[2021] UKFTT 0199 (TC)

TC08149

VAT – Appellant makes only taxable supplies – whether receipt of subsidy ie outside the scope income meant that his recovery of input tax should be restricted – held no – appeal allowed

FIRST-TIER TRIBUNAL
TAX CHAMBER

Appeal number: TC/2018/03780

BETWEEN

COLIN NEWELL **Appellant**

-and-

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

TRIBUNAL: JUDGE JEANETTE ZAMAN

The hearing took place on 29 to 30 April 2021. With the consent of the parties, the form of the hearing was a remote video hearing on the Tribunal video platform. A face to face hearing was not held because of the ongoing restrictions arising from the COVID-19 pandemic. The documents to which I was referred are described in the decision notice.

Prior notice of the hearing had been published on the gov.uk website, with information about how representatives of the media or members of the public could apply to join the hearing remotely in order to observe the proceedings. As such, the hearing was held in public.

David Small, counsel, instructed by MHA MacIntyre Hudson LLP, for the Appellant

Elizabeth McIntyre, litigator of HM Revenue and Customs' Solicitor's Office, for the Respondents

DECISION

INTRODUCTION

1. Mr Newell operates a business in which he generates hot air from burning wood chips. The hot air is used to dry wood chips and other materials, belonging to him or others, and Mr Newell either sells the dried materials, retains them for burning himself or charges third parties for drying their own materials. He had also received periodical support payments ("PSPs") under the Renewable Heat Incentive scheme for Northern Ireland (the "RHI scheme"). Mr Newell had prepared his VAT returns on the basis that all of the input tax which he had incurred on supplies made to him by other VAT-registered traders is deductible input tax. HMRC disagreed and have issued assessments for the VAT periods 1/15 to 4/18 on the basis that only a proportion of Mr Newell's input tax is deductible.

2. For the reasons set out below, I have concluded that Mr Newell is entitled to full recovery of his input tax. I have allowed Mr Newell's appeal.

EVIDENCE

3. The hearing bundle comprised several pdfs in various volumes (1, 2.1 to 2.4, 3.1 to 3.2, 4 and 5). The bundle included the Notice of Appeal, HMRC's statement of case, correspondence between the parties, correspondence between Mr Newell and OfGem relating to the accreditation of the boilers, audit and the fuel logs, photos of the boilers and the accounts of the business. I also had a bundle of authorities, two additional cases and skeleton arguments from both parties.

4. Both parties adduced witness evidence.

5. Mr Newell had prepared a witness statement dated 15 July 2019 and a supplementary witness statement dated 24 March 2020. He gave additional evidence at the hearing, and was cross-examined by Mrs McIntyre. I considered him to be a credible witness and, so far as matters of fact were in dispute between the parties, I accept his evidence.

6. There was also a witness statement from Raymond Baxter of HMRC dated 27 June 2019. Mr Baxter had issued the assessments which are under appeal. His statement describes his visit to the business, inspection of records, the advice he had obtained from HMRC policy, the issuance of his initial view of the matter letter on 22 June 2017, his analysis of the business income and expenditure, the raising of the assessments and the subsequent adjustments made. This statement was agreed by Mr Newell and although Mr Baxter did attend the hearing he was not called to give evidence.

FACTS

7. I had the benefit of a statement of agreed facts dated 19 August 2020. My further factual findings are based on the evidence of Mr Newell and evidence as to the conditions for and operation of the RHI scheme in Northern Ireland.

Statement of Agreed Facts

8. At all material times Mr Newell was registered for VAT.

9. At all material times, the sales made by Mr Newell's biomass business (of woodchips, dried animal bedding and drying bedding delivered by others) were all taxable supplies, bearing VAT at the standard rate, a reduced rate or the zero rate (in the case of exports to another Member State). The business made no exempt supplies.

10. Between 1 November 2014 and 31 January 2017 (VAT periods 1/15 to 1/17), Mr Newell made taxable supplies totalling £755,214 and received PSPs under the RHI scheme totalling

£679,937. Taking those periods together, the payments under the RHI scheme represented 47.37% of total receipts.

11. Between 1 February 2017 and 30 April 2018 (VAT periods 04/17 to 04/18), Mr Newell made taxable supplies totalling £696,190 and received PSPs under the RHI scheme totalling £283,873. Taking those periods together, the payments under the RHI scheme represented 28.96% of total receipts.

12. The following assessments and decisions are under appeal:

(1) Period 01/15 (3 months to 31 January 2015) - assessment £6,180.

(2) Period 04/15 (3 months to 30 April 2015) - assessment £4,160.

(3) Period 07/15 (3 months to 31 July 2015) - assessment £8,514.

(4) Period 10/15 (3 months to 31 October 2015) - assessment £24,012.

(5) Period 01/16 (3 months to 31 January 2015) - assessment £14,242.

(6) Period 04/16 (3 months to 30 April 2016) - assessment £27,529.

(7) Period 07/16 (3 months to 31 July 2016) - assessment £12,730.

(8) Period 10/16 (3 months to 31 October 2016) - assessment £10,230

(9) Period 01/17 (3 months to 31 January 2017) - assessment £18,578.

(10) Period 04/17 (3 months to 30 April 2017) - assessment £15,861 (the parties are agreed that even if HMRC are successful in the present appeal on matters of principle this assessment should be reduced to £9,697).

(11) Period 07/17 (3 months to 31 July 2017) - assessment £835 (the parties are agreed that even if HMRC are successful in the present appeal on matters of principle this assessment should be reduced to £NIL and that there is an excess of input tax over output tax for the quarter of £3,473).

(12) Period 10/17 (3 months to 31 October 2017) - assessment £2,500 (the parties are agreed that even if HMRC are successful in the present appeal on matters of principle this assessment should be reduced to £NIL and that there is an excess of input tax over output tax for the quarter of £1,612).

(13) Period 01/18 (3 months to 31 January 2018) - assessment £3,295 (the parties are agreed that even if HMRC are successful in the present appeal on matters of principle this assessment should be reduced to £NIL and that there is an excess of input tax over output tax for the quarter of £421).

(14) Period 04/18 (3 months to 30 April 2018) - decision that excess of input tax over output tax for the quarter should be £4,670 (the parties are agreed that even if HMRC are successful in the present appeal on matters of principle the excess of input tax over output tax for the quarter is in fact £11,237).

Further findings of fact

13. Mr Newell has invested in biomass boilers in three main phases:

(1) Phase 1 started in 2014, when he installed two boilers. This required an initial investment of approximately £70,000, and he committed to a 20-year lease at £9,600pa for the site.

(2) In September 2014 he extended his lease to cover a larger part of the site with rent therefore increasing to £16,800pa. Between September and December 2014, he carried

out Phase 2 of his investment, installing four more boilers. The total cost of Phase 2 was £160,000, which was funded partly from profits, but also funding from equipment suppliers who were prepared to deliver against an initial deposit followed by monthly payments until the equipment was fully paid for.

(3) Phase 3 investment commenced in July 2015 and was commissioned in September 2015. Mr Newell purchased and installed six more boilers which, along with associated works, cost between £250,000 and £300,000.

14. Mr Newell explained that separate boilers make sense commercially as it enables flexibility in use. He now has 12 boilers, any one of which can be used individually so he only uses boilers as required. These smaller boilers can also reach optimum temperature within 15 minutes, so are very flexible to adjust to demand.

15. Mr Newell has what he described as a mixed business model – drying animal bedding delivered by others; buying sawdust to dry and grade for animal bedding which he then sold; and buying logs (which are stored on-site) to chip, dry and grade to sell as fuel in biomass boilers and for animal bedding. He also dries animal feed (grain) on a seasonal basis. Some of the woodchips which he produces and dries are used as fuel in his own boilers; the rest are sold.

16. Mr Newell has one business bank account, and all payments of PSPs as well as receipts from customers were paid into that bank account.

RHI Scheme

17. The Renewable Heat Incentive Scheme Regulations (Northern Ireland) 2012 (the "RHI Regulations 2012") establish, according to regulation 3(1) thereof, an incentive scheme to facilitate and encourage the renewable generation of heat and make provision regarding its administration.

18. Paragraph 1.4 of the guidance published by the Department of Enterprise, Trade and Investment in Northern Ireland in March 2016 describes the RHI scheme as follows:

> "The Northern Ireland RHI is a financial incentive scheme designed to increase the uptake of renewable heat and reduce the UK's carbon emissions. Broadly speaking, the scheme provides a subsidy per kWth [kilowatt thermal] of eligible renewable heat generated from accredited installations … . The objective of the NIRHI is to significantly increase the proportion of the UK's heat that is generated from renewable sources, driving change in a heat sector that is currently dominated by fossil fuel technologies. It aims to encourage the uptake of renewable heat technologies by compensating for barriers to their adoption, including the current higher upfront costs and operational expenditure for these technologies as compared to those using traditional fossil fuels."

19. Regulation 3(2) provides that the Department of Enterprise, Trade and Investment must pay participants who are owners of accredited RHI installations payments, referred to in the RHI Regulations 2012 as periodic support payments, "for generating heat that is used in a building for any of the following purposes – (a) heating a space; (b) heating liquid; or (c) for carrying out a process".

20. There have been various changes to the RHI scheme:

(1) The amounts payable were changed for new entrants in November 2015 by the introduction of a new tiered system, and in February 2016 the scheme was closed to new entrants.

(2) From April 2017 new regulations put all participants who had been accredited to the scheme before November 2015 (such as Mr Newell) on the same tiered payment system as applied to participants who joined the scheme after that date. The change applied retrospectively to the anniversary of the introduction of each boiler onto the scheme. More exactly, the new lower payments applied to any production in excess of 1314 kwh by a boiler from its last anniversary date before April 2017.

21. The changes in April 2017 drastically reduced the amount of PSPs available. During 2018 the maximum subsidy per boiler was capped at 400,000 kwh, equivalent to £12,000 to £13,000. A further reduction in the cap to approximately £2,000 per boiler has been introduced from April 2019. So, from April 2019 the maximum amount Mr Newell has been able to claim under the RHI scheme is £24,000pa (12 boilers, each capped at £2,000).

Development of Mr Newell's export business

22. By the end of the periods in issue, approximately 40% to 50% of his sales are for export, principally to the Republic of Ireland. The exports were not at this level earlier – Mr Newell was not able to be specific as to when he had begun exporting, but thought it was probably in the middle of the periods under appeal, which I took to be around 2016. These sales are zero-rated where his customer is able to provide a VAT number; Mr Newell does charge VAT on some of his exports as some of his customers are not VAT-registered.

23. Mr Newell had started to focus on exports as a certain stigma had become attached to the RHI scheme in Northern Ireland in consequence of media reports (as described further below).

Impact of RHI scheme on pricing

24. As the rates of payments under the RHI scheme have reduced Mr Newell has where possible sought to charge more to customers.

25. Mr Newell's evidence was that when RHI was being paid at the unrestricted rate it had a downward pressure on prices, because the market had factored it in; if he had tried to charge prices as if the RHI scheme did not exist, he would have been undercut by everyone else. The restriction on payments has reduced that downward pressure on prices, but heat from woodchips still has to compete with other energy sources. I accept that evidence.

Amounts claimed under RHI scheme

26. The boilers needed to be accredited by Ofgem in to qualify for PSPs. The boilers were required to comply with conditions related to sustainability and air quality control, and obtaining accreditation meant that operators were agreeing to be monitored under the RHI scheme.

27. All of Mr Newell's boilers were accredited:

(1) For the first phase (which involved the installation of two boilers), the accreditation process was dealt with by the boiler installer.

(2) On phase two (four boilers) the accreditation was dealt with by another party, Action Renewables. The installer redirected Mr Newell to Action Renewables, who were engaged by the installer as a contractor to handle accreditation. The cost of this service was built into the price of the boilers - whilst Mr Newell liaised with Action Renewables to ensure accreditation with Ofgem after the boilers were installed, he did not contract directly with them and did not pay them separately.

(3) For phase three, the same process was followed - Action Renewables were engaged by the installer and assisted with the accreditation process.

28. Mr Newell's evidence was that if he had contracted directly with an accreditation specialist such as Action Renewables, the cost would have been between £200 and £350 per boiler. That evidence was not challenged by HMRC and I accept it.

29. In order to claim RHI payments, Mr Newell submitted quarterly readings onto an online database. The readings were taken from meters attached to each boiler. The meters record the flow and temperature of water out of and into each boiler, which then generates a measure of KWh thermals.

30. The amount Mr Newell received under the RHI scheme peaked at £396,000 in financial year 2016/2017. The maximum available payment under the scheme for his boilers in that year was £676,000 – this is on the assumption that he had run all 12 boilers for 24 hours a day at full capacity. There was not sufficient demand from customers to require operating at that level.

31. The PSPs received by Mr Newell fell to £109,000 in 2018/19 (out of a maximum available of approximately £150,000), and the new rules which applied from 1 April 2019 (ie after the periods under appeal) cap payments at £24,000.

32. However, Mr Newell's sales income continues to rise and he is still able to operate profitably (although profit margins are down on what they were), principally due to demand from the Republic of Ireland which historically has a strong biomass industry generating high levels of demand. Sales to customers in the Republic of Ireland are (as at July 2019) in excess of £200,000pa.

Potential for abuse of the RHI scheme

33. Mr Newell explained that there had been suggestions in the media in Northern Ireland that some traders were burning biomass purely to qualify for payments under the RHI scheme with no genuine business purpose. Mr Newell was critical of these rumours and considered that participants were used as scapegoats. A later report showed that more than 98% of participants had been compliant – the so-called abuses didn't exist. His own view was that the government had spent money it didn't have and had mismanaged its budget.

34. In any event, Mr Newell denied that he had done this. He explained that not only would it be contrary to the RHI Regulations 2012, but also that commercially it "doesn't add up" for a participant to burn logs and generate heat simply to claim the subsidy without any sale of a product. I accept this evidence.

RELEVANT LAW

35. The VAT periods in respect of which decisions and assessments are under appeal in the present case begin with that ending 31 January 2015 and conclude with that ending 30 April 2018. The decisions and assessments were made in 2017 and 2018. Those periods and dates all precede 31 January 2020, the date on which the UK left the EU, and 31 December 2020, the end of the implementation period. Nevertheless, the European Union (Withdrawal) Act 2018 and subsequent legislation enacted to effect the UK's withdrawal from the EU have only limited relevance.

36. I note that this is a Northern Irish appeal. Under Article 12(4) and (5) of the Protocol to the Withdrawal Agreement, EU law is to continue to have the same effect in Northern Ireland in relation to VAT on supplies of goods as it did before withdrawal, and the right to make references to the Court of Justice of the European Union ("CJEU") in respect thereof is preserved. Mr Newell made supplies of both goods and services. However, neither party submitted that the differences between the rules currently applying to goods and those applying to services should have any bearing on this appeal.

37. The relevant provisions of EC Council Directive 2006/112 (the "Principal VAT Directive") are set out below:

> "Article 1
>
> …
>
> (2) The principle of the common system of VAT entails the application to goods and services of a general tax on consumption exactly proportional to the price of the goods and services, however many transactions take place in the production and distribution process before the stage at which the tax is charged.
>
> On each transaction, VAT, calculated on the price of the goods or services at the rate applicable to such goods or services, shall be chargeable after deduction of the amount of VAT borne directly by the various cost components.
>
> Article 2
>
> (1) The following transactions shall be subject to VAT;
>
> a) The supply of goods for consideration within the territory of a member of state by a taxable person acting as such
>
> b) The supply of services for consideration within the territory of a member of state by a taxable person acting as such.
>
> Article 9
>
> (1) "Taxable person" shall mean any person who, independently, carries out in any place any economic activity whatever the purpose of that activity.
>
> Any activity of producers, traders or persons supplying services… shall be regarded as an economic activity. The exploitation of tangible or intangible property for the purpose of obtaining income there from on a continuing basis shall in particular be regarded as an economic activity…
>
> Article 14
>
> (1) "Supply of goods" shall mean the transfer of the right to dispose of tangible property as owner.
>
> Article 15
>
> (1) Electricity, gas, heat or cooling energy and the like shall be treated as tangible property.
>
> Article 24(1)
>
> (1) "Supply of services" shall mean any transaction which does not constitute a supply of goods.
>
> Article 62
>
> For the purposes of this Directive;
>
> (1) "chargeable event" shall mean the occurrence by virtue of which the legal conditions necessary for VAT to become chargeable are fulfilled;
>
> (2) VAT shall become "chargeable" when the tax authority becomes entitled under the law, at a given moment, to claim the tax from the person liable to pay, even though the time of payment may be deferred.
>
> Article 63

The chargeable event shall occur and VAT shall become chargeable when the goods or services are supplied.

Article 65

Where a payment is to be made on account before the goods or services are to be supplied, VAT shall become chargeable on receipt of the payment and on the amount received.

Article 66

By way of derogation … Member States may provide that VAT is to become chargeable … at one of the following times;

(a) no later than the time the invoice is issued;

(b) no later than the time the payment is received;

(c) …

Article 73

In respect of the supply of goods or services, other than as referred to in Articles 74 to 77, the taxable amount shall include everything which constitutes consideration obtained or to be obtained by the supplier, in return for the supply, from the customer or a third party, including subsidies directly linked to the price of the supply.

Article 138

Member States shall exempt the supply of goods dispatched or transported to a destination outside their respective territory but within the Community, by or on behalf of the vendor or the person acquiring the goods, for another taxable person …

Article 167

A right of deduction shall arise at the time the deductible tax becomes chargeable.

Article 168:

Insofar as the goods and services are used for the purposes of the taxed transactions of a taxable person, the taxable person shall be entitled…to deduct the following from the VAT which he is liable to pay:

(a) the VAT due or paid…in respect of supplies to him of goods or services carried out or to be carried out by another taxable person.

Article 169

In addition to the deduction referred to in Article 168, the taxable person shall be entitled to deduct the VAT referred to therein in so far as the goods and services are used for the purposes of the following;

(b) transactions which are exempt pursuant to Articles 138 …

Article 173

(1) In the case of goods or services used by a taxable person both for transactions in respect of which VAT is deductible pursuant to article 168…and for transactions in respect of which VAT is not deductible, only such proportion of the VAT as is attributable to the former transactions shall be deductible.

The deductible proportion shall be determined, in accordance with Articles 174 and 175, for all the transactions carried out by the taxable person.

(2) Member States may take the following measures –

… …

(c) authorise or require the taxable person to determine a proportion for each sector of his business and to keep separate accounts for each sector.

Article 174

(1) The deductible proportion shall be made up of a fraction comprising the following amounts;

(a) as numerator, the total amount, exclusive of VAT, of turnover per year attributable to transactions in respect of which VAT is deductible pursuant to Articles 168 and 169;

(b) as denominator, the total amount, exclusive of VAT, of turnover per year attributable to transactions included in the numerator and to transactions in respect of which VAT is not deductible.

Member states may include in the denominator the amount of subsidies, other than those directly linked to the price of supplies of goods or services referred to in Article 73.

Article 175

(1) The deductible proportion shall be determined on an annual basis, fixed as a percentage and rounded up to a figure not exceeding the next whole number."

38. The relevant provisions of the Value Added Tax Act 1994 ("VAT Act 1994") are as follows:

"4 (1) VAT shall be charged on any supply of goods or services made in the United Kingdom where it is a taxable supply made by a taxable person in the course or furtherance of any business carried on by him.

(2) A taxable supply is a supply of goods or services made in the United Kingdom other than an exempt supply.

5(1) Schedule 4 shall apply for determining what is or is to be treated as a supply of goods or a supply of services.

(2) Subject to any provision made by that Schedule…

(a) "supply" in this act includes all forms of supply, but not anything done otherwise that for a consideration;

(b) anything which is not a supply of goods but is done for a consideration (including, if so done, the granting, assignment or surrender of any right) is a supply of services.

6(1) The provisions of this section shall apply … for determining the time when supply of goods or services is to be treated as taking place for the purposes of the charge to VAT. …

(3) Subject to subsections (4) to (14) below, a supply of services shall be treated as taking place at the time when the services are performed.

(4) If, before the time applicable under subsection … (3) above, the person making the supply issues a VAT invoice in respect of it or if, before the time applicable under subsection … (3) above, he receives a payment in respect of it, the supply shall, to the extent covered by the invoice or payment, be treated as taking place at the time the invoice is issued or the payment is received.

(5) If, within 14 days of the time applicable under subsection … (3) above, the person making the supply issues a VAT invoice in respect of it, then, unless he has notified the Commissioners in writing that he elects not to avail himself of this subsection, the supply

shall (to the extent that it is not treated as taking place at the time mentioned in subsection (4) above) be treated as taking place at the time the invoice is issued.

7

…

(7) Goods whose place of supply is not determined under any of the preceding provisions of this section but whose supply involves their removal to or from the UK shall be treated –

(a) as supplied in the UK where their supply involves their removal from the UK without also involving their previous removal to the UK…

…

19(1) For the purposes of this Act the value of any supply of goods or services shall … be determined in accordance with this section and Schedule 6 …

(2) If the supply is for a consideration in money its value shall be taken to be such amount as, with the addition of the VAT chargeable, is equal to the consideration.

(3) If the supply is for a consideration not consisting or not wholly consisting of money, its value shall be taken to be such amount in money as, with the addition of the VAT chargeable, is equivalent to the consideration.

…

24(1) Subject to the following provisions of this section "input tax", in relation to a taxable person means the following tax, that is to say-

(a) VAT on the supply to him of any goods or services...

being … goods or services used or to be used for the purpose of any business carried on or to be carried on by him.

(2) Subject to the following provisions of this section "output tax" in relation to a taxable person, means VAT on supplies which he makes…

(5) Where goods or services supplied to a taxable person…are used or to be used partly for the purposes of a business carried on or to be carried on by him and partly for other purposes –

(a) VAT on supplies…shall be apportioned so that only so much as is referable to his business purposes is counted as his input tax, and

(b) the remainder of that VAT ("the non-business VAT") shall count as that person's input tax only to the extent (if any) provided for by regulations under subsection (6)(e).

(6) Regulations may provide -

(e) in cases where an apportionment is made under subsection (5), for the non-

business VAT to be counted as the taxable person's input tax for the purposes of any provision made by or under section 26 in such circumstances, to such extent and subject to such conditions as may be prescribed.

25

…

(2) Subject to the provisions of this section, [a taxable person] is entitled at the end of each prescribed accounting period to credit for so much of his input tax as is allowable under section 26, and then to deduct that amount from any output tax that is due from him.

(3) If either no output tax is due at the end of the period, or the amount of the credit exceeds that of the output then … the amount of the credit or, as the case may be, the amount of the excess shall be paid to the taxable person by the Commissioners …

26(1) The amount of input tax for which a taxable person is entitled to credit at the end of any period shall be so much of the input tax for the period … as is allowable by or under regulations as being attributable to supplies within subsection (2) below.

(2) The supplies within this subsection are the following supplies made or to be made by the taxable person in the course or furtherance of his business;

(a) taxable supplies; …

(3) The Commissioners shall make regulations for securing a fair and reasonable attribution of input tax to supplies within subsection (2) above …"

ISSUES

39. The following were common ground:

(1) Mr Newell makes only taxable supplies.

(2) The PSPs under the RHI scheme are not subsidies directly linked to the price of the supply, nor are they consideration received from a third party for supplies made to customers.

(3) The PSPs are income which is outside the scope of VAT.

40. Furthermore, no challenge was made by Mr Newell as to whether or not the assessments were made to the best of the assessing officer's judgment.

41. The difference between the parties concerns the question whether, and if so to what extent, the receipt of PSPs should affect Mr Newell's entitlement to deduct input tax which he has incurred on the purchase of goods and services.

42. I refer to both parties' submissions further in the Discussion. I have summarised here their respective positions.

43. Mr Small submitted that given that Mr Newell made only taxable supplies and did not make any exempt supplies, the mere fact of receipt of PSPs under the RHI scheme did not mean that he should suffer any restriction on the recovery of his input tax:

(1) Under the Principal VAT Directive, a trader who makes only taxable supplies is entitled to deduct all the input tax incurred on his purchases. VAT is a neutral tax for traders who make no supplies which are not taxable supplies. The 100% deduction of input tax to which a fully taxable trader is entitled is not affected by the fact that he or she happens also to be in receipt of subsidies which are outside the scope of VAT. Five decisions of the CJEU directly support that proposition and there is no authority against it.

(2) The Supreme Court has also confirmed the right of a trader who only makes taxable supplies, but who is in receipt of an outside the scope subsidy, to deduct 100% of his input tax, even on costs specifically incurred in order to obtain or qualify for the subsidy.

44. Alternatively, if any restriction on Mr Newell's right to deduct input tax falls to be made, Mr Small submitted that the only input tax which falls to be disallowed is that borne on expenses which were specifically incurred with a view to obtaining the PSPs themselves; such expenses are believed to be minimal.

45. Mrs McIntyre submitted that HMRC's position was that Mr Newell is not entitled to recover the proportion of his input VAT on expenditure which relates to the receipt of PSPs. The expenditure he had incurred was a cost component of the generation of a mixture of taxable and outside the scope income, and input tax is only recoverable when it is used or to be used in the making of taxable supplies.

DISCUSSION

46. The burden of proof is on Mr Newell to establish, on the balance of probabilities, that he has been overcharged by the assessments, ie that he is entitled to recover all of the input tax which he has incurred.

Provisions of EU law relevant to recovery of input tax and/or subsidies

47. Article 9 of the Principal VAT Directive states that a taxable person is one carrying out an economic activity. An activity which is not an economic activity is often referred to as being "outside the scope" of VAT.

48. Article 168 provides:

> "Insofar as the goods and services are used for the purposes of the taxed transactions of a taxable person, the taxable person shall be entitled…to deduct the following from the VAT which he is liable to pay:
>
> (a) the VAT due or paid…in respect of supplies to him of goods or services carried out or to be carried out by another taxable person."

49. This provision therefore sets out that the input tax deductible is that which has been incurred on the acquisition of goods and services which are "used for the purposes of the taxed transactions". It is implicit in Article 168 that if goods and services which a taxable person has acquired are not used, or not used wholly, by the trader for making taxable supplies then the input tax incurred on buying those goods and services is not deductible, or is not wholly deductible.

50. Articles 173 to 175 then provide for the situation in which purchased goods and services are used for the purposes of making a mixture of different types of output transactions; those in respect of which VAT is deductible, and those in respect of which it is not. In that situation, only a proportion of the input VAT can be deducted. Articles 174 and 175 specify what that proportion is, and the last sentence of Article 174(1) allows Member States to include in the denominator of that fraction subsidies other than those directly linked to the price of the goods or services supplied (subsidies directly so linked would already be included in the value of transactions in respect of which VAT is deductible).

51. Articles 173 to 175 only apply to purchased goods and services which are used for the purpose of making both taxable and exempt supplies. On the basis of the agreed fact that Mr Newell does not make any exempt supplies, Articles 173 to 175 cannot apply here.

52. The principles relevant to the deduction of input tax are well-established, eg in Case C-465/03 *Kretztechnik AG v Finanzamt Lenz* [2005] STC 1118. The CJEU has emphasised:

> (1) the importance of the right to deduct input tax, an integral part of the VAT scheme, a right which cannot be limited beyond such explicit restrictions as exist in the Directive;
>
> (2) the principle of neutrality, ie that traders who make only taxable supplies should be able to recover all of the input tax which they incur;

(3) VAT is a neutral tax on taxable economic activity, irrespective of purpose and results; and

(4) the input transactions must have a direct and immediate link with the output transactions giving rise to a right of deduction. Thus, the right to deduct VAT charged on the acquisition of input goods or services presupposes that the expenditure incurred in acquiring them was a component of the cost of the output transactions that gave rise to the right to deduct.

53. The Principal VAT Directive makes two express references to subsidies. Article 73 specifies when subsidies may be liable to output VAT, while Article 174(1) (as referred to above) allows Member States to require partially exempt traders to include subsidies which are not liable to output VAT in the denominator of the partial exemption fraction.

Summary of Appellant's main submissions

54. Mr Small's submission was that the Directive has set out the circumstances in which the receipt of subsidies are to be taken into account, and national governments cannot go further than this and introduce additional restrictions, whether in legislation or by the approach taken by the tax authority.

55. Mr Small referred to five decisions of the CJEU which he submitted demonstrated that the receipt of a subsidy does not prejudice input tax recovery by a fully taxable trader. He also relied on the decision of the Supreme Court in *HMRC v Frank A Smart & Son Ltd* [2019] UKSC 39 as the basis for an alternative line of argument to illustrate that a trader who made only taxable supplies but received a subsidy was entitled to recover all of his input tax on costs which were specifically incurred in order to obtain or qualify for the subsidy.

56. The first of CJEU decisions to which Mr Small referred is Case C-204/03 *Commission v Kingdom of Spain* [2006] STC 1087. Spain's VAT law included two particular provisions about subsidies, a general rule and a special rule:

(1) The general rule provided that in any case where a trader received a subsidy which was not itself subject to (output) VAT as part of the consideration for a supply made by the trader, there would be a proportional restriction on his right to deduct input tax; the denominator of the fraction would in all cases include the subsidy received. This rule applied to both mixed taxable persons and fully taxable persons, ie taxable persons who use the goods and services obtained as inputs to carry out transactions in respect of which VAT is deductible and other transactions of a similar nature in respect of which it is not (mixed taxable persons) and taxable persons who use goods and services exclusively to carry out transactions in respect of which VAT is deductible (fully taxable persons).

(2) The special rule provided that, where a subsidy was received specifically to fund the purchase of certain goods or services for use in making taxable supplies, the right to deduct input tax on the cost of the goods or services was to be restricted to the same extent as the subsidy contributed to the cost of the asset.

57. The CJEU found that neither the general nor the special rule was in accordance with the Sixth Directive. The CJEU set out its findings as follows:

(1) It repeated (at [23]) the established principle that "any limitation of the right to deduct VAT affects the level of the tax burden and must be applied in a similar manner in all the Member States. Consequently, derogations are permitted only in the cases expressly provided for in the Sixth Directive".

(2) At [25] and [26] it found that (what are now) Articles 173 and 174 of the Principal VAT Directive only apply to mixed taxable persons, ie traders who make both taxable

and exempt supplies. The option given to Member States by Article 174 to include subsidies in the denominator of the fraction used to restrict input tax deduction permits limitations of the right to deduct only in the case of mixed taxable persons. Consequently, by extending the restriction of the right to deduct to fully taxable persons, the general rule introduces a restriction which goes beyond the one expressly provided for by the Directive and infringes the provisions of the Directive.

(3) In relation to the special rule, the CJEU said at [27] "… it is sufficient to point out that it introduces a mechanism for limiting the right to deduct which is not provided for in arts [173 and 174] … or in any other provision of the directive." Consequently, such a mechanism is not authorised by the Directive.

(4) The CJEU noted at [28] that Member States are required to apply the Sixth Directive even if they consider it to be less than perfect. Even if the interpretation put forward by certain Member States better served certain aims of the Directive, such as fiscal neutrality, the Member States may not disregard the provisions expressly laid down in that Directive by introducing, in this case, limitations of the right to deduct other than those laid down in what are now Articles 173 and 174.

(5) At [31] the CJEU concluded by saying "… by providing for a deductible proportion of VAT for taxable persons who carry out only taxable transactions, and by laying down a special rule which limits the right to deduct VAT on the purchase of goods and services which are subsidised, the Kingdom of Spain has failed to fulfil its obligations under Community law and, in particular, arts [168, 173 and 174]".

58. The four further cases on which Mr Small relied in this context are Case C-243/03, *EC Commission v French Republic* [2006] STC 1098, Case C-74/08 *PARAT Automotive*, Case C-25/11 *Varzim Sol – Turismo, Jogo e Animacao SA v Fazenda Publica* [2012] STC 971 and Case C-126/14 *Sveda UAB v VMI* [2016] STC 447. Those decisions are entirely consistent with the decision in *Kingdom of Spain*.

59. I do (briefly) note at this stage the facts which were before the CJEU in *PARAT* as they serve to illustrate an argument (which I set out further below) put forward by HMRC on which they rely to distinguish this line of authority. *PARAT* concerned a provision of Hungarian VAT law to the effect that where a trader received a subsidy from public funds to assist in the purchase of assets, they could only deduct input tax on the part of the cost not covered by the subsidy. PARAT had enlarged its production capacity and received a subsidy of 47% of the investment cost. The tax authority sought to restrict the deductible VAT incurred on the cost of the investment to 53% of the total.

60. The CJEU referred to *Kingdom of Spain* and *French Republic* and held that the Hungarian legislation represented a restriction of the right to deduct input tax which was not permissible under the Directive.

61. Mr Small put forward what he described as an alternative argument as the basis for Mr Newell's appeal being allowed, relying on the decisions of the CJEU in *Kretztechnik* and the Supreme Court in *Frank A Smart*.

62. Dealing first with *Kretztechnik*, in that case the taxpayer conducted a fully taxable business. It incurred professional fees in relation to a public issue of shares to raise capital on the stock exchange to invest in that business. The CJEU decided that the issue of shares was not the making of a supply for a consideration; the transaction was outside the scope of the Directive. The question was then whether the taxpayer was entitled to deduct the input tax which it had borne on those fees.

63. The CJEU held that it was, framing the question at [30] as "essentially…whether art 17(1) and (2) of the Sixth Directive confer a right to deduction of input VAT paid on supplies linked with a share issue". Having set out the arguments of the parties and the principles governing the recovery of input tax, the CJEU found as follows:

> "35. It is clear from the last-mentioned condition that, for VAT to be deductible, the input transactions must have a direct and immediate link with the output transactions giving rise to a right of deduction. Thus, the right to deduct VAT charged on the acquisition of input goods or services presupposes that the expenditure incurred in acquiring them was a component of the cost of the output transactions that gave rise to the right to deduct (see Midland Bank, para 30, and Abbey National, para 28, and also Cibo Participations SA v Directeur régional des impôts du Nord-Pas-de-Calais (Case C-16/00) [2002] STC 460, [2001] ECR I-6663, para 31).
>
> 36. In this case, in view of the fact that, first, a share issue is an operation not falling within the scope of the Sixth Directive and, second, that operation was carried out by Kretztechnik in order to increase its capital for the benefit of its economic activity in general, it must be considered that the costs of the supplies acquired by that company in connection with the operation concerned form part of its overheads and are therefore, as such, component parts of the price of its products. Those supplies have a direct and immediate link with the whole economic activity of the taxable person (see BLP Group, cited above, para 25; Midland Bank, para 31; Abbey National, para 35 and 36, and Cibo Participations, para 33).
>
> 37. It follows that, under art 17(1) and (2) of the Sixth Directive, Kretztechnik is entitled to deduct all the VAT charged on the expenses incurred by that company for the various supplies which it acquired in the context of the share issue carried out by it, provided, however, that all the transactions carried out by that company in the context of its economic activity constitute taxed transactions. A taxable person who effects both transactions in respect of which VAT is deductible and transactions in respect of which it is not may, under the first sub-paragraph of art 17(5) of the Sixth Directive, deduct only that proportion of the VAT which is attributable to the former transactions (Abbey National, para 37, and Cibo Participations, para 34)."

64. Mr Small submitted that *Kretztechnik* is thus an example of the receipt of funds which are outside the scope of VAT not prejudicing 100% deduction of input tax by a fully taxable trader where those funds are to be deployed in the taxable business to make further taxable supplies. He submitted that the same result should follow in the present case, especially given that none of the purchases made by Mr Newell can be related specifically to the obtaining of the PSPs.

65. In *Frank A Smart* the taxpayer made only taxable supplies. It bought units of Single Farm Payment Entitlement ("SFPE"), paying VAT on the purchase price. It bought these units in order to claim a subsidy called the Single Farm Payment ("SFP") each year. It intended to accumulate the SFPs until it was in a position to spend the surplus on capital projects to improve and expand the agricultural farm, and to construct a wind farm producing electricity, all of which would enable the business to make more taxable supplies. The subsidies received were outside the scope of VAT. The taxpayer sought to deduct all the VAT it had paid on the cost of the units of SFPEs. HMRC opposed the claim on the grounds that the cost of the units of SFPE was directly and immediately linked with the outside the scope receipts of SFP, and not with (or not solely with) the taxable supplies which would be made by the taxpayer in its expanded business.

66. The Supreme Court upheld the taxpayer's claim. It did not regard deduction of input tax as blocked by the receipt of the outside the scope SFPs, which would necessarily precede in time the investment of the funds and the making of further taxable supplies. Lord Hodge summarised the case law:

> "65. I derive the following propositions which are relevant to this appeal from the case law:
>
> (i) As VAT is a tax on the value added by the taxable person, the VAT system relieves the taxable person of the burden of VAT payable or paid in the course of that person's economic activity and thus avoids double taxation. This is the principle of deduction set out in art 1(2) and operated in art 168 of the PVD ….
>
> (ii) There must be a direct and immediate link between the goods and services which the taxable person has acquired (in other words the particular input transaction) and the taxable supplies which that person makes (in other words its particular output transaction or transactions). This link gives rise to the right to deduct. The needed link exists if the acquired goods and services are part of the cost components of that person's taxable transactions which utilise those goods and services …
>
> (iii) Alternatively, there must be a direct and immediate link between those acquired goods and services and the whole of the taxable person's economic activity because their cost forms part of that business's overheads and thus a component part of the price of its products…
>
> (iv) Where the taxable person acquires professional services for an initial fund-raising transaction which is outside the scope of VAT, that use of the services does not prevent it from deducting the VAT payable on those services as input tax and retaining that deduction if its purpose in fund-raising, objectively ascertained, was to fund its economic activity and it later uses the funds raised to develop its business of providing taxable supplies. … The same may apply if an analogous transaction involving the sale of shares is classified as an exempt transaction...
>
> (v) Where the cost of the acquired services, including services relating to fund-raising, are a cost component of downstream activities of the taxable person which are either exempt transactions or transactions outside the scope of VAT, the VAT paid on such services is not deductible as input tax. … Where the taxable person carries on taxable transactions, exempt transactions and transactions outside the scope of VAT, the VAT paid on the services it has acquired has to be apportioned under art 173 of the PVD.
>
> (vi) The right to deduct VAT as input tax arises immediately when the deductible tax becomes chargeable: art 167 of the PVD, …. As a result, there may be a time lapse between the deduction of the input tax and the use of the acquired goods or services in an output transaction, as occurred in Sveda. Further, if the taxable person acquired the goods and services for its economic activity but, as a result of circumstances beyond its control, it is unable to use them in the context of taxable transactions, the taxable person retains its entitlement to deduct...
>
> (vii) The purpose of the taxable person in carrying out the fund-raising is a question of fact which the court determines by having regard to objective evidence. The CJEU states that the existence of a link between the fund-raising transaction and the person's taxable activity is to be assessed in the light of the objective content of the transaction: … The ultimate question is whether the taxable person is acting as such for the purposes of an economic

> activity. This is a question of fact which must be assessed in the light of all the circumstances of the case, including the nature of the asset concerned and the period between its acquisition and its use for the purposes of the taxable person's economic activity ..."

67. Lord Hodge then stated at [67]:

> "On the FTT's findings of fact, the purchase of the SFPE's was part of an exercise raising funds for FASL's economic activities. The underlying principle is the principle of neutrality which relieves the taxable person of the burden of VAT payable and paid in the course of all its economic activities."

68. Mr Small drew attention to the fact that in that case the input tax had been incurred on buying the units of SFPE, ie the rights to the subsidy itself. Nevertheless, the input tax was deductible by reference to the making of current and future taxable supplies by the taxpayer. Mr Small submitted that if expenditure on the right to receive a subsidy does not block recovery of input tax, how can such input tax recovery be restricted in the present case where the input tax was incurred on supplies that were used for the making of taxable supplies. Mr Small submitted that HMRC's argument that all of Mr Newell's purchases were used for two purposes – to make taxable supplies and to generate outside the scope income in the form of PSPs – runs counter to the basis of the decision in *Frank A Smart*.

Summary of HMRC's main submissions

69. HMRC argued that in order to receive PSPs under the RHI scheme, Mr Newell had to conduct an activity – regulation 3(2) of the RHI Regulations 2012 provides that PSPs are paid to participants "for generating heat that is used in a building for any of the following purposes – (a) heating a space; (b) heating liquid; or (c) for carrying out a process". Mrs McIntyre submitted that:

> (1) It was the activities of Mr Newell in buying logs and then burning chips to generate heat that entitled him to claim PSPs under the RHI scheme (along with registering under that scheme and entering details to log the heat generated) and that this could not be separated out from his making of taxable supplies.
>
> (2) There is a direct and immediate link between the costs incurred by Mr Newell and both income streams, and because of this the general overheads of his business and the cost of the logs are a cost component of generating both taxable and outside the scope income.
>
> (3) The operation of the RHI scheme (prior to the changes which introduced limits on the amounts of PSPs that could be claimed) incentivised participants to operate the boilers for longer periods as the amount of the payments was calculated by reference to the amount of heat generated.

70. The input tax was thus incurred on running costs which were used to generate both taxable income and outside the scope income. The recovery of that input tax should be restricted in proportion that the amount of the RHI payments received bore to the consideration received for the making of taxable supplies.

71. Mrs McIntyre relied on the decisions of the CJEU in Case C-316/18 *University of Cambridge v HMRC* [2019] 4 WLR 126 and the Upper Tribunal in *Vehicle Control Services Ltd v HMRC* [2016] UKUT 316 (TCC) in support of HMRC's position, as well as seeking to distinguish the cases relied upon by Mr Small.

72. In *University of Cambridge*, the university made both exempt supplies (the provision of education) and taxable supplies (its commercial activities including sales of publications, accommodation and the hiring of facilities). One source of funding was that provided by

donations and endowments, and those funds were managed by a third party. The university sought to deduct the input tax borne on fees paid to that third party in accordance with the agreed partial exemption special method, arguing that the income generated by the fund was used to fund all of its activities.

73. HMRC relied in particular on the CJEU's statements that:

> "24. Thus, transactions that do not fall within the scope of the VAT Directive or that are exempt similarly do not, in principle, give rise to a right to deduct (see, to that effect, judgment of 14 September 2017, Direktor na Direktsia 'Obzhalvane i danachno-osiguritelna praktika' - Sofia v 'Iberdrola Inmobiliaria Real Estate Investments' EOOD (Case C-132/16) EU:C:2017:683, para 30 and the case-law cited).
>
> 25. In accordance with settled case-law, in order for a taxable person to have a right to deduct input VAT, there must be a direct and immediate link between a particular input transaction and a particular output transaction or transactions giving rise to the right to deduct. The right to deduct VAT charged on the acquisition of an input asset or service presupposes that the expenditure incurred in acquiring that asset or service was a component of the cost of the output transactions that gave rise to the right to deduct (judgment of 14 September 2017, Iberdrola Inmobiliaria Real Estate Investments, para 28 and the case-law cited)."

74. HMRC also relied on the decision of the Upper Tribunal in *Vehicle Control Services*. The taxpayer managed car parks for clients. The client paid Vehicle Control Services ("VCS") a fee to be provided with a number of permits which the client would issue, eg, to employees or residents who were to be able to park without charge. Other persons were warned, on signs supplied by VCS, that parking in the area concerned would incur a penalty. VCS derived 92% of its trading revenue from issuing parking charge notices ("PCNs"), ie penalties, and collecting the sums so levied.

75. Income from PCNs is outside the scope of VAT. To the extent that the company's input tax could be specifically attributed to the outside the scope activity or the taxable supplies, the parties agreed that there was, respectively, no recovery or full deduction of that input tax. The dispute was as to whether an apportionment was required (between outside the scope activity and taxable supplies) of the amount of input tax incurred by VCS on the cost of general overheads, ie supplies which had been purchased for use in both parts of its business (and which could not be attributed to one or other business stream).

76. The Upper Tribunal upheld HMRC's contention that an apportionment was required (and the parties had agreed that if the Tribunal found for HMRC on the point of principle, 92% of the input tax was irrecoverable). The Upper Tribunal stated as follows:

> "47. Consistently with this, s 26 VATA provides only three activities for which a taxable person is able to deduct as input tax. One of these is 'taxable supplies' which are 'made by the taxable person in the course or furtherance of his business'. Non-taxable supplies, such as exempt supplies and activities outside the scope of VAT, are not listed.
>
> 48. Furthermore, reg 100 of the Regulations prohibits a taxable person deducting 'the whole or any part of VAT' paid on the supply to him of goods or services where those goods or services 'are not used or to be used by him in making supplies in the course or furtherance of a business carried on by him'. Thus, if and to the extent that revenue is generated without making supplies, VAT incurred on supplies used in generating that revenue cannot be deducted. It follows that it is unnecessary to consider the correct interpretation of reg 101(2) of the Regulations.

> 49. Turning to the present case, for the reasons explained above we conclude that the First-Tier Tribunal was correct to hold that it is necessary to make an apportionment of the input VAT incurred by VCS on its general overheads between VCS's taxable transactions and its non-taxable transactions. As is common ground, the PVD does not specify how the apportionment should be carried out. It is clear from the case law of the CJEU discussed above, however, that the method of apportionment selected by the member state must be in accordance with the aims and broad logic of the PVD. In the present case HMRC has used a revenue-based apportionment ie it has apportioned the input VAT pro rata to the two different types of revenue. There is no challenge to the method of apportionment adopted by HMRC, as opposed to HMRC's entitlement to make an apportionment."

77. Mrs McIntyre submitted that this decision, and in particular the approach set out at [48], was equally applicable to the present appeal. Mrs McIntyre submitted that the input tax incurred by Mr Newell was a cost component of the overheads of the business and should be apportioned.

78. HMRC sought to distinguish the cases on which Mr Small relied:

(1) The fact patterns of the decisions of the CJEU on subsidies did not involve the same activities of the taxpayer generating both the taxable supplies and outside the scope income. By way of illustration, in *PARAT* the taxpayer had received a subsidy in respect of its expenditure on expanding its facilities, and those facilities would then be used to generate further taxable supplies. This differed from the present situation as Mr Newell's activities in generating heat gave rise to both the income from taxable supplies and the outside the scope income. There was no asset remaining – everything produced by Mr Newell's activities was consumed.

(2) *Kretztechnik* makes it clear that VAT incurred on costs is deductible only to the extent that those taxable inputs were used or to be used in the making of taxable supplies. The input tax incurred by Mr Newell cannot be directly attributed to either a business activity or a non-business activity. The amounts of VAT incurred are cost components of the making of taxable supplies and the receipt of outside the scope income under the RHI scheme, whereas the taxpayer in *Kretztechnik* only made taxable supplies.

(3) In *Frank A Smart* there were multiple steps involved in claiming the subsidies, including in relation to the land itself. Mr Newell's business can be differentiated from the position in *Frank A Smart* as he generates income that is a mixture of taxable and outside the scope income.

Consideration and conclusions

79. The crucial difference between the parties was thus that whereas Mr Small characterised the PSPs as subsidies which were outside the scope income received without Mr Newell having conducted outside the scope activities, Mrs McIntyre submitted that there was an activity which was involved in the generation of the heat which gave rise to the entitlement to the PSPs - all of the activities of Mr Newell in buying logs, chipping them and burning them were linked both to the making of taxable supplies and to receiving the PSPs, and furthermore there had been specific activities related only to the entitlement under the RHI scheme, eg accreditation of the boilers and logging the amounts of heat generated.

80. It is clearly established that (save in the cases falling within in Article 73, in which the subsidy is consideration for making a supply or is directly linked to price) in the circumstances where a trader takes steps to qualify for a government subsidy he is not making a supply to – not performing a service for - the government (*Mohr* (C-21/94) [1996] STC 328 and

Landboden-Agrardienste GMBH (C-384/95) [1998] STC 171). HMRC was instead arguing that there is outside the scope income and not a supply, but also that there is an activity undertaken by Mr Newell to generate the heat and thus the outside the scope income.

81. I have found as facts that:

(1) Mr Newell received PSPs under the RHI scheme for generating heat.

(2) He had registered as a participant under that scheme, took steps to ensure that his boilers were accredited and took meter readings to record the heat generated and submitted those readings online.

(3) He had not burnt chips and generated heat purely to qualify for RHI payments; this does not make commercial sense.

82. Against that background, I have considered further the cases on which HMRC rely.

83. In *University of Cambridge*, it is acknowledged throughout the decision that the university not only made both taxable and exempt supplies but that it also (necessarily) thus conducted both taxable and exempt activities. The questions which were referred to the CJEU were summarised by the CJEU at [19] as:

> "19. Those clarifications having been made, by its questions, which it is appropriate to consider together, the referring court is to be regarded as asking, in essence, whether art 168(a) of the VAT Directive must be interpreted as meaning that a taxable person that (i) is carrying out both taxable and exempt activities, (ii) invests the donations and endowments that it receives by placing them in a fund and (iii) uses the income generated by that fund to cover the costs of all of those activities is entitled to deduct, as an overhead, input VAT paid in respect of the costs associated with that investment."

84. The CJEU then set out the following:

(1) In order to have a right of deduction, it is necessary, first, that the person concerned be a taxable person and, second, that the goods or services relied on to confer entitlement to that right be used by the taxable person for the purposes of his taxed output transactions (at [23]).

(2) Transactions that are outside the scope or are exempt do not in principle give rise to a right to deduct (see [24]).

(3) In order for a taxable person to have a right to deduct input VAT, there must be a direct and immediate link between a particular input transaction and a particular output transaction or transactions giving rise to the right to deduct. The right to deduct VAT charged on the acquisition of an input asset or service presupposes that the expenditure incurred in acquiring that asset or service was a component of the cost of the output transactions that gave rise to the right to deduct (at [25]).

(4) Whether there is such a direct and immediate link will depend on whether the cost of the input goods or 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 (at [27]).

85. These propositions are well-established; but they do not provide any guidance on the question whether a taxpayer who receives outside the scope income but has not made an outside the scope supply nevertheless is conducting outside the scope activity, save to the extent that the CJEU has reiterated the principle that there must be a direct and immediate link between the input transaction and the output transaction giving rise to the right to deduct. There is

clearly a direct and immediate link between the input tax and the taxable supplies made by Mr Newell.

86. The CJEU then went on to consider whether the collection of donations and endowments and their investment in a fund constitute an economic activity within the scope of the Directive. These activities were separate from the other activities of the university which involved the making of taxable and exempt supplies, and the CJEU found that:

> (1) In raising and collecting donations and endowments, the University of Cambridge is not acting as a taxable person. In order to be considered to be a taxable person, a person must carry out economic activities, that is to say activities for consideration. As the donations and endowments - which are essentially made for subjective reasons on charitable grounds and on a random basis - are not consideration for any economic activity, the raising and collection of them do not fall within the scope of the VAT Directive (see [29]). It followed that the input VAT paid in respect of any costs incurred in connection with the collection of donations and endowments is not deductible, regardless of the reason why those donations and endowments were received
>
> (2) Both the activity consisting in the investment of donations and endowments, and the costs associated with that investment activity must be treated in the same way for VAT purposes as the non-economic activity consisting in the collection of donations and endowments and any costs associated with the latter (see [30]).

87. In the present case, there was no such separation of activities; I am not persuaded that the reasoning of the CJEU in this case supports HMRC's contentions given the facts as I have found them.

88. In *Vehicle Control Services* it is notable that counsel for VCS had submitted (as is apparent from [19] of the Upper Tribunal's decision) that VCS's exploitation of its contracts with clients constituted economic activity both in so far as that exploitation generated revenue from parking permits but also in so far as it generated revenue from PCNs. The Upper Tribunal noted at [21] that VCS accepted that Article 173 requires an apportionment where the goods or services are used for transactions which are not taxed because they do not constitute economic activity or are exempt, but contends there is no equivalent provision for apportionment where the goods or services are used for transactions which constitute economic activity but are out of scope.

89. There was thus an acceptance by VCS that it was conducting economic activity which generated both income from taxable supplies and also outside the scope income, and that the goods or services on which input tax had been borne were used for transactions which were economic activity but outside the scope. Furthermore, it was common ground (see [20]) that there was a direct link between the general overheads of the business in respect of which VCS incurred input VAT on the one hand, and both VCS's taxable supplies in respect of parking permits and the PCN revenue on the other hand.

90. In the present appeal, Mr Small did not accept that Mr Newell was conducting economic activity that generated outside the scope income, nor (if different) that Mr Newell had any outside the scope activity, and he submitted that there was no direct link (or direct and immediate link) between the overheads and costs of Mr Newell and the receipt of PSPs.

91. These differences are significant in the present context.

92. When the Upper Tribunal concluded at [44] that where goods or services are used by a taxable person both for transactions in respect of which VAT is deductible (ie taxable supplies) and for transactions in respect of which VAT is not deductible (ie transactions which are not economic activity or taxable supplies, or where the supplies are exempt), VAT may only be

deducted to the extent that it is attributable to taxable supplies, it was addressing a situation in which the inputs were agreed to have been used for the purposes of transactions which are outside the scope (as well as taxable supplies).

93. Mrs McIntyre relied on [48] where the Upper Tribunal said that if and to the extent that revenue is generated without making supplies, VAT incurred on supplies used in generating that revenue cannot be deducted. However, I have concluded that this paragraph needs to be read in the context of the whole of the decision in which it is apparent throughout that VCS accepted that the income from PCNs arose from economic activity, albeit one which did not involve the making of supplies. I do not read this decision as stating that where a taxpayer receives outside the scope income but does not have outside the scope activity then its recovery of input tax must be restricted. The Upper Tribunal did not address such a situation, which is unsurprising as that is not the fact-pattern that was before it.

94. I therefore turn to the question as to whether in the present instance there was a direct and immediate link between the purchases made by Mr Newell and the receipt of the PSPs.

95. This requirement for there to be a direct and immediate link has been laid down by the CJEU, albeit that it is for the national court to decide whether or not such a link exists. The need for a direct and immediate link narrows the potential scope of "use" which will satisfy the requirement of Article 168 that in order for the input tax on goods and services to be deductible, the goods and services must be used for the purposes of taxable transactions.

96. I have already referred (at [81] above) to some of the relevant findings of fact. I would add that it was acknowledged by Mr Small that if Mr Newell had not incurred the overheads and bought the logs for burning (ie incurred the expenditure) then he would not have been able to claim payments under the RHI scheme as he would not have been generating heat.

97. In *Customs & Excise Commissioners v Southern Primary Housing Ltd* [2003] EWCA Civ 1662 the Court of Appeal considered this requirement, and Mrs Hall QC for the Commissioners had submitted that the High Court had erred, one of which errors was stated as that the judge had "(d) applied a test of attribution for which there is no authority - namely whether the input enabled the taxpayer to make a taxable supply". Jacob LJ, in a judgement which was agreed by the remaining judges, said:

> "32. … I particularly consider that point (d) is right. The land purchase transaction was commercially necessary to make its performance commercially possible, but it was not a cost component of the contract itself in the same way as the costs of materials used. There is a link with the contract but the link was not direct and immediate. The development contract would not have been made but for the associated land purchase and sale. But 'but for' is not the test and does not equate to the 'direct and immediate link' and 'cost component' test.
>
> 33. One can look at it another way. There is nothing about the development contract as such which makes the land purchase and sale essential. If the housing association had already owned the land or had bought it from some third party, the inputs of the development contract would have been just the costs of carrying it out. The fact that there were commercially linked land transactions does not mean that those transactions are directly linked to the costs of the development contract. One would not say that the cost of buying the land was a cost of the development contract itself. It follows that the input tax on that cost is not a cost of the contract."

98. It is not therefore sufficient to create a direct and immediate link that Mr Newell could not claim payments under the RHI scheme if he had not bought logs (and incurred other costs) to burn them.

99. I consider that there is a direct and immediate link between Mr Newell's purchases and his taxable supplies, as the goods and services on which input tax were incurred were used to generate heat and make taxable supplies. This forms the basis of the entitlement to recover his input tax under Article 168. I do not consider that the fact that he was also able to qualify for payments under the RHI scheme and receive PSPs either detracts from this conclusion or means that there is a direct and immediate link between the purchases and the receipt of the outside the scope income.

100. The decision of the CJEU in *Kingdom of Spain* clearly established that the Sixth Directive, in provisions which are now set out in the Principal VAT Directive, does not permit national rules which restrict the right of fully taxable traders who receive subsidies to deduct their input tax. The receipt of subsidies will always be subject to conditions, and I am not satisfied that the steps taken by Mr Newell to qualify for payments (eg ensuring accreditation of the boilers and logging meter readings) means I should seek to distinguish this line of authority. I see no reason to depart from the reasoning of the CJEU in the present appeal; and indeed consider that I am required not to do so.

101. This conclusion is consistent with the other line of authority on which Mr Small relied, namely the decisions in *Kretztechnik* and *Frank A Smart.* The grounds on which HMRC seeks to distinguish those cases fails to address the fact that those taxpayers also received outside the scope income (in the form of the proceeds of the share issue and the subsidy). Furthermore, in those cases the taxpayer had taken specific additional steps to obtain the outside the scope income (in the case of *Frank A Smart*, not just registering under the scheme, but ensuring the land was in appropriate condition and buying SFPEs) and were able to recover all of their input tax on the basis that they made only taxable supplies. It would be inconsistent with these decisions to apply any restriction to Mr Newell's recovery of input tax.

102. Finally, I note that HMRC had set out in their statement of case that "the "Biomass" business would not have been realistic without the receipt of RHI payments". In correspondence they had said that the business trades at a significant loss and "is viable because the consideration you receive on taxable outputs is complemented by the receipt of RHI payments". This point remained in HMRC's skeleton argument where they made the statement that "HMRC submit that the only way that the business was sustainable was the receipt of RHI" (without any further explanation of the point being made). Mrs McIntyre did not advance this argument further at the hearing.

103. In these circumstances, I address it only briefly. I have found as facts that when RHI was being paid at the unrestricted rate it had a downward pressure on prices. The restriction on RHI has reduced that downward pressure on prices, but heat from woodchips still has to compete with other energy sources. The amounts received by Mr Newell under the RHI scheme have been capped but he is still able to operate profitably.

104. In any event, the question whether the business would have been viable without Mr Newell having received PSPs under the RHI scheme is irrelevant to his entitlement to deduct input tax. In Case 50/87 *Commission v French Republic* [1988] ECR 4797 France had introduced VAT rules which restricted the amount of input tax that a landlord could deduct if the rent which he received from a property was less than one-fifteenth of the property's value. France claimed that this law was aimed at certain lettings of property for socially beneficial reasons where the income would inevitably be less than the expenditure, implying that the landlord would be in receipt of perpetual repayments of VAT.

105. The CJEU said (at [16] to [18]) that a desire on the part of the Member State to prevent perpetual repayments from VAT could not justify the introduction by a Member State of measures restricting the right of VAT registered businesses to deduct input tax which went

beyond the restrictions on the right to deduct input tax which appear in the Directive. One argument advanced by France was that the deduction of input tax must be limited in the case of persistently loss-making businesses because some of their costs could not be "cost components" of onward supplies – the cost would never be recovered from taxable consideration charged to customers. This argument was rejected by the CJEU (at [23]).

106. The sustainability or viability of the business are thus irrelevant to whether or not Mr Newell is entitled to recover all of his input tax.

107. I have therefore concluded that Mr Newell is entitled to recover all of the input tax which he had incurred and his appeal is allowed.

Alternative basis of restriction of input tax relevant to quantum

108. As referred to under Issues, Mr Small had put forward an alternative argument which is only relevant if I were to decide that there should be a restriction on Mr Newell's input tax recovery. That argument relates to the amount of the restriction. On the basis of my conclusions, this argument is not relevant. However, I have addressed it very briefly below as the submission was put to me.

109. Mr Small submitted that if the Tribunal is for any reason disinclined to favour his primary position, and considers that some disallowance of input tax should be made in respect of costs specifically related to the obtaining of the PSPs, the Tribunal should indicate the nature of the costs on which it feels some disallowance should be made, and invite the parties to agree the quantum thereof.

110. Mr Small was thus arguing that if there is to be a restriction on recovery of input tax I should move away from the approach taken by HMRC in making their assessments which were based on the proportions of taxable and outside the scope income received by Mr Newell and instead set out a different approach which had regard to what he submitted was the fact that any costs which could be said to have specifically related to applying for and obtaining the PSPs were minimal (speculating that this might be the costs of heating/lighting used whilst Mr Newell was taking meter readings from the boilers and reporting this information, arguing that the "cost" of the accreditation process was subsumed within a composite supply of the boilers themselves).

111. The difficulty with this submission is that I consider that the approach taken by HMRC to quantifying the restriction is entirely consistent with the basis of HMRC's argument as to why there should be such a restriction, namely that all of the inputs of Mr Newell's business were used for both the taxable supplies and to receive the outside the scope income. Therefore, if I had agreed with HMRC on their primary argument, I anticipate that I would have been minded to agree with the approach taken by HMRC to the calculation of that restriction.

CONCLUSION

112. For the reasons given above, Mr Newell's appeal is allowed.

RIGHT TO APPLY FOR PERMISSION TO APPEAL

113. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

JEANETTE ZAMAN
TRIBUNAL JUDGE

RELEASE DATE: 01 JUNE 2021