[2017] UKUT 315 (TCC)

Appeal number: UT/2016/0066

VAT – whether paragraph 1 Schedule 6 VATA (supplies of services between connected parties at below open market value) applied – whether standard method of recovery of input tax on overheads appropriately reflected use of inputs – whether correct approach affected by principle of fiscal neutrality – whether activities carried on by two separately registered companies amounted to a single business – appeal dismissed

UPPER TRIBUNAL
TAX AND CHANCERY CHAMBER

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE & CUSTOMS — **Appellants**

- and -

(1) TEMPLE FINANCE LIMITED
(2) TEMPLE RETAIL LIMITED — **Respondents**

TRIBUNAL: JUDGE GREG SINFIELD
JUDGE SARAH FALK

Sitting in public at The Royal Courts of Justice, The Strand, London WC2A 2LL on 5 and 6 June 2017

Sarabjit Singh, Counsel, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Appellants

Nicola Shaw QC and Michael Firth, instructed by Grant Thornton UK LLP for the Respondents

DECISION

1. This is an appeal by the Appellants ("HMRC") against a decision in principle by the First-tier Tribunal ("FTT") released on 25 January 2016 with neutral citation [2016] UKFTT 41 (TC) ("the Decision"). Save as otherwise indicated, paragraph references in square brackets in this decision are to the paragraphs in the Decision.

2. The Respondents, Temple Retail Limited ("TRL") and Temple Finance Limited ("TFL"), are two wholly-owned subsidiaries of PerfectHome Holdings Limited. TRL and TFL together carry on the activities of "PerfectHome", which operates showrooms in various parts of the UK supplying household goods. TRL and TFL are not members of a group for VAT purposes.

3. In summary, the FTT decided that:

(1) supplies of "store services" by TRL to TFL were not made at below open market value ("OMV") as had been contended by HMRC;

(2) the OMV of advertising services supplied by TRL to TFL should be determined by reference to their respective operating profits rather than in the manner proposed either by HMRC or by the Respondents; and

(3) TFL's recoverable input tax on overheads should be determined using the standard method as submitted by TRL and TFL, no standard method override ("SMO") being required.

The Decision also addressed a number of procedural and evidential matters that are not relevant to this appeal and to which we will not make further reference.

4. HMRC appeals on eight grounds. These are as follows:

Ground 1: the FTT failed to apply the principle of fiscal neutrality.

Ground 2: there was inadequate reasoning to support the FTT's erroneous finding that TRL and TFL carry on separate businesses.

Ground 3: the FTT made an irrational or erroneous finding that there is a "shop within a shop" arrangement between TRL and TFL, with TFL acting as a concessionaire.

Ground 4: alternatively, the FTT took an irrational approach to the assessment of the appropriate "concession fee".

Ground 5: the FTT's approach to determining the OMV of advertising services was flawed.

Ground 6: the FTT misdirected itself in the approach to be taken to determining TFL's recoverable input tax on its overheads (the partial exemption issue).

Ground 7: the FTT erred in deciding that the standard method for determining the proportion of input tax recoverable on TFL's overheads was fair and reasonable.

Ground 8: the FTT erred in its decision in respect of "quality refurbished" or "QR" goods, the value of which should have been excluded in TFL's partial exemption calculation.

Background

5. PerfectHome's activities are aimed principally at credit-constrained customers. Only around 2% of sales are made for cash. The remaining 98% are made on hire-purchase (HP) terms, involving weekly payments typically over a three-year period. Insurance cover is required and approximately 88% of customers buy theft and damage insurance ("TAD") alongside the product. Around 90% also buy an extended warranty product which at the time was called Coverplus, typically paid for by an additional loan.

6. Up to around half of customers terminate their HP arrangements early, not only on default but also under Coverplus terms that entitle them to do so without penalty. Recovered goods are checked and after any necessary repairs they are typically sold as QR goods, usually again on credit and with Coverplus and TAD cover. These goods represent approximately 30% of all sales. QR goods are refurbished by TRL and have been sold by TFL since April 2011. Prior to that they were sold by TRL who acquired them from TFL.

7. The arrangements between TRL and TFL are governed by an Intra-Group Services Agreement ("IGSA"). TRL is the tenant under the showroom leases and enters into contracts with third parties to supply shop launch and other advertising services. TRL is also responsible for acquiring goods to be sold and stocking showrooms. In the 2% of cases where no HP is required TRL effects the sale direct to the customer. In other cases TRL first sells the goods to TFL at a price equal to 97% of the advertised price of the goods and TFL enters into the HP agreement. In VAT terms, this involves TFL selling the goods for 100% of the advertised price (a standard rated supply made at the time of sale) and making an exempt supply of credit. TFL also enters into any contracts to supply TAD (an exempt supply) and Coverplus (a standard rated supply). It is also responsible to the customer for arranging delivery, and pays TRL 5% of the purchase price of the goods to deliver them on its behalf (a standard rated supply of services by TRL to TFL). Under the TAD and Coverplus contracts TFL is responsible to customers for servicing and repairing goods, although repairs are subcontracted to TRL (a standard rated supply from TRL to TFL). Staff have been jointly employed by TFL and TRL since 1 April 2011. Prior to that date TFL was the sole employer and staff costs were shared under the IGSA.

8. TRL makes only taxable supplies for VAT purposes and therefore recovers 100% of its input tax. TFL is partially exempt and therefore its input tax recovery is restricted. In essence the dispute concerns the overall level of VAT cost that the group

should suffer. HMRC approached this in two ways. First, HMRC issued a direction to TRL under paragraph 1 of Schedule 6 to the Value Added Tax Act 1994 ("VATA") that the value of the services supplied by TRL to TFL in respect of occupation and use of the shops ("store services") and in respect of shop advertising and launch costs ("advertising services") were made at below OMV, and should be treated as made at OMV. HMRC subsequently made their own determinations of the OMV of these supplies and assessed TRL to additional output tax on that basis. The effect of this approach would be to increase the quantum of the irrecoverable input tax incurred by TFL. Secondly, HMRC made assessments against TFL on the basis that it should apply the SMO in determining the proportion of input tax recoverable on its overheads, rather than the standard method that TFL had applied, and in doing so that the proportion of TFL's input tax that it is able to recover should be reduced.

The statutory framework

9. The general rule under s19 VATA is that the VAT chargeable on a supply is determined by reference to the consideration. Schedule 6 sets out some exceptions to this. Paragraph 1 of Schedule 6 provides, so far as relevant:

> "(1) Where –
>
> (a) the value of a supply made by a taxable person for a consideration in money is (apart from this paragraph) less than its open market value, and
>
> (b) the person making the supply and the person to whom it is made are connected, and
>
> (c) if the supply is a taxable supply, the person to whom the supply is made is not entitled under sections 25 and 26 to credit for all the VAT on the supply,
>
> the Commissioners may direct that the value of the supply shall be taken to be its open market value.
>
> (2) A direction under this paragraph shall be given by notice in writing to the person making the supply, but no direction may be given more than 3 years after the time of the supply.
>
> (3) A direction given to a person under this paragraph in respect of a supply made by him may include a direction that the value of any supply-
>
> (a) which is made by him after the giving of the notice, or after such later date as may be specified in the notice, and
>
> (b) as to which the conditions in paragraphs (a) to (c) of sub-paragraph (1) above are satisfied
>
> shall be taken to be its open market value."

10. It is accepted that TRL and TFL are connected for these purposes. Open market value is defined in s19(5) as "the amount that would fall to be taken as [the value of the supply] … if the supply were for such consideration in money as would be payable by a person standing in no such relationship with any person as would affect that consideration".

11. Paragraph 1 of Schedule 6 is derived from what is now Article 80 of Council Directive 2006/112/EC ("the Principal VAT Directive"), which permits Member States to take steps to ensure that the taxable amount is the open market value in circumstances where the consideration charged between persons with close ties is lower than the open market value and the recipient of the supply does not have a full right of deduction. Open market value is defined in Article 72 as follows:

> "For the purposes of this Directive, 'open market value' shall mean the full amount that, in order to obtain the goods or services in question at that time, a customer at the same marketing stage at which the supply of goods or services takes place, would have to pay, under conditions of fair competition, to a supplier at arm's length within the territory of the Member State in which the supply is subject to tax."

The FTT applied the definition in Article 72 on the basis that it differed slightly from that in s19 VATA.

12. TFL's supplies under the HP agreements comprise a taxable supply of the product under paragraph 1(2) of Schedule 4 VATA and an exempt supply of finance under item 3 of Group 5 of Schedule 9 VATA. In addition, as already mentioned, it makes exempt supplies of insurance (Group 2 of Schedule 9) and taxable supplies under the Coverplus arrangements. As a partially exempt business input tax recovery is restricted. Input tax that is directly attributable to particular supplies is fully recoverable if it is directly attributable to a taxable supply or wholly irrecoverable if it is directly attributable to an exempt supply. Supplies made to TFL that are not directly attributable to supplies it makes (referred to as overheads) are recovered in accordance with a formula provided in regulations made under s26(3) VATA, which requires HMRC to make regulations "for securing a fair and reasonable attribution of input tax to supplies".

13. The default formula provided for is the "standard method", under which input tax on overheads is recovered in the proportion that turnover attributable to taxable supplies bears to total turnover: regulation 101 of the Value Added Tax Regulations 1995 (the "VAT Regulations"). However, under regulations 107A to 107F of the VAT Regulations a taxable person must make an annual adjustment where the attribution produced by the standard method "differs substantially from one which represents the extent to which the goods or services are used by him or are to be used by him… in making taxable supplies". A difference is "substantial" if it exceeds £50,000 or 50% of the input tax to be apportioned (subject to de minimis limits). This is the SMO override. In TFL's case HMRC determined that, in applying the SMO, taxable supplies of goods should be excluded from both the numerator and the denominator of the turnover calculation. In the example used by the FTT, using figures from the 03/11 period, this would result in a reduction in the percentage of recoverable input tax on overheads from 61.98% to 25.64% ([204] to [206] of the Decision).

14. The basis of the domestic law provisions governing recovery of overheads by a partially exempt business is Articles 173 to 175 of the Principal VAT Directive. Article 173 provides, so far as relevant:

> “(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 Articles 168, 169 and 170, 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 make the deduction on the basis of the use made of all or part of the goods and services;
>
> …”

15. Article 174 defines the “deductible proportion” in a way that corresponds to the standard method. It provides, so far as relevant:

> “(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.
>
> …
>
> (2) By way of derogation from paragraph 1, the following amounts shall be excluded from the calculation of the deductible proportion:
>
> (a) the amount of turnover attributable to supplies of capital goods used by the taxable person for the purposes of his business;
>
> (b) the amount of turnover attributable to incidental real estate and financial transactions;
>
> (c) the amount of turnover attributable to the transactions specified in points (b) to (g) of Article 135(1) in so far as those transactions are incidental.”

The Decision

The FTT’s findings on the Schedule 6 issue

16. The FTT’s findings of fact in relation to the OMV question (the “Schedule 6 issue”) are set out at [59] to [141] of the Decision. The FTT first considered what services were covered by the Schedule 6 direction. It concluded that the reference to occupation and use of the shops covered not only the formal licence to occupy granted by TRL to TFL under the IGSA but also the other steps it took to organise the stores to facilitate TFL being able to conduct its activities, including not only sales of

products on HP terms along with insurance and warranty protection, but also the collection of weekly payments from its customers. Advertising services covered advertising and marketing materials commissioned from third-party suppliers on a basis that promoted TFL's activities as well as TRL's.

17. The FTT found that TRL typically pays wholesalers around 60% of the retail price, so that it makes a 37% margin when it sells to TFL at 97% of that price, and that the vast majority of the group's profit came from taxable supplies of goods and the Coverplus product. The FTT also decided that PerfectHome was a specialist business which was not in competition with shops such as Currys or DFS to any significant extent, but rather with other businesses focused on credit-constrained customers such as BrightHouse.

18. The FTT concluded at [72] that, although TFL and TRL operate under a single brand and have the same directors who make their decisions in the interests of PerfectHome as a whole, they carry on separate businesses. The reasons given were first that TRL and TFL are separate companies and there was no evidence of a partnership. Profits are not shared, although some services are provided between them and costs are shared. Secondly, it is not uncommon for separate companies within a group to carry on different businesses using the same branding. It did not matter that the directors take decisions in the interests of PerfectHome as a whole. Finally the FTT relied on the evidence of the group's finance director that there are two businesses. The FTT went on to describe TRL's and TFL's respective activities at [73] and [74], noting at [76] that although the businesses are separate they are "highly symbiotic". If the 2% of sales for cash are ignored then either both TRL and TFL make a sale or neither does. TRL makes its profit from the 37% margin and TFL makes all or most of its profit from the finance element of the HP arrangements.

19. The FTT went on to make findings about the usage of floor space, concluding that TFL is not the primary user of the stores, and about the reasons for the "two company structure", concluding at [86] that it was not set up with a view to securing VAT advantages. The FTT also found that TRL does not overcharge for goods sold to TFL as suggested by HMRC, essentially on the basis that it is not a wholesaler, and did not accept that TRL overcharges for repair and delivery services: paragraphs [89] to [98]. (The context for these points was HMRC's suggestion that TRL compensates for undercharging for advertising and store services by overcharging for these items.) In relation to advertising material, the FTT concluded at [105] that it is designed to benefit, and does benefit, both TRL's and TFL's businesses.

20. The FTT considered three transfer pricing reports produced by Grant Thornton for the PerfectHome group (from paragraph [111]). The first report, dated February 2009, sought to apply the "comparable uncontrolled price" method to identify comparable transactions for what Grant Thornton described as a concession charge by TRL to TFL. The report stated that for normal store concessions in the retail industry the range of charges was approximately 10% to 25% of the concession's turnover, but noted that "one of the most unique features" of this particular concession was that TFL sources all its goods from TRL at 97% of the final selling price, with every sale made by TFL resulting in a sale by TRL, and said that this needed to be taken into

account. The report concluded that the combination of the actual fee paid by TFL to TRL under the IGSA of £20,000 per store plus 5% of non-product sales revenue, plus the additional income TRL generated by making sales to TFL at a 37% margin, did fall within the 10% to 25% range, and therefore that TRL was receiving an arm's length return.

21. The second Grant Thornton report, produced in June 2012, reached similar conclusions, except that it updated the 10% to 25% range to 15% to 35% of the concession's turnover and contained a calculation showing that TRL's profit on the sale of goods and the store fees received under the IGSA fell within that range.

22. The third report was produced during the course of the dispute with HMRC and was the only one to deal with advertising fees in any detail, concluding that the "cost plus" method was appropriate and proposing an approach which shared costs taking account of the relative representation of TRL's and TFL's activities in the advertising material and their sharing of floor space.

23. The FTT also considered a report produced by John Murphy, an independent consultant to the group, in January 2009 which sought to establish the percentage of staff time at various levels of seniority that was occupied on each task undertaken. The results were used to apportion payroll costs between TRL and TFL. HMRC's approach was to determine the OMV of store services by following the methodology in this report (with some adjustments) and marking up TFL's share of the costs by 10%.

24. Having considered the parties' submissions the FTT reached a number of conclusions that are set out from paragraph [151] onwards. In the absence of a challenge under *Halifax* principles (*Halifax plc v Customs and Excise Commissioners* (Case C-255/02) [2006] STC 919) the FTT said that there was no scope to recharacterise the supplies, so the question to determine was the OMV of the actual supplies made. The FTT decided that the OMV of store services should be determined by following Grant Thornton's approach of using the analogy of a store concession (or "shop within a shop") arrangement, and concluded at [189] that TFL was not paying less than the OMV for store services.

25. In relation to advertising services, the FTT was not satisfied that Grant Thornton's approach was correct but also rejected HMRC's approach. This approach was to allocate 98% of advertising and launch costs to TFL on the basis that it made 98% of sales to customers, and to mark that up by 10%. The FTT thought that conceptually HMRC's approach was the better one because it attempted to value the services by reference to concepts of cost and income rather than the composition of advertisements and floor space, but it ignored the fact that each sale by TFL involved a sale by TRL at a 37% margin. The FTT decided that the correct approach was to calculate the OMV of advertising services by apportioning their cost in accordance with TRL's and TFL's operating profits, and adding a 10% mark up to TFL's share (paragraph [198]).

The FTT's findings on the partial exemption dispute

26. HMRC's justification for excluding taxable supplies of goods from the turnover calculation for partial exemption purposes was based on their view that TFL's overheads costs are used not for the purposes of supplying goods but for the supply of credit, together with insurance and Coverplus. The FTT noted that the relevant HMRC officer had accepted that there was potentially a very small amount properly attributable to the supply of goods, but the SMO was not required to be calculated with precision and their approach amounted to a fair and reasonable estimation (paragraph [211]).

27. The FTT considered the Court of Appeal's decision in *Volkswagen Financial Services (UK) Limited v HMRC* [2015] EWCA Civ 832, [2016] STC 417 ("*VWFS*") and concluded that whilst it was not determinative because it related to whether input tax was directly attributable to exempt supplies, it was still highly relevant because the SMO deals with questions of "use" which are very similar to those addressed in *VWFS* (paragraph [229]). The FTT concluded that HMRC's approach was not correct, in particular because TFL incurred residual input tax in order to collect weekly payments that relate at least in part to the sale price of the goods, and disagreed with the view that because overhead costs are not priced into the sale price of the goods they are not "used" for the purposes of supplying them. The FTT went on to conclude at paragraph [235] that TFL does use its overheads in the course of its entire business, which involves making both taxable and exempt supplies, and that an apportionment on the basis of use would not lead to a different result from the standard method. The FTT also decided that the same conclusions applied equally to QR goods (paragraph [237]). Accordingly, the FTT found that TFL's approach to calculating input tax was correct.

Discussion: general comments

28. Although there are eight separate grounds of appeal there is a significant recurring theme in HMRC's approach. HMRC's starting point is to compare the VAT treatment of TFL and TRL as contended for by the Respondents with what the VAT treatment of the PerfectHome business would be if it was carried on by a single taxable person for VAT purposes. In HMRC's view a single taxable person would have incurred a higher amount of irrecoverable input tax. HMRC sought to illustrate this by providing calculations which they said were based on the VAT returns for the periods in dispute. The Respondents objected to the production of these calculations on the basis that they amounted to fresh evidence that was not before the FTT, and although we were taken through them in the course of Mr Singh's submissions we have not relied on them as anything more than illustrations of the arguments being put.

29. The calculations produced by HMRC also showed the position that HMRC considered would arise if it succeeded on both the Schedule 6 and the partial exemption issues. They clearly illustrated that if HMRC were successful on both questions then the group would suffer a more severe restriction of input tax than if the PerfectHome activities were carried on by a single taxable person (at least assuming that person adopted the standard method of input tax recovery on overheads). Mr

Singh accepted before us, and before the FTT, that HMRC's arguments on the two issues could not both be justified in full. Mr Singh described the assessments on TFL as protective, and our understanding was that the partial exemption issue was essentially a fallback argument in the event that HMRC failed to succeed under Schedule 6.

30. A further general comment to make relates to the scope of an appeal to the Upper Tribunal. Under s11 Tribunals, Courts and Enforcement Act 2007 an appeal from the FTT only lies on points of law. In other words it is only if there is an error of law that the Upper Tribunal is entitled to intervene. If there is an error of law then under s12 the Tribunal "may" set aside the decision and either remit the case or re-make the decision. Whether it is appropriate to set aside a decision will clearly depend upon the materiality of the error.

31. The grounds of appeal raised by HMRC recognise that an error of law is required before the Upper Tribunal can intervene. However, at least in the case of Grounds 1 and 2, it is not immediately obvious how the issue raised is material to the FTT's conclusions on either the Schedule 6 or partial exemption issue. Mr Singh relied on the comments of Lord Carnwath in *Pendragon plc v HMRC* [2015] UKSC 37, [2015] STC 1825 at [50] and [51] to the effect that, once an error of law is identified, it is appropriate for the Upper Tribunal to exercise its power to remake the decision, including making any evaluative judgments that may be required. Whilst we can see the argument that in applying Schedule 6 and the partial exemption rules, as with any VAT legislation, the principle of fiscal neutrality must be observed, there are limitations to that principle (discussed further below) which make its potential application to the issues that the FTT had to decide not at all obvious. It is even harder to see how succeeding on Ground 2 could further HMRC's case on the matters in dispute.

32. A final important point to stress at this stage is that HMRC have not sought to argue that the way in which the PerfectHome activities are structured is abusive under *Halifax* principles, such that the arrangements can be recharacterised for VAT purposes.

Grounds 1 and 2: fiscal neutrality and separate businesses

33. It is convenient to address these two grounds together, because in our view they are closely linked. They are also relevant to both the Schedule 6 and partial exemption issues.

34. Mr Singh submitted that the FTT had failed to apply the principle of fiscal neutrality in reaching its conclusions on both the Schedule 6 and partial exemption issues. The FTT had wrongly assumed that it would have needed to see evidence of the tax treatment of competitors and how that differed, when all it needed to do was compare the TRL/TFL arrangements with the PerfectHome business structured as a single company or a VAT group. The FTT's decision resulted in the tax burden being very different from what it would have been with a single company or VAT group structure, which offended the principle of fiscal neutrality since it led to similar

supplies of goods and services, which are therefore to be treated as in competition with each other, being treated differently for VAT purposes. It was not necessary to show actual competition and a hypothetical comparison was sufficient. In applying the principle of fiscal neutrality it was also necessary to look at the position from the consumer's perspective. In addition, the FTT used conflicting assumptions, because for OMV purposes TRL was treated as the retailer, incurring most of the showroom expenses (and recovering the majority of the input tax on the showrooms accordingly), whereas for partial exemption purposes TFL was treated as the retailer by being allowed to use the full value of the retail sales in its overheads input tax calculation.

35. In relation to Ground 2, Mr Singh criticised the FTT's reasons for concluding at [72] that TRL and TFL carry on separate businesses (see [18] above) as both inadequate and flawed. A single business could be carried on by more than one legal person, including in the absence of a formal partnership or profit-sharing arrangement. The FTT's conclusion placed legal form, in particular the existence of two companies, over substance. The effect of the arrangements is that there is a single business of selling goods on credit: the reality is that customers deal with the "PerfectHome" business. Neither company could carry on business without the other. HMRC were not saying that there was a single taxable person or that single supplies were being made by two persons, but there was no authority that suggested that a single business (or economic activity in VAT terms) could not be carried on by more than one person. HMRC was entitled to challenge the FTT's approach and evaluative judgment on this issue. Inadequate reasoning was capable of constituting an error of law.

36. Ms Shaw for the Respondents maintained that HMRC's case misunderstood the principle of fiscal neutrality. That principle required traders carrying on the same transactions not to be treated differently. It was a principle of interpretation that did not either require or permit transactions to be recast. That would cut across the freedom to choose between different transactions or structures with different VAT consequences. In addition the FTT had not made conflicting assumptions. The relative use of the showrooms was fully taken into account in determining the recharge for OMV purposes. The partial exemption issue was concerned with a separate matter of the relative use, as between its taxable and exempt supplies, of that part of the showroom cost that had been apportioned to TFL at the first stage. In contrast HMRC's approach sought to treat TRL as a mere wholesaler incurring no retail costs, with the result (as noted by the FTT at paragraph [156]) that TRL would become inexplicably profitable and TFL effectively insolvent, but also denied TFL input costs on the basis that TRL undertook all the retail activity.

37. On Ground 2, Ms Shaw submitted that the FTT's reasoning was plainly adequate and the conclusion was one that it was entitled to reach. HMRC had also failed to explain how two separately VAT registered companies should be treated as carrying on a single business in the absence of a VAT group.

38. Mr Singh's response to the allegation that HMRC was seeking to recast the transactions was that they were not doing so. HMRC was simply using its powers under Schedule 6 and in relation to the SMO.

39. In our view it is clear that HMRC cannot succeed on these issues. Dealing with Ground 2 first, TRL and TFL are separate legal entities that are separately registered for VAT purposes. In VAT terms they carry on separate economic activities, each being a taxable person that is making and receiving its own supplies. There was no evidence before the FTT that the PerfectHome business was being conducted in partnership ([72] of the Decision), which would have engaged the rules in s45 VATA which provides for registration in the name of the firm. It makes no difference to that whether a partnership is formal or informal in nature. Mr Singh was unable to point to any case where a single economic activity has been treated as carried on by two legal persons who were not in partnership or in a VAT group.

40. In *Lower Mill Estate Ltd v HMRC* [2010] UKUT 463 (TCC), [2011] STC 636 the Upper Tribunal confirmed at [43] that, absent abuse or sham, it is not possible to combine supplies by two suppliers under two contracts so as to result in one supply for VAT purposes. This followed the Court of Appeal's decision in *Telewest Communications plc v Customs and Excise Commissioners* [2005] EWCA Civ 102, [2005] STC 481, where the Commissioners sought to argue that the supply of a monthly listings magazine alongside television services amounted to a single supply even though the magazine was supplied by a separate entity outside the VAT group, because from the customer's perspective there was a single package of television services which included the magazine as a compulsory part. Arden LJ said at [70]:

> "…there are limits to the extent to which transactions can be recharacterised in VAT law… Accordingly, I would accept [Counsel for Telewest's] submission that the expectation of the customer is relevant to the question whether two contracts constitute, for VAT purposes, principal and ancillary contracts, but not to the question of whether there is more than one supplier."

41. Although this is not a case where HMRC are alleging that a single supply was being made by two companies, *Lower Mill* and *Telewest* are nonetheless relevant. They demonstrate that, absent abuse, it is not possible to treat persons as having entered into different transactions or having organised themselves in another way, whatever the perception or expectation of the customer. In our view this is the case not only where HMRC is seeking to challenge what supplies are made and by whom (as in *Telewest* and *Lower Mill Estate*), but also where HMRC is raising the point in a less direct way, by claiming that alternative transactions or a different structure should inform how other VAT rules apply, in this case those relating to OMV and partial exemption. So the fact that customers may consider that they are dealing with the "PerfectHome business" and not draw any distinction between TFL and TRL is not determinative, just in the same way that the customer's perception in *Telewest* did not affect whether there was more than one supplier.

42. In our view the FTT was not only entitled but absolutely correct to conclude at paragraph [72] that TRL and TFL carry on separate businesses for the reasons given,

and in particular the absence of partnership. The FTT was also entitled to rely on the evidence of the group's finance director that there were two businesses. Its conclusion on that point was supported by detailed findings at [73] and [74] about the different activities carried on by each business.

43. We agree with Ms Shaw that the principle of fiscal neutrality does not permit transactions or structures to be recharacterised. In the absence of abuse in the *Halifax* sense the transactions and structures entered into must be respected. The Court of Justice has made this clear in a number of cases, including *Halifax* itself where the Court made the following comment at paragraph [73] in the context of choosing between exempt and taxable transactions:

> "Where the taxable person chooses one of two transactions, the Sixth Directive does not require him to choose the one which involves paying the highest amount of VAT. On the contrary… taxpayers may choose to structure their business so as to limit the tax liability."

44. Once a taxable person has chosen a particular transaction, the VAT consequences of that choice must be followed in the absence of abuse. The principle of fiscal neutrality does not affect this. Where that principle is relevant is in circumstances where a taxable person enters into one transaction but seeks to benefit from the VAT analysis that would apply if another transaction had been undertaken. This was made clear by the ECJ in *Customs and Excise Commissioners v Cantor Fitzgerald International* (Case C-108/99) [2001] STC 1453 at [33], and in *MVM Magyar Villamos Művek Zrt. v Nemzeti Adó- és Vámhivatal Fellebbviteli Igazgatóság*, (Case C-28/16) [2017] STC 452 ("*Magyar*"). In *Magyar* the Court of Justice referred to the taxpayer's decision not to charge members of its group for management services and said at [45]:

> "In that regard, suffice it to note that, on the one hand, traders are generally free to choose the organisational structures and the form of transactions which they consider to be most appropriate for their activities (see, to that effect, judgment of 12 September 2013, *Le Crédit Lyonnais*, C-388/11, EU:C:2013:541, paragraph 46) and, on the other hand, the principle of fiscal neutrality does not mean that a taxable person with a choice between two transactions may choose one of them and avail himself of the effects of the other (judgment of 9 October 2001, *Cantor Fitzgerald International*, C-108/99, EU:C:2001:526, paragraph 33).

45. The principle of fiscal neutrality is one of interpretation and no more: see the Supreme Court's decision *Airtours Holidays Transport Limited v HMRC* [2016] UKSC 21 at [52]. The principle prevents traders carrying on the same or similar transactions (which are thus in competition with each other) from being treated differently for VAT purposes: *JP Morgan Claverhouse v HMRC* (Case C-363-05) [2008] STC 1180 at [46]. But just in the same way that it is not open to a taxable person to avoid the VAT consequences of the type of transaction he has chosen, HMRC must also respect that choice. In this case the choice has been made to carry on the PerfectHome activities through two separately VAT registered companies, and not through a single company, a partnership or a VAT group. In the absence of abuse we do not consider that HMRC can rely on the principle of fiscal neutrality to seek to

impose a VAT cost on the group that might have arisen if a different structure had been chosen. The structure and transactions that were implemented have to be respected. So whilst it is correct that the provisions in Schedule 6 allowing HMRC to impose OMV need to be interpreted having regard to the principle of fiscal neutrality, the limitations of that principle need to be observed.

46. Mr Singh relied on *Rank Group plc v HMRC* (Cases C-259/10 and C-260/10) [2012] STC 23. One of the questions raised in that case was whether the principle of fiscal neutrality required not only a difference in treatment between identical or similar supplies but also the actual existence of competition or a distortion of competition. The Court held that the actual existence or distortion of competition was not a separate requirement, saying at [36]:

> "…the principle of fiscal neutrality must be interpreted as meaning that a difference in treatment for the purposes of VAT of two supplies of services which are identical or similar from the point of view of the consumer and meet the same needs of the consumer is sufficient to establish an infringement of that principle."

47. The court went on to say at [43] that, in order to determine whether two supplies of services are similar, "account must be taken of the point of view of a typical consumer…, avoiding artificial distinctions based on insignificant differences", and at [44]:

> "Two supplies of services are therefore similar where they have similar characteristics and meet the same needs from the point of view of consumers, the test being whether their use is comparable, and where the differences between them do not have a significant influence on the decision of the average consumer to use one such service or the other (see, to that effect, Case C-481/98 *Commission* v *France*, paragraph 27, and, by analogy, Joined Cases C-367/93 to C-377/93 *Roders and Others* [1995] ECR I-2229, paragraph 27, and Case C-302/00 *Commission* v *France* [2002] ECR I-2055, paragraph 23)."

48. Mr Singh submitted that from the perspective of the credit constrained customer of PerfectHome it made no difference how the business was organised, and in particular whether there was only one taxable person in the supply chain or two. Although the *Rank* case concerned the correct tax treatment of supplies made to the consumer (that is, outputs) it was too simplistic to confine the comments to such a case. A different treatment of input tax, and the extent of irrecoverable VAT, also affected competition.

49. Mr Singh also referred to *Elida Gibbs Limited v Customs and Excise Commissioners* (Case C-317/94) [1996] STC 1387, where the Court said at [20] that "one of the principles on which the VAT system was based was neutrality, in the sense that within each country similar goods should bear the same tax burden whatever the length of the production and distribution chain". The court then applied this principle in concluding that account needed to be taken of reductions or repayments provided to the consumer by a taxable person in the chain (the manufacturer) that did not have a direct relationship with the consumer. Mr Singh

submitted that it was inconsistent with this to consider TRL's and TFL's supplies separately for fiscal neutrality purposes since the entire chain was relevant.

50. We do not consider that these cases assist HMRC. *Cantor Fitzgerald* and *MVM Magyar* are clear: the type of transaction chosen must be respected. *Rank* demonstrates that it is not necessary to show actual competition or distortion of competition, and that the similarity of supplies should be judged from the perspective of the consumer of those supplies, but not that fiscal neutrality can affect the treatment of inputs received by the supplier. *Elida Gibbs* decided (in the context of fully taxable transactions) that the manufacturer in that case was not liable to account for VAT on an amount that exceeded the sum finally received by it because otherwise a basic principle of the VAT system, that tax should only be charged on the amount borne by the final consumer, would be breached because the tax authority would collect more VAT than the final consumer had paid and the position of taxable persons in the chain of supply would not be neutral.

51. We also do not agree with Mr Singh that the FTT had made conflicting assumptions, treating TRL as the retailer for Schedule 6 purposes and TFL as the retailer for partial exemption purposes. The FTT found that TRL could not be regarded as a wholesaler (see in particular [91] of the Decision). But this does not mean that TFL's own sales of goods to customers can somehow be ignored or left out of account when it comes to looking at TFL's partial exemption position. That is a separate point and depends on the position of TFL, not TRL.

Ground 3: "shop within a shop"

52. The FTT decided at [165] and [166] that because TFL conducts its business in TRL's stores the OMV of store services could be determined by considering the fees that are paid in similar situations where one business operates in the premises of another, and therefore that Grant Thornton were right to consider that a concession or "shop within a shop" arrangement was an appropriate analogy to use. Mr Singh submitted that the reasoning that led to this conclusion was inadequate and the conclusion was irrational. HMRC had put forward seven reasons for its view that the analogy was inapplicable, which the FTT summarised at [162] of the Decision but did not, or did not properly, address. In particular, the FTT did not address HMRC's submissions that a host business would not normally depend on a concessionaire to provide credit (the provision of credit being central to the business in this case), that a concessionaire would not ordinarily offer the same products as the host business (whereas here the same goods are sold and as part of the same transaction), and that a customer would normally be aware that they were buying goods from a concessionaire whereas TFL is the sole face of the business rather than a tenant selling complementary products.

53. We agree with Ms Shaw that the conclusion the FTT reached was one that was open to it. The FTT primarily relied on the fact that TFL actually conducts its business in TRL's stores, and on the fact that Grant Thornton, with extensive transfer pricing experience, had considered that the "shop within a shop" analogy was the most appropriate way of seeking to ascertain the OMV of store services (paragraphs

[166] and [167]). The FTT's conclusions on this point were consistent with its findings of fact, including findings at [64] and [80] that TFL is permitted to use the stores but is not the primary user. The FTT was clearly aware that there are material differences between a "classic" retail concession arrangement (such as a cosmetics counter in a department store) and the arrangements between TRL and TFL (see for example [163] of the Decision), which is why the comparison was in terms of an analogy. The reasons given by HMRC and summarised by the FTT at [162] are effectively a list of differences between a typical concession arrangement and the arrangements in this case (together with a repetition of the argument that there is a single business), and it was not necessary to address each of them expressly. A judge need not deal with every point provided that the basis of his decision is clear (see for example Lady Justice Arden's comments in *Battista v Bassano* [2007] EWCA Civ 370 at [56] and [57], referring to *English v Emery Reimbold & Strick Ltd* [2002] EWCA Civ 605). In our view the basis of the FTT's decision on this point was clear.

54. HMRC's own approach to calculating the OMV of store services, based on an analysis of staff time, was clearly rejected by the FTT at [181] to [184]. In our view, the FTT was clearly entitled to do so for the reasons given. In particular, HMRC had produced no evidence to indicate that the method it was proposing was one that was actually used by parties transacting at arm's length, whereas Grant Thornton had done so in performing their own benchmarking exercise.

Ground 4: irrational approach to the "concession fee"

55. As an alternative to Ground 3, but also effectively in support of it, HMRC challenged the FTT's conclusion at [173] that it was appropriate to take into account the 37% margin on sales by TRL to TFL. If that was excluded then the fee charged by TRL was less than 4% of turnover rather than falling within either of the ranges proposed by Grant Thornton. In HMRC's view this alone suggested that the arrangements are not analogous to a shop within a shop. The host store in any concession arrangement would hope that the presence of a concessionaire would attract additional custom for its own products, and the wide ranges suggested by Grant Thornton (10% to 25% or 15% to 35% of turnover) reflected the differing degrees to which host stores expected that this would occur in relation to particular concessions.

56. In our view the FTT's conclusion was one that it was clearly entitled to reach on the evidence. Any sale by TFL guaranteed a sale by TRL at a 37% margin. TFL's presence in the stores enabled TRL to make 98% of its sales. It was not irrational for the FTT to adopt the approach taken by Grant Thornton of taking account of these unique features, which would not be present in a typical concession arrangement, in determining the arm's length price for store services. This approach accepts that the "shop within a shop" comparison is not an exact analogy, and that account needs to be taken of the differences.

Ground 5: flawed approach to determining the OMV of advertising services

57. Mr Singh submitted that the FTT's conclusion that advertising costs should be allocated according to operating profits was flawed because it failed to recognise that

the companies are in the same ownership and their statutory accounts are consolidated, so that the allocation of profit between them is entirely at their disposal. This was illustrated by the fact that TFL consistently makes a loss on the purchase of goods when delivery is taken into account. The FTT's failure to take this relevant factor into account was an error of law.

58. We agree with Ms Shaw that the FTT's conclusion was plainly open to it on the evidence. The FTT found that TRL was not overcharging TFL for goods or for other services provided (paragraphs [98] and [155]) and that TFL made a commercial profit from its activities as a whole (paragraph [97]). HMRC produced no evidence that the allocation of profits was manipulated. As the FTT pointed out at [196], HMRC's alternative approach of allocating TFL 98% of the cost ignores a key relevant factor, namely TRL's 37% profit margin on every sale made by TFL. That point significantly undermines HMRC's argument that TFL made 98% of the sales and therefore benefited from the advertising that drove the sales to the same extent.

Ground 6: misdirection in determining the PE issue

59. Mr Singh submitted that the FTT had adopted the wrong approach in asking itself whether it preferred TFL's approach or HMRC's approach to the calculation of recoverable input tax on overheads. The correct approach was to (a) decide what the use of the input tax was, (b) consider the standard method and whether the SMO applied, (c) if the SMO applied, consider whether TFL's calculation fairly and reasonably reflected use, (d) if it did not, consider whether HMRC's calculation did so, and (e) if neither calculation fairly and reasonably reflected use, impose its own use-based calculation.

60. We do not agree. Only two methods were before the FTT, TFL's and HMRC's. The FTT was not required to make its own enquiry as to whether there might be another method that was preferable. As Lord Carnwath said in the Supreme Court's decision in *VWFS,* [2017] UKSC 26 at [7], where the parties are substantial litigants represented by experienced counsel the tribunal "is entitled to assume that the parties will have identified with some care what they regard as relevant issues for decision".

61. HMRC's arguments also do not take sufficient account of the fact that the starting point is the standard method. As discussed further below in relation to Ground 7, that method is the appropriate method unless a special method applies or the proportion of recoverable input tax "differs substantially" from what would be recoverable under a use-based method, so that the SMO applies. The FTT rejected HMRC's approach for the reasons set out at paragraphs [231] to [235], including that TFL's residual input tax is incurred to collect the weekly payments that relate to the sale price of the goods as well as the finance element. This effectively left the default standard method contended for by TFL as the applicable one. In fact, the FTT also went on to consider whether TFL's approach was correct and concluded at [235] that it was, on the basis that TFL's business involves the making of taxable supplies of goods as well as exempt supplies, that the supplies are inextricably linked and, therefore, that TFL uses its overheads in the course of its entire business.

Ground 7: error in deciding that the standard method was fair and reasonable

62. Mr Singh submitted that the FTT did not take proper account of the fact that the Court of Appeal in *VWFS* drew a distinction between the question of whether overheads were cost components of supplies (which was the question for decision in that case) and the question of the apportionment of those costs between different supplies, which was the relevant question in this case. The way in which overhead costs are recovered is highly material to a fair and reasonable apportionment, and in this case the overheads are built into the price of the finance and not the goods. In HMRC's view the standard method vastly overstates TFL's costs in selling goods, because the goods are already sold before TFL gets involved, TFL makes no effective profit on the goods and the profit is derived from the finance. Essentially, HMRC relied on precisely those arguments that TRL relied on in the context of the OMV dispute, namely that TRL is the retailer.

63. Ms Shaw submitted that the dispute is effectively the same as in *VWFS*, because in each case HMRC contend that none of the overhead costs can be apportioned to taxable supplies of goods. It cannot be said that the overheads are "used" in making taxable supplies to the extent of zero. The question of apportionment only arises once it is accepted that the costs are overheads, meaning that they are used for the purpose of the business as a whole. There was no need to show that the costs are built into the price of the taxable supplies. HMRC's approach also failed to take account of the fact that the standard method is the default method, and it is not necessary to show that the result produced by it is fair and reasonable.

64. Mr Singh disagreed that HMRC was saying that the overheads are not used at all in making taxable supplies of goods. Instead the officer that made the assessments on TFL had accepted that there was potentially a very small amount of residual input tax incurred in relation to sales of goods, but SMO adjustments are not precise and excluding taxable supplies from the numerator and denominator produced a fair and reasonable estimation of use, both for new and QR goods.

65. As already noted, the basis of the domestic legislation governing the right to deduct input tax incurred on goods and services used both for taxable and exempt transactions is now contained in Articles 173 to 175 of the Principal VAT Directive. The basic approach is equivalent to the standard method. Under Article 173(2)(c) (see [14] above) Member States are permitted to derogate from this method and require the deductible proportion to be established on the basis of use. When considering the case law it is relevant to note that this derogation is the basis not only of the SMO but also of the regulations permitting HMRC to agree a special method. So case law relating to whether a special method is appropriate is highly relevant.

66. In order for adjustments to be made under the SMO the standard method of attribution must differ substantially "from one which represents the extent to which the goods or services are used … or are to be used … in making taxable supplies" (see [13] above). It was not argued that the differences that would result from applying HMRC's approach would not be "substantial" (within the numerical definition of that term in the VAT Regulations), so the key question is whether the application of the standard method by TFL reflects use. It is worth noting that although s 26(3) VATA

refers to a “fair and reasonable” attribution, that is in the context of describing the Commissioners’ regulation making powers. We do not think that it amounts to an independent requirement for the taxpayer to demonstrate that the standard method, which reflects the terms of the Principal VAT Directive, itself produces a fair and reasonable result. The only relevant derogation is that reflected in the SMO, namely that the standard method can be departed from if it does not reflect use. (In contrast, regulation 102 of the VAT Regulations, which governs the agreement of special methods, does make specific reference to whether the method is fair and reasonable, but also only in the context of use: the question is whether the method “fairly and reasonably represents the extent to which goods or services are used … in making taxable supplies”: regulation 102(9) and (11).)

67. The key question, therefore, is how the question of “use” is determined. We agree with the FTT that although the Court of Appeal’s decision in *VWFS* is not determinative of the point it is highly relevant. (We should note here that, although the Supreme Court has referred the case to the European Court of Justice, the Court of Appeal’s decision is of course binding on us and the FTT.) VWFS, like TFL, carried a hire purchase business, supplying cars but also supplying finance. It made no profit on the supply of the goods. The principal question in that case was whether any of the input tax incurred by VWFS in respect of overheads was deductible against the output tax on the taxable supplies cars to customers or, as HMRC contended, it was all attributable to the exempt supplies of finance. Patten LJ, with whom Sharp LJ and King LJ agreed, said at [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.”

This comment clearly indicates the relevance of the decision to this case.

68. Patten LJ then noted at [50] the curiosity that HMRC was running an argument that none of the input tax related to the taxable supplies of vehicles in the context of a dispute about the fairness of a partial exemption special method, because if HMRC was correct then Article 173 had no application, but nevertheless proceeded to deal with HMRC’s argument about whether the costs needed to be recovered as part of the price charged for the output supply. Commenting on the ECJ case law, he went on to say:

> “[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*[1], read as a whole, is clearly speaking of price in the sense of the costs of making the supply and the

[1] (Case C-243/11) [2013] STC 243

same can be said of the judgment in *Skatteverket*[2] at para 62. In *Sveda*[3] Advocate General Kokott returned to the same issue. Paragraphs 33–35 express the test in conventional terms and paras 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] [Counsel for HMRC] 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*[4] and *Abbey National*[5] 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 art 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*[6] case I referred to earlier and it is worth reminding

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[2] (Case C-29/08) [2010] STC 419

[3] (Case C-126/14) [2016] STC 447

[4] (Case 268/83) [1985] ECR 655, ECJ

[5] (Case C-408/98) [2001] STC 297

[6] [2011] EWCA Civ 1323, [2012] STC 388

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*[7] which Etherton LJ quotes in para [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."

69. Patten LJ went on to reject HMRC's contention that the only fair and reasonable method of apportionment was one which attributed the entire economic use of the residual inputs to the supply of finance, relying on the inclusion of the costs in the price of the supply of finance as corroborative of their only economic use being in relation to an exempt supply, saying:

> "[61] …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 art 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

[7] (2002) VAT Decision 17797

> 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 para 26 of *BLP*[8]."

70. Mr Singh relied heavily on the comments in paragraphs [55] and [62] that the attribution of costs to outputs "may" be relevant to a fair and reasonable apportionment, arguing that what was at issue in this case was apportionment, which was not the case in *VWFS*. However, we do not think that this takes proper account of the reasoning in that case. It is very clear that the Court of Appeal rejected HMRC's argument that the concept of "use" depended on costs being passed on and recovered in the price of the particular supply, see in particular paragraphs [49], [54] and [55]. In our view that is precisely the argument that HMRC is raising here.

71. It is right that Patten LJ referred to the attribution of costs to outputs as potentially being relevant to the question of apportionment. However, that needs to be understood in context of the cases which he was considering which addressed the question of apportionment. Two particular cases considered were *London Clubs Management Ltd v HMRC* [2011] EWCA Civ 1323, [2012] STC 388 and the earlier tribunal case of *Aspinall's Club Ltd v Commissioners of Customs and Excise* (2002) VAT Decision 17797. In each case the question was whether a proposed partial exemption special method based on the use of floor area for exempt gambling and taxable catering supplies was appropriate. The alternative contended for by the Commissioners was a method based on turnover. In *Aspinall's* the floor area method was rejected on the basis that the costs were primarily incurred to facilitate exempt gaming. Aspinall's derived its income overwhelmingly from gaming, and 90% of the food and drinks were not charged for. The catering business was clearly loss-making. A floor area method would have attributed up to 55% of the refurbishment expenditure in question to catering whereas only about 1% of the turnover was taxable.

72. In *London Clubs* the Court of Appeal refused to set aside the FTT's decision that a floor area method had been wrongly rejected by HMRC, on the grounds that although the concept of use was not limited to physical use and real economic use should be considered, the FTT had found that the catering activities were businesses

[8] (Case C-4/94) [1995] STC 424

in their own right and a potential source of profit. As explained by Patten LJ in *VWFS*, the alternative was again a turnover method, on the basis that HMRC considered that it would more fairly represent use. It was not argued in either *London Clubs* or *Aspinall's* that, because the catering activities were in fact loss-making, there should be no apportionment of input tax to the catering business. In each case a turnover based method was put forward as the appropriate alternative. We think that the comments made by Patten LJ about the attribution of costs potentially being relevant to apportionment must be understood in the context of those cases.

73. In this case, the FTT emphasised two relevant facts at [213], namely that TFL only provides finance in conjunction with a supply of goods, and that once TFL has entered into an HP agreement it continues to incur expenses associated with the supply of goods, in particular in relation to activities aimed at collecting outstanding amounts in respect of both the finance element and the supply of goods. The second of these points is reiterated at [232]. We agree and would add that TFL's goods-related activities also extend to recovering goods from customers and dealing with problems in relation to goods sold: see [74] of the Decision. In our view, TFL's overheads are indeed used both in making its supplies of finance and in making supplies of goods. Those supplies are made as part of a single transaction and we consider that it would be contrary to economic reality to distinguish between them and seek to attribute overhead costs to one element only. The fact that there is little or no mark up on the goods element is not determinative, since it is not necessary to demonstrate that the costs are recovered from particular supplies. The supply of goods is an essential part of its business which cannot be either completely disregarded (as in *VWFS*) or substantially disregarded (as would be the effect of HMRC's approach here). The comments made by Patten LJ at [61] of *VWFS* about the nature of the business are equally applicable in this case.

Ground 8: the FTT erred in its decision on QR goods

74. The final ground of appeal relates to the FTT's conclusion at [237] that it was appropriate to include the value of supplies of QR goods in the calculation of recoverable input tax on overheads whether those goods were sold to TRL (as was the case up to 2011) or to customers, in the same way as supplies of new goods to customers. Mr Singh submitted that the FTT should have recognised that the costs incurred in supplying QR goods are insignificant compared to the value of the goods, so that their value should be excluded in determining input tax recovery in the same way as the value of supplies listed in regulation 101(3) of the VAT Regulations. Regulation 101(3) requires certain specified supplies to be excluded in determining the proportion of recoverable input tax under the standard method. The supplies specified include supplies of capital goods used in the business, and (where the supplies are incidental to one or more business activities) exempt supplies of finance and other financial and real estate transactions.

75. Mr Singh relied on *Régie Dauphinoise-Cabinet A Forest SARL v Ministre du Budget* (Case C-306/94) [1996] STC 1176, which considered the provisions of Article 19(5) of the Sixth Directive from which regulation 101(3) is derived (now Article 174(2) of the Principal VAT Directive: see [15] above). Advocate General Lenz

explained the exclusion in terms of the distortion that would arise if (exempt) transactions were taken into account in the turnover calculation in circumstances where "the resources applied are slender but the transaction for which they are used is proportionally much greater", because including them in the denominator would result in a "disproportionately high" diminution of the deduction (paragraph 39). The ECJ endorsed these comments at paragraph [21] of the judgment, referring to the calculation being distorted if all receipts from financial transactions were included in the denominator even where the creation of the receipts did not entail use, or only very limited use, of goods or services subject to VAT.

76. This ground of appeal cannot succeed. The comments about distortion in *Régie Dauphinoise* explain why certain specified types of transaction are excluded from the calculation under what is now Article 174(2) of the Principal VAT Directive. They do not provide a justification for excluding other types of transaction where some element of distortion is perceived. The supplies in question here clearly do not fall within regulation 101(3) or Article 174(2).

77. The FTT found that the sales process for QR goods was virtually identical to the sales process for new goods (paragraph [16]). In our view, the FTT was fully entitled to conclude that there was no material distinction between the two, and therefore that supplies of QR goods should be included in the calculation in the same way as new goods and that no adjustment to the standard method was required.

Disposition

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

Costs

79. Any application for costs in relation to this appeal must be made in writing within one month after the date of release of this decision as required by rule 10(5) and (6) of the Tribunal Procedure (Upper Tribunal) Rules 2008.

Judge Greg Sinfield
Upper Tribunal Judge

Judge Sarah Falk
Upper Tribunal Judge

Release date: 4 August 2017