elizabeth Bridge) in a decision released on 18 August 2011 allowed VWFS's appeal on the basis that a PESM which attributed part of the residual input tax incurred on overheads to the taxable supplies of vehicles is fair and reasonable. Because this was in their view the only objection which HMRC had taken to VWFS's preferred methodology for the retail sector of its business, that issue was conclusive of the appeal. Before turning to their reasons and to the contrary decision reached by the Upper Tribunal, it is useful to look at the relevant authorities on the deduction of residual input tax in order to identify the test which the jurisprudence of the ECJ required the tribunals to apply in order to determine these appeals.

19. As mentioned earlier, the language of Article 168 of the Principal Directive is that the person making the supply is entitled to deduct input tax on goods and services "used for the purpose of the taxed transactions". Article 2 of the First Council Directive labels such expenditure as the cost components of the taxable supply.

20. A general statement of the reasons for allowing the deduction of input tax against VAT payable on a taxable supply can be found in the judgment of the ECJ in Case 268/83 *Rompelman v Minister van Financiën* [1985] ECR 655:

> "16. As the court pointed out in its judgment of 5 May 1982 in case 15/81 (*Schul v Inspecteur Der Invoerrechten En Accijnzen*, (1982) ECR 1409), 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 and that the deduction procedure is so designed that only taxable persons may deduct the vat already charged on the goods and services from the vat for which they are liable.
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> …..
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> 19. From the provisions set forth above it may be concluded that the deduction system is meant 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 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."

21. The language of the Directive has been transposed in the cases into at least two formulations of a test. In Case C-4/94 *BLP Group v Customs and Excise Commissioners* [1995] STC 424 the question was whether BLP could deduct input tax which it had incurred on professional services in connection with the sale of shares in a German subsidiary. The share sale was an exempt transaction but the deduction of input tax was claimed on the basis that the purpose of the sale was to raise money to pay off debts that had arisen as a result of various taxable transactions.

22. The ECJ held that the input tax was not deductible. There had to be a direct and immediate link in the chain of supplies between the inputs and the transaction on which the output tax was payable:

> "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 deductible, and for transactions 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.
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> …..
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> 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 and that if BLP had decided to take out a bank loan for the purpose of meeting the same requirements, it would have been entitled to deduct the VAT on the accountant's services required for that purpose. 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.

26. In that respect it should be noted that a trader's choice between exempt transactions and taxable transactions may be based on a range of factors, including tax considerations relating to the VAT system. The principle of the neutrality of VAT, as defined in the case law of the court, does not have the scope attributed to it by BLP. That the common system of VAT ensures that all economic activities, whatever their purpose or results, are taxed in a wholly neutral way, presupposes that those activities are themselves subject to VAT (see in particular *Rompelman v Minister van Financiën* (Case 268/83) [1985] ECR 655 at 664, para 19)."

23. The decision in *BLP* emphasises the need for an objective assessment of the link between the goods and services subject to the input tax and the supply to which they relate. BLP's claim to deduct the input tax failed because the only direct and immediate link which the inputs had was to the exempt sale of the shares. This is essentially a structural analysis rather than one directed to any more general theory of economic use. As Advocate General Lenz said in his Opinion in *BLP*:

> "30. A consideration of those provisions together shows that the Community legislature, proceeding from an ideal image of 'chains of transactions'—to adopt the neat phrase used at the hearing by the representative of the United Kingdom—intended to attach to each transaction only so much VAT liability as corresponds to the added value accruing in that transaction, so that there is to be deducted from the total amount the tax which has been occasioned by the preceding 'link in the chain' (see, for example, the judgment in *EC Commission v France* (Case 50/87) [1988] ECR 4797 at 4817, para 16)."

24. The invoices for the accountants' services showed that they had been provided in connection with the sale of the shares in the German subsidiary. They formed a cost component of the exempt supply whose purpose was irrelevant to their appropriate tax treatment. Once linked to the exempt supply, BLP became the ultimate consumer in the chain of taxable transactions and no input tax was deductible.

25. The next relevant case chronologically is Case C-98/98 *Midland Bank plc v Customs and Excise Commissioners* [2000] STC 501. Samuel Montagu & Co Ltd, one of the companies in the Midland Bank group of which Midland Bank was the representative member, acted as merchant bank for a client in a takeover bid. The bid culminated in an agreement with a rival bidder for the takeover of the target company and the sale of its broking arm to the bank's client. The agreement was not adhered to and led to litigation which included a claim against Samuel Montagu. Samuel Montagu incurred solicitors' fees in connection with the agreement and the subsequent litigation which it claimed were directly and solely attributable to the services supplied to its client. The Commissioners contended that the legal services were not used solely for the purpose of carrying out the taxable services supplied to the client but were also attributable to Samuel Montagu's business generally which included the making of

both taxable and exempt supplies. The matter was referred to the ECJ for guidance of the test of deductibility. The ECJ said:

> "29. It should be borne in mind that, according to the fundamental principle which underlies the VAT system, and which follows from art 2 of the First and Sixth Directives, VAT applies to each transaction by way of production or distribution after deduction of the VAT directly borne by the various cost components (see, to this effect, *BP Supergas Anonimos Etairia Geniki Emporiki-Viomichaniki kai Antiprossopeion v Greece* (Case C-62/93) [1995] STC 805 at 821, [1995] ECR I-1883 at 1913, para 16).
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> 30. It follows from that principle as well as from the rule enshrined in the judgment of *BLP Group plc v Customs and Excise Comrs* (Case C-4/94) [1995] STC 424 at 437, [1995] ECR I-983 at 1009, 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 [2000] STC 501 at 519 generally have arisen before the taxable person carried out the taxable transactions to which they relate.
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> 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 transaction, the fact remains that it is not generally part of the cost components 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 transaction. 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."

26. The judgment is a recognition that the absence of a direct and immediate link with the specific output transactions is not fatal to the deductibility of VAT on residual inputs if the expenses in question are nonetheless cost components of the supplier's business as a whole. The *BLP* test is deemed to be satisfied on the basis that the general

overheads in question are incurred at least in part in making the taxable supply. The meaning of paragraph 31 is, however in dispute in this appeal. HMRC attach some importance to the reference to general overheads being "components of the *price* of an undertaking's product" as indicative that the costs which they represent must in some part be transferred to the ultimate consumer as part of the price he is charged for the taxable supply. VWFS contend that the phrase means no more than the expenditure should be a cost component of making the supply regardless of whether that cost is recovered from the particular consumer.

27. The ECJ returned to the question of VAT on general overheads in Case C-408/98 *Abbey National plc v Customs and Excise Commissioners* [2001] STC 297. This concerned a claim to deduct the VAT on professional fees incurred in connection with the sale of various leasehold interests. Because the sale was treated as a transfer of a going concern, no VAT was payable on the sale price. To overcome this difficulty, Abbey National sought to recover the VAT as residual input tax on general overheads of the business. Having set out the direct and immediate link test of deductibility, the Court said:

> "35. However, the costs of those services form part of the taxable person's overheads, and as such are cost components of the products of a business. Even in the case of a transfer of a totality of assets, where the taxable person no longer effects transactions after using those services, their costs must be regarded as part of the economic activity of the business as a whole before the transfer. Any other interpretation of art 17 of the Sixth Directive would be contrary to the principle that the VAT system must be completely neutral as regards the tax burden on all the economic activities of a business provided that they are themselves subject to VAT, and would make the economic operator liable to pay VAT in the context of his economic activity without giving him the possibility of deducting it (see, to that effect, *Gabalfrisa SL and ors v Agencia Estatal de Administración Tributaria* (*AEAT*) (Joined Cases C-110/98 to C-147/98) [2000] ECR I-1577, para 45). An arbitrary distinction would thus be drawn between expenditure incurred for the purposes of a business before it is actually operated and that incurred during its operation, on the one hand, and, on the other hand, the expenditure incurred in order to terminate its operation.
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> 36. Thus in principle the various services used by the transferor for the purposes of the transfer of a totality of assets or part thereof have a direct and immediate link with the whole economic activity of that taxable person.
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> 37. It follows from art 17(5) of the Sixth Directive that a taxable person who effects both transactions in respect of which VAT is deductible and transactions in respect of which it is not may deduct only that proportion of the VAT which is attributable to the former transactions.

> 38. However, as the court held in the para 26 of the *Midland Bank* judgment ([2000] STC 501 at 519), 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 art 17(2), (3) or (5) of the Sixth Directive applies.
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> 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."

28. There is no reference in this judgment to the cost of the overheads being passed on to the ultimate consumer as part of the price. But price is mentioned in Case 435-05 *Investrand BV v Staatssecretaris van Financiën* [2007] ECR 1315 at [24] and in her Opinion in Case C-234/11 *TETS Haskovo AD* [2012] ECR 1 Advocate General Kokott says:

> "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.
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> …
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> 34. Clearly, these abstract requirements of the court are not straightforward to implement in a specific case. It itself pointed out early on that the link between input and output transactions necessary for deduction cannot be described more accurately in abstract terms on account of the large variety of economic activities. Therefore, in principle it is for the national court to apply the 'direct and immediate link' test specifically to the facts of each case before it."

29. Similarly, in Case 29/08 *Skatteverket v AB SKF* (Case C-29/08) [2010] STC 419 the Court said:

> "58. 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* (paras 23 and 31); *Abbey National* (para 35); *Kretztechnik* (para 36); and *Investrand* (para 24)).

…..

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 is based on the premise that 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 which SKF intends to sell or whether they are only among the cost components of SKF's products."

30. Two other cases need to be mentioned at this stage. The first is Case C-183/13 *Fazenda Pública v Banco Mais SA* [2014] STC 2325. It concerned a bank which carried out the leasing of motor vehicles and other financial activities, some of which were exempt supplies. In relation to its general overheads, the bank reclaimed VAT under a method of apportionment based on the proportion of the receipts and turnover of all leasing transactions in respect of which VAT was deductible to the receipts and turnover of all financial transactions. This resulted in the bank deducting 39% of the residual input tax which the Portuguese Treasury contended was excessive. Most of the judgment is concerned with the detail of the method of apportionment and the need for the amount of deductible input tax to be calculated with precision. As such, it is said to be supportive of HMRC's contentions about whether the new proposed PESM produces a fair and reasonable result if they are permitted to argue that question. But, in my view, it does not assist in relation to the principle of deductibility not least because the leasing transactions in that case were single transactions and were taxable supplies.

31. After the conclusion of argument on the appeal VWFS wrote to the Court to draw our attention to the recently delivered Opinion of Advocate General Kokott in C-126/14 *Sveda*. The case concerned the recoverability of input tax by a company called Sveda in relation to costs incurred in the construction of a recreational facility. Entry to the facility is free but Sveda makes taxable supplies in the form of catering and the sale of souvenirs. The principal issue considered by the Advocate General in her Opinion is whether the taxable supplies acquired by Sveda as part of the construction project could be said to be used for the purpose of its later economic activity in the form of the making of the taxable supplies I have indicated. It was not a case where there were both exempt and taxable supplies made and the fairness of an apportionment was the issue. No charge was made for entry and, for that reason alone, the provision of the recreational facility to the public was not taxable. The issue, as the Advocate General put it, was:

> "31. The acquisition or production of capital goods therefore has two different purposes. Firstly, we see the availability of the recreational trail to the public free of charge (primary use) which does not, under Article 168 of the VAT Directive, confer any right to deduct input tax. Secondly, we see however, use of the recreational trail as a means of supplying to visitors services which are liable to tax (secondary use), from which the right to deduct input tax arises. Which of these two purposes is then decisive in the context of Article 168 of the VAT Directive?"

32. The case raises essentially the same factual issue as in *BLP* which the Advocate General refers to in [32] by reference to the "direct and immediate link" test. But she then goes on:

> "33. The Court has however developed its case-law. Although it is true that application of Article 168 of the VAT Directive, which confers entitlement to the deduction of input tax, presupposes again the finding of a direct and immediate link between a particular input transaction and a particular output transaction or transactions, such a connection may also exist with the taxable person's business as a whole where the costs of input services are part of that taxable person's general costs and are, as such, components of the price of the goods or services that it supplies.
>
> 34. According to more recent case-law, 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. The same applies, irrespective of the fact that this is question of use of goods or services by the taxable person.
>
> 35. A right to deduct input tax therefore exists in this case if the costs of acquisition or of production of the capital goods of the recreational trail are incorporated, within the meaning of case-

law, in the costs of output services taxed by virtue of the VAT Directive."

33. At [41]-[47] of her Opinion the Advocate General addresses perhaps more specifically the question whether the existence of a direct link between input costs and a taxed output transaction depends in any way on the incorporation of those costs in the price charged for the output supply. We are not assisted by the fact that there is as yet no official translation of the Advocate General's Opinion and the parties are not in complete agreement about how [41]-[47] should be translated. But using for present purposes the translation provided by HMRC, the Advocate General said:

> "41. If the referring court were however to find that setting in place of the recreational trail by Sveda does not constitute, vis-a-vis the National Paying Agency, a taxed transaction, the right to deduct input tax would then depend solely on the question of whether the capital goods of the recreational trail are used, within the meaning of Article 168 of the VAT Directive, for the future supply of services for consideration to its visitors. To this end, it is appropriate to determine whether the costs of acquisition and of production of these capital goods are integrated in the price of these services.
>
> a) The objective notion of costs
>
> 42. Contrary to the opinion of the United Kingdom, it is appropriate to answer this question irrespective of the taxable person's intention to integrate the respective costs in the price of these output transactions.
>
> 43. According to the judgment *Becker*, the finding of a direct and immediate link between input transactions and output transactions is based on the objective content of the input services. In the judgment *BLP Group*, the Court had already determined in this sense that the necessary link between input transactions and output transactions may not be determined by the intention of the taxable person.
>
> 44. In addition, in the common system of VAT, services supplied below the cost price are also taxed. In this case, the price is fixed by the taxable person subjectively, without taking account of the entirety of the costs of supply of the output service. In this case, it is however, out of the question that the entirety of the input transactions which, under paragraph two of Article 1(2) of the VAT Directive, belong objectively to the components of the costs of the output transactions, can justify the deduction of input tax. In fact, according to established case-law, the deduction system is meant to relieve the trader entirely of the burden of the VAT payable or paid in the course of all his economic activities, because the common system of VAT is intended to tax only the final consumer and not the taxable trader.

> 45. The existence of an objective economic link between input transactions and output transactions is therefore decisive for the question of whether the costs may be integrated in the price of a service within the meaning of case-law. A simple causal link is not sufficient. If an input transaction however, objectively serves the purpose of execution of certain output transactions of a taxable person, or of all of them, there also exists then between both, a direct and immediate link within the meaning of case-law. In fact, in this case, the input transaction constitutes, from an economic point of view, a component of the cost of the supply of output services. As already shown by the content of Article 168 of the VAT Directive, it is therefore the objective purpose of the use of an input transaction which is decisive.
>
> 46. In this case, the installation of the recreational trail serves, according to the findings of the referring court, to attract visitors in order to supply services to them for consideration. From an economic point of view, installation of the recreational trail therefore comes under the components of the costs of these transactions.
>
> 47. There is therefore, in principle, between the acquisition and production of the capital goods and services for consideration offered to visitors a direct and immediate link within the meaning of case-law."

34. The main interest in this part of the Opinion is the rejection in [42] of the UK's argument about the need for there to be an intention by the taxable person to incorporate the costs in the price charged to the ultimate consumer. Ms Shaw QC for VWFS says this is consistent with the implicit rejection of a similar submission by the CJEU in *Banco Mais*. The non-inclusion of the input costs in the price charged for the output supply will not prevent the inputs being treated as cost components of that supply and therefore from satisfying the used for test under Article 168. Mr Thomas for HMRC says that the Opinion does not help VWFS because (unlike here) Sveda had made no exempt supplies to which the input costs could relate. The only issue was whether, objectively viewed, a direct economic link existed between the input costs and the taxable supplies which Sveda intended to make at the facility. Had the use of the facility by the public involved the making of an exempt supply rather than simply a no-cost facility there would have been (as in *BLP*) a direct link between that supply and the input costs which would have precluded any claim by Sveda for the deduction of the latter. At [48]-[51] the Advocate General said:

> "48. The fact that the recreational trail is made available to visitors free of charge does not constitute a restriction on the right to deduct input tax.
>
> 49.·Although this is question of [sic] the primary use of capital goods of the recreational trail, primary use may only interrupt the direct and immediate link with the secondary use of output transactions in two cases.

> 50. This is the case, firstly, when the primary use occurs for services supplied for consideration but which are exempt from VAT. Input transactions then come under the components of cost of exempt output transactions and are therefore integrated in their price. For these transactions, Articles 168 et seq. of the VAT Directive do not provide however, in principle, for any right to deduct input tax. In such circumstances, it is irrelevant, according to case-law, that the input transactions pursue another "ultimate" aim which also entails taxed output transactions.
>
> 51. In this particular case, primary use does not however occur for exempt transactions for consideration, but for a use free of charge."

35. I will return to these statements of principle a little later in this judgment. But I observe at this stage that there is an obvious factual difference between cases like *BLP* and *Sveda* where what Advocate General Kokott describes as the primary use of the capital goods or supplies is in connection with an exempt or non-taxable transaction and the only relevant taxable supply is one further link down the causative chain, and cases like *Midland Bank* where the inputs relate to the whole of the taxable person's business including the making of both taxable and exempt supplies. In the latter case there can be said to be a direct and immediate link with both types of output transaction and the only issue is one of fairly apportioning the residual input tax between the two according to use.

36. The difficulty in the first type of case occurs where the primary and therefore direct link is not with a free (and therefore non-taxable) supply but with one which is exempt. In such a case (as the Advocate General explains at [50]), the inputs are, by the application of the direct and immediate link test, treated as cost components of the exempt supply and, being an exempt supply, the input tax is irrecoverable. The fact that the taxable person may have intended to expend money on the inputs as part of that exempt supply in order to put himself in the position of being able to make taxable supplies in the future is irrelevant. The only direct economic use of the inputs is as part of the cost of the exempt supply.

37. Much of the Opinion in *Sveda* is taken up with a discussion of when the necessary link can be made between alternative types of supply whether consequential or secondary (as in *BLP* and *Sveda*) or immediate (as in *Midland Bank*). HMRC's reliance on the fact that the costs of VWFS's general overheads are recovered as part of the price for the exempt supply of finance and not as part of the cost of the supply of the vehicle is directed to the need to find what the Advocate General in [45] of her Opinion in *Sveda* described as an objective economic link between the input and output transactions. Regardless of whether the incorporation of the cost of the inputs into the price of the output transaction is a condition precedent to the inputs being treated as cost components of the taxable output transaction, Mr Thomas contends that the fact that all of the costs in dispute were incorporated into the cost of the finance means that, as a matter of objective fact, they fall to be treated as components of that supply.

38. In *St Helen's School Northwood Ltd v Revenue and Customs Commissioners* [2006] EWHC 3306 the school constructed a swimming pool and sports hall which it intended to use for the school and also commercially. It set up a company (referred to as "SHEL") for this purpose which was to use the complex for club and community use outside school hours and granted to SHEL a licence for that purpose at a fee of £18,600 per annum. SHEL provided services to club members in return for subscriptions and the school paid it £124,000 for the supply of personnel who worked in the complex during school hours. A dispute arose about the PESM proposed by the school for apportioning the VAT incurred on the costs of construction by reference to the hours of use of the complex by the school. Warren J held that the costs of construction had been met out of charitable or other funds raised for the educational purposes of the school. Income generated from out-of-school use from the licence granted to SHEL had never been intended to meet the costs of construction and was a secondary use. Any apportionment of the VAT between the exempt supplies of education made by the school's use of the complex and the taxable supply to SHEL had to reflect the economic use made by the school of the complex and that this was best achieved by the standard method. The judge said:

> "75. I agree with Mr Thomas 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 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.
>
> …
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> 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 SHEL 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 *Yarburgh Children's Trust*.
>
> 78. On the evidence, it is clear that, objectively assessed, the principal purpose of the School in building the sports complex was the furtherance of its educational activities and was carried out in connection with its business of making exempt supplies of education. That conclusion is clear from the way the matter was put in the first draft of the business plan and the approach of the School to the generation of funds by out-of-school use which was designed to meet the running costs of the complex and, if possible, something over and above that. Further, the capital cost of the complex was met out of funds which were either charitable funds or derived from a fund-raising exercise and which were clearly dedicated to the educational purposes of the School. The generation of income by out-of-school use was essentially a secondary consideration, albeit that the benefit thereby produced was an aspect of the whole project from the beginning."

39. This general approach to economic use was approved by this court in *Revenue and Customs Commissioners v London Clubs Management Ltd* [2011] EWCA Civ 1323 which concerned a PESM for apportioning the residual input tax of a gambling business. Some of its gaming supplies were exempt; some standard rated. But it also made standard rated bar and catering supplies. The taxpayer proposed changing its existing turnover-based PESM to a floor space method which calculated the amount of deductible residual input tax by reference to the amount of floor space occupied for the making of taxable supplies as a fraction of the area used to make both taxable and exempt supplies with an adjustment to take account of the costs of food and beverages supplied to customers at no charge. The taxpayer's catering activities were not profitable but the FtT had found that they constituted businesses in their own right and were not merely ancillary to the taxpayer's gaming business. The Commissioners contended that the floor space PESM did not produce a fair and reasonable result by comparison with the earlier PESM based on the turnover and that the finding about the catering being a separate business could not have been reached on a correct application of the law.

40. The Court of Appeal dismissed the Commissioners' appeal. Etherton LJ said:

> "33. The need for a process of attribution only arises where an item is a cost component (within Article 2 of the First Directive) of two supplies, one taxable and one exempt: *Dial-a-Phone Ltd v Customs and Excise Commissioners* [2004] STC 987 (especially at [28] and [71]). If the standard (turnover) method does not result in a fair and reasonable attribution of the cost component, the search is for a more fair and reasonable method of attribution. The onus is on the taxpayer to show that the proposed PESM is more fair and reasonable, that is to say, more accurate: Case C-488/07 *Royal Bank of Scotland Group plc v Revenue and Customs Commissioners* [2009] STS 461 at [24].

> 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."

41. Having referred to the decision of Warren J in *St Helen's School* and that of the VAT and Duties Tribunal in *Aspinall's Club Ltd v Revenue and Customs Commissioners* (2002) (VAT Decision No. 17797), he went on:

> "41. That case 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."
>
> 42. As both *St Helen's School* and *Aspinall's Club* show, and as was emphasised in *Dial-a-Phone v Customs and Excise Commissioners* [2004] STC 987 at [72] by Parker LJ (with whom the other members of the Court agreed), analysis of attribution for the purposes of Article 2 of the First Directive, Article 17 of the Sixth Directive and Regulation 101 is highly fact sensitive."

42. The FtT had found as a fact that, although unprofitable, the catering activities were businesses in their own right and that the relevant overheads had not been primarily incurred to facilitate gaming but rather to facilitate all parts of the taxpayer's business. Since both the Upper Tribunal and the Court of Appeal had no basis on which they could disturb that finding, it was not possible to say that the only economic use made

of the relevant overheads was in relation to the gaming services. The judgment of Etherton LJ considers at [84]-[88] whether or not the PESM based on floor space rather than turnover properly reflected the balance of economic reality given the unprofitable nature of the catering activities. So he says at [86]-[87]:

> "86. Business is carried on with a view to profit. If the only activity of the respondent capable of generating a profit in the foreseeable future was its gaming activity, then the principal purpose and effect of any other activity capable of generating a positive return, short of profit, would simply be to enable a greater proportion of the profits from gaming to be retained than would otherwise be the case. The only possible purpose of the non-gaming activity would be to help to defray some of the overheads that would otherwise have to be defrayed by the gaming revenue.
>
> 87. As the Commissioners have pointed out, that would not mean that the loss-making catering function did not use any residual costs. Plainly, catering would use some of those costs. The issue is whether, on the hypothetical facts, the more fair, suitable and accurate proxy for attribution of those costs between taxable catering activity and exempt gaming activity would be the existing method, based primarily on the standard turnover method, or the proposed floor space PESM. On the hypothetical facts, without the gaming activity there would not merely be no present profit, but, more importantly, no profit in the foreseeable future, and hence no commercial purpose to the existence of respondent. In the absence of some special funding arrangements, it would presumably be insolvent and would have to be wound-up. On the hypothetical facts, the reality, in terms of the true economic use of the relevant overheads, would be that the driver for the catering activity and any expenditure associated with that activity would be the gaming activity and the enhancement of the profits to be made from the gaming activity. Adopting the language and test in paragraph 49 of *Aspinall's Club*, gambling would be the foundation of the business and it would primarily be the furtherance of that gaming which would cause and would be seen as justifying commercially the decisions to incur the expenditure. It would be the maintaining and enhancing of the gaming profits that would be the principal driver of all the overheads. As it presently seems to me, that would make the existing PESM, under which attribution of residual input tax is primarily related to the respective turnover of the catering and gambling activities, more fair, suitable and accurate than the proposed floor space PESM, under which (on the figures before the FTT) nearly 50 per cent of residual inputs would attributed to the loss-making catering activity."

43. Nothing in this judgment suggests, however, that the test of economic reality or the search for what Advocate General Kokott describes as an objective economic link allows the Court to ignore (if factually correct) that the overheads in question have been incurred in relation to the whole of the taxpayer's business.

The decision of the FtT

44. The FtT rejected HMRC's case that the jurisprudence of the CJEU requires the cost of the input supplies to be included in the price of the output transaction as a pre-condition to the inputs being treated as cost components of the output supply. The appearance of references to the "price" of the goods and services in [16] in *Rompelman*; [31] of *Midland Bank*; in the Opinion of the Advocate General in *Haskovo*; and in [58] of the judgment in *Skatteverket* led the FtT to examine the French text which refers to "éléments constitutifs du prix". But, as the FtT observed, this takes the question of meaning little further forward and we have not been asked to undertake the same exercise.

45. The FtT said:

> "64. … In our view, 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.
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> 65. Mr Thomas submitted that the issue in this case is not whether the costs in question are residual at all – it is common ground that they are – but whether the methodology put forward by VWFS is fair and reasonable despite the fact that the input tax on those costs is not a cost component of the price (or even the intended price) of the taxable output represented by the sale of the car. He argued that the input tax in making the HP transaction should either be passed on to the consumer as part of the supply of the vehicle (in respect of which value VWFS has a liability to account for output tax) or consumed by VWFS as the final consumer in making the supply of exempt credit.
>
> 66. Mr Thomas further submitted that the plain result of VWFS's methodology is that there is a third category of input tax which is incurred in making the supply of goods, but is not passed on to the consumer as part of the value of the supply of goods but is passed on as part of the value of the supply of exempt credit but in respect of which it nonetheless enjoys a right to deduct. He argues that such an outcome frustrates the normal operation of the tax. It is illogical, he says, and artificial as it assumes that one element of a single transaction (which

has two component VAT supplies) cross subsidises the remainder of the same transaction.

67. Miss Shaw submitted that HMRC's argument in this respect proceeded on the fallacious basis that an input must be a cost component of the price of an onward taxable transaction before it can be recovered by the trader. She referred to *Revenue and Customs Commissioners v London Clubs Management Limited* [2010] STC 2789 where (at [36] – [38]) Proudman J in the Upper Tribunal (Tax and Chancery) had rejected HMRC's submission that the supplies in question in that case were made at a loss and could not support the costs attributed to them in the proposed partial exemption special method. The learned judge held that this submission conflated the issue of profitability with the costs of making it. As Etherton J had observed in *Banbury Visionplus Limited v Revenue and Customs Commissioners* [2006] STC 1568 (at [68]):

> "… the issue of profitability or loss is of no significance … The critical 30 issue is the use of inputs in the provision of outputs. There is no obvious or necessary correlation between that issue and the issue of profitability or loss."

68. We have concluded that, in relation to overheads, there is no requirement that the input tax referable to those expenses should be reflected in the price of the products of the overall economic activity to which the expenses are related. It is not necessary to trace the costs into the price of particular products. What is needed is a fair and reasonable proxy for the use by VWFS of the relevant costs in making both taxable and exempt supplies. Whilst it is clear that the use in question is economic use, and not physical use (see *St Helen's School Northwood Ltd v Revenue and Customs Commissioners* [2007] STC 633, per Warren J at [75]), that is not directed at profitability, but at the true nature and characterisation of the taxable person's business."

46. The FtT reminded itself that this is not a case of direct attribution of the input costs to one or other of the taxable and exempt supplies comprised in the retail sector of VWFS's HP business. The appeal concerns residual input costs; that is general overheads of the kinds described earlier; which support the company's business as a whole:

> "69. ….. 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 20 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."

47. In relation to the argument that the economic use of the supplies lay in the making of the supplies of HP finance (as evidenced by the inclusion of the costs in the price of those supplies), the FtT said:

> "75. ….. We agree that economic purpose, objectively ascertained, is an important element in such cases, and also in a fair and reasonable attribution under a partial exemption special method (*St Helens School*, at [77]). However, we do not accept that the purpose of the supply of the vehicle in an HP transaction is, as Mr Thomas submitted, to give rise to a supply of credit. The economic purpose of VWFS is not simply to supply credit; it is to supply credit on hire purchase terms. It may be the case that, according to those terms, the supply of the

> vehicle cannot take place without the supply of the credit, and that the supply of the vehicle lacks the normal characteristics of a simple sale of goods, but that does not in our view change the essential economic characteristics of an HP transaction, objectively ascertained, namely that it is one indivisible transaction that comprises, for VAT purposes, two supplies, one taxable and one exempt."

48. On appeal, the Upper Tribunal also rejected the argument that the deductibility of input tax depends in some way on the costs to which it relates being passed on to the next consumer in the chain as part of the price charged for the output supply. References in the cases to the residual inputs being components of the cost of the outputs or being components of their price are used interchangeably. But in relation to whether the residual inputs had a direct and immediate link with or were cost components of the taxable supplies of vehicles, the Upper Tribunal took a different view. Applying the criterion of economic use derived from this Court's decision in *London Clubs Management Ltd*, it held that there was no direct or immediate link between the overheads and the taxable supply of vehicles and that the residual inputs were linked directly to the supplies of finance which are largely exempt:

> "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. 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."

Discussion

49. The refusal by HMRC to allow the deduction of any part of VWFS's residual input tax against the output tax on the supply of vehicles unless the relevant overheads are included in and recovered as part of the price charged for the taxable output supplies can only be justified in terms of the Principal Directive if the "use" of the overheads as cost components of the taxable supply depends upon the costs being passed on to the ultimate consumer. As indicated earlier, Mr Thomas relies on two principal arguments to support HMRC's position. The first is essentially a recourse to the decisions of the ECJ on the recoverability of overheads which, properly understood, he says, have established as a condition of deductibility of the residual input tax the inclusion of the relevant costs in the price of the output supply. This involves a consideration of the principle of deductibility and therefore of the nature of the economic link between overheads and a taxable supply which must exist before the inputs fall to be treated as cost components of the output supply. The second line of argument is more evidential in nature: namely that in a case where the taxable person has recovered the cost of the overheads as part of the price charged for an exempt supply, it is impossible, or at least difficult, to regard those costs as anything but the components of that exempt supply with the result (as in *BLP*) that the supplier is treated as the final consumer and the input tax is irrecoverable.

50. A curiosity of the present appeals is that HMRC should be running an argument that none of the input tax relates to the taxable supplies of vehicles in the context of a dispute about the fairness of a PESM. If the arguments on which they rely are correct then Article 173 has no application and the issue of whether it is appropriate to derogate from the standard method to some bespoke method of apportionment does not arise. But I propose, nonetheless, to begin with the price/cost argument which, as I have indicated, was rejected by both of the lower tribunals.

51. Simply in terms of the language used in the decisions of the ECJ:

    (1) there is an established need to find a "direct and immediate link" between the overheads and the taxable transactions. The existence of such a link is a matter of objective assessment and is not determined by the subjective aim of the taxable person: see *BLP* at [19];

    (2) a direct and immediate link exists where the expenditure is "part of the costs of the output transactions which utilise the goods and services acquired": see *Midland Bank* at [30]. This is why the costs must generally be incurred before the output supply is made; and

    (3) even where the costs are not directly linked to a particular supply in the sense described above they will be treated as having a direct and immediate link to the taxable person's business as a whole and will therefore be deductible under Article 173 of the Principal Directive (formerly Article 17(5) of the Sixth Directive) if they are "part of the taxable person's general costs and are, as such, components of the price of an undertaking's products": see *Midland Bank* at [31].

52. Those statements of principle in *Midland Bank* are directed, as I read them, to whether (in the absence of a specific link between the input and the output supply), the

residual inputs constitute expenditure incurred by the taxable person in order to maintain his economic activity as a whole. Where that is demonstrated, the overheads are treated as cost components of the supplies which are made and the only issue is how to apportion those costs between exempt and taxable supplies. The words "as such" in [31] of *Midland Bank* mean that the general costs are *ipso facto* cost components of those supplies. The reference to "price" has to be read in that sense. This is, I think, confirmed by what is said about the link between costs and the taxable person's economic activities in the extract from the decision in *Abbey National* quoted at [27] above which post-dates the decision in *Midland Bank.* It is also consistent with [19] of the decision in *Rompelman* (quoted at [20] above) which seems to confirm that profitability is not the key to deductibility.

53. Mr Thomas, I think, accepts that both the supply of vehicles and the supply of finance form part of the economic activity of VWFS as a taxable person within the meaning of Article 4(1) of the Sixth Directive. It is also part of the agreed facts that the residual inputs with which we are concerned in these appeals were all incurred in the course of VWFS's business including the retail sector. His argument has therefore to be that the jurisprudence of the ECJ has developed the concept of a direct and immediate link in respect of general overheads so as to include a requirement that the costs should actually be incorporated into and recovered as part of the price charged for the output supply. In this case, that condition is satisfied in respect of the exempt supply of finance but not in respect of the taxable supply of the vehicles.

54. None of the more recent cases in which price has been mentioned seem to me to do this and the imposition of such a requirement in my view runs contrary to the established reasoning of the court on what is necessary to establish a direct and immediate link. Paragraph [32] of the Advocate General's Opinion in *Haskovo*, read as a whole, is clearly speaking of price in the sense of the costs of making the supply and the same can be said of the judgment in *Skatteverket* at [62]. In *Sveda* Advocate General Kokott returned to the same issue. Paragraphs [33]-[35] express the test in conventional terms and [42]-[44] indicate her view that the principles are to be applied regardless of whether the costs are actually incorporated into the price charged. Their inclusion in the price charged is at most of evidential value in confirming the link. But it is not a pre-requisite to its existence. The references to the integration of the overheads in the price of the output supply mean no more than they become cost components of the taxable transactions or, in the French version of the text, "éléments constitutifs du prix".

55. Mr Thomas accepts that residual input tax remains deductible in relation to taxable supplies made at a loss and that these cases have therefore to be treated as exceptions to the general rule that the cost of overheads must be passed on to the ultimate consumer for the residual input tax to become deductible. But this seems to me to be contrary to principle. As cases like *Rompelman* and *Abbey National* demonstrate, the ability of the taxable person to deduct input tax depends on its use for the purpose of the taxable transactions which he makes, not on whether that expenditure is actually built into the price charged for the supply. The way in which he chooses to attribute those costs to the supplies he makes and so recover them from his consumers is likely to be based on a range of factors including tax considerations. It may be highly material to the apportionment of the costs and therefore the input tax between the different supplies which are made. But *non sequitur* in my judgment that the

inclusion of the costs in the price of a particular supply is in itself a pre-condition to the recovery of the input tax. There is simply no authority to justify such a rule.

56. The alternative way in which HMRC puts their case is to contend that there was, objectively speaking, no direct and immediate link between the residual inputs and the taxable supplies of vehicles in this case because all of the costs were recovered as part of the price of the supply of finance. Use for the purposes of Article 173 has, they submit, to be economic use so that, in judging the fairness of the apportionment method in the proposed PESM, it was both legitimate and necessary to consider what, in economic terms, the overheads were really used for. The fact that the overheads may relate to all parts of VWFS's business in the sense that they are costs of the operation of each sector of its business does not necessarily mean that they are deductible in respect of each taxable supply which the business makes. It is necessary to identify which of those supplies represents the real economic use of the relevant asset.

57. This test is derived, of course, from the judgment of Etherton LJ in the *London Clubs* case I referred to earlier and it is worth reminding oneself of the context in which it was employed. As mentioned earlier at [39], the court was faced (as here) with a dispute as to whether a PESM provided for a fair apportionment of residual input tax between the company's gaming and catering supplies. The proposed method of apportionment was based on the floor space occupied by each part of the business rather than turnover. The references to profitability in the passages I have quoted reflect the fact that the catering business was largely loss-making compared to the gaming business which was profitable. Hence the argument that any formula for apportioning residual input tax should recognise that the main purpose of the company's overheads was to enable and support the profitable gaming business rather than the ancillary catering operation. This appears most clearly in the extract from the Tribunal's judgment in *Aspinall's Club* which Etherton LJ quotes in [41] of his judgment. But the result of the appeal in *London Clubs* demonstrates that the existence of a separate less profitable, or even loss-making business, which cannot be regarded merely as ancillary to the principal business (in that case) of gaming and to be entirely dependent on the latter's existence, is not to be disregarded in assessing the use made of the general overheads of the company conducting both economic activities. Nor did the Commissioners in that case contend that the predominance of the company's gaming business should lead to a nil appropriation of residual input tax to the catering business. Their argument was that the balance of use was more fairly represented by an apportionment based on turnover.

58. In the present case, HMRC contend that the only fair and reasonable method of apportionment is one which attributes the entire economic use of the residual inputs to the supply of finance. So far as they need to, they rely, as I have explained, on the inclusion of those costs in the price of the supply of finance as corroborative of the fact that their only economic use is in relation to an exempt supply. Mr Thomas criticises the FtT's analysis of this issue as flawed by an assumption that because a portion of the residual input costs has been allocated (by agreement) to the retail sector of VWFS's business, it follows that those costs necessarily function as cost components of all the taxable supplies which that sector of the business makes. An objective analysis of the economic use of the overheads should indicate that these are costs of the supply of finance. VWFS is not a car dealership and acquires the vehicles

it supplies only as a pre-requisite to its supply of finance to the customers who wish to acquire vehicles on those terms. Unfinanced sales of vehicles form no part of its business.

59. Mr Thomas therefore submits that the FtT's conclusion at [75] of its decision is inconsistent with a proper analysis based on economic use and that the Upper Tribunal reached the correct conclusion on this issue.

60. The Upper Tribunal's analysis of economic use proceeds on the basis that the major part of VWFS's retail business comprises the provision of finance and that the supply of the vehicles is no more than an ancillary (although necessary) part of the finance transaction. There is no mark-up on the vehicles and the acquisition and the sale of the vehicles is essentially cost neutral. The profit lies in the finance of those sales.

61. There is obvious force in these points but they do not in my view justify treating the entirety of the residual input costs as attributable to (or used for) the purpose of making the exempt supply of finance. VWFS is not a bank. It operates to provide a service to customers of VW who wish to purchase their vehicles on HP. To provide that service it has to make supplies both of the vehicles and of the finance required for their purchase. Neither can exist as part of its business without the other. This is not a case like *London Clubs* or *Aspinall's* where the gaming business could have continued without the making of the catering supplies. On the facts found by the FtT, it was therefore entitled in my view to conclude as it did that the general overheads were used in part for the making of taxable supplies of vehicles.

62. There is, I think, a danger in reading the decision of this court in *London Clubs* out of context and as some kind of proxy for Article 173. The issue in the case was whether the PESM provided a fairer and more reasonable attribution of the residual inputs between two supplies, it having been accepted that those inputs were cost components of both sets of supplies. It was not and could not be part of the Commissioners' argument that use of a cost component by a taxable supply should be assessed at nil and the same inconsistency arises in the present appeal which is also a choice between two methods of attribution. Etherton LJ does not say that predominant economic factors such as profitability can reduce an assessment of use to nil and he would, in my view, have been wrong to do so. Once it is conceded that the taxable supply (in this case of the vehicles) was part of the economic activities of the taxable person then the use of the overheads to fund that business is, on *Midland Bank* principles, sufficient to establish the direct and immediate link which the jurisprudence of the ECJ requires. The overheads are general costs of the business and (as such) cost components of all the relevant supplies. How the taxable person chooses to recover those costs as between the output supplies he makes may, as I have said, be relevant to a fair and reasonable attribution of those costs as between the outputs. But I do not see any principled basis on which it can lead to the overheads ceasing to be treated as cost components of that particular supply. To do so runs contrary to what is said in [26] of *BLP*.

63. The Upper Tribunal (at [97]) criticises the FtT for looking at the transactions through VAT-tinted spectacles. But that, with respect to the Upper Tribunal, is what it failed to do. In my view, it has substituted for the conventional and established approach of the ECJ to the recovery of general overheads a new test of economic activity derived from the *London Clubs* decision which is misplaced. The FtT correctly identified in

[70] of its decision that the supply of vehicles was for VAT purposes part of VWFS's relevant economic activity to which its general overheads related without distinction. In those circumstances, they were cost components of the taxable supplies. A zero attribution is therefore unsustainable.

64. Mr Thomas submitted that the points raised by his submissions are not *acte clair* and that we should make a reference to the CJEU. In my view, the appeal turns on established principles for which no reference is necessary.

Ground 2

65. The second issue in the appeal is whether HMRC raised before the FtT the fairness of a 50% recovery rate under the proposed PESM and contended that a lesser amount should be apportioned to the use of the input supplies by the output supplies of vehicles. As mentioned earlier, the FtT's understanding of HMRC's case was that no partial attribution of residual input tax to the supply of vehicles was fair and reasonable and that they had not advanced any secondary case about the methodology of the PESM: see [42] and [77] of the FtT decision. But Mr Thomas submits, and the Upper Tribunal accepted, that he had run a secondary case about the proper level of attribution in case he was wrong in his primary submission that there should be a nil attribution.

66. One might have thought that this issue was capable of being easily resolved either by counsel's own recollection of what was argued or by looking at the written submissions and other materials put before the FtT. It might also be thought that the FtT, in front of whom the appeals were argued, was best placed to decide what points were and were not in issue. But counsel are not in agreement as to what occurred and we have therefore been asked to resolve the question of what matters were in issue on the appeals.

67. HMRC's skeleton argument before the FtT contains a general challenge in [1]-[5] about whether the preferred method of apportionment proposed by VWFS is fair and reasonable but then contains a summary of the ECJ decisions which are said to support the requirement that the input costs should be included in the price of the output supplies. In [33] the submission is made that although comprising two supplies, they should not be looked at independently for the purpose of determining whether the PESM is fair and reasonable. An analysis based on economic use is necessary. The skeleton then goes on to compare the rival methodologies and to describe the Commissioners' methodology which, as I explained earlier, leaves out of account the value of the vehicles. Reference is also made to Revenue & Customs Brief 82/09 which sets out HMRC's published policy in relation to HP transactions in which goods are re-sold without any price increase to capture overheads.

68. As part of its evidence before the FtT, HMRC relied upon two witness statements made by Mr Jonathan Cannon, in the second of which he analysed the rival methodologies of HMRC and VWFS. He explains (in [11]) that the VWFS methodology is at odds with HMRC's published policy and says that it offends the principle of fiscal neutrality because HP finance enjoys a cost subsidy not available to other finance providers.

69. We have been provided with Judge Berner's notes of the hearing which record the following submission made by Mr Thomas:

> "[The] value of the car does not bear on the use of overheads. What [VWFS] says is [that] if [that is done] it would be 80%, but 50% is fair. But why? The Appellant does not say. 50% is an arbitrary selection of a figure. No analysis has been put forward. [This] comes from the weighting exercise. HP contracts [are] treated as 2 transactions. [It is] wholly unexplained as [to] why it is fair to treat HP [transactions] 1:1. Why not another fraction?"

70. Ms Shaw does not dispute the accuracy of the judge's note but says that the submission it records has to be read in the context of HMRC's case as a whole. Although Mr Thomas was attacking as arbitrary the 50% apportionment proposed by VWFS, he did so as part of a general attack on its methodology based on there being no economic use by the taxable outputs of the general overheads. Their only alternative to 50% was 0%. As the judge recorded in his notes, the dispute was one of principle in relation to whether the VWFS methodology offended against the principle of fiscal neutrality.

71. The Upper Tribunal did not need to decide this second point but it expressed the view that a more general point about the fairness of the proposed PESM was in play as a result of the submission made by Mr Thomas which I have quoted and also his cross-examination of Ms Norma Doherty, VWFS's indirect tax accountant. But my own reading of the judge's notes on these issues is that Mr Thomas was challenging the basis of the 50% attribution as arbitrary in the context, as Ms Shaw has submitted, of an argument that any attribution was impermissible. HMRC did not rely upon some alternative methodology which attributed to the use of the residual inputs by the taxable supply of vehicles a figure somewhere between 1% and 50%. I do not see how this court is in the position to gainsay Judge Berner's understanding of the parties' position on the appeals which the FtT heard and none of the materials we have been asked to look at demonstrate that the FtT misunderstood HMRC's case.

72. In these circumstances the FtT, having rejected Mr Thomas' point of principle based on Brief 82/09, had no alternative but to endorse the PESM proposed by VWFS and its decision discloses no error of law.

Conclusion

73. For these reasons, I would allow VWFS's appeal on both grounds.

Lady Justice Sharp :

74. I agree.

Lady Justice King :

75. I also agree.