Appeal numbers FTC/44/2010, FTC/73/2010
[2011] UKUT 258 (TCC)

Whether VAT recoverable as input tax on professional fees incurred by a bidding company in the course of a takeover of a target company which was a member of a VAT group; whether such services were attributable to the economic activities of the acquiring company combined with the taxable supplies of the VAT group; whether there was a direct and immediate link between the supplies constituted by the services and taxable supplies made by the VAT group; appeal by HMRC against decision of First-tier Tribunal successful; claim for input tax denied

UPPER TRIBUNAL (TAX AND CHANCERY CHAMBER)

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS

Appellants

- and -

BAA LIMITED

Respondent

BAA LIMITED

Appellant

-and-

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS

Respondents

TRIBUNAL: The Hon Mrs Justice Proudman DBE and Mr Julian Ghosh QC
Sitting in public at the Royal Courts of Justice Strand London WC2A 2LL

Mr Owain Thomas and Mr Edward Brown, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Appellants

Mr Roderick Cordara QC, Mr David Southern and Miss Rebecca Murray, instructed by Herbert Smith LLP for the Respondent

DECISION

TRIBUNAL JUDGES: The Hon Mrs Justice Proudman DBE and Mr Julian Ghosh QC

RELEASE DATE:

1. This is an appeal by the Commissioners for Her Majesty's Revenue and Customs ('the Commissioners') against a decision of the First-tier Tribunal (Tax Chamber) allowing an appeal by BAA Limited, against an assessment to value added tax ('VAT') raised by the Commissioners.

2. The appeal concerns the recovery of VAT incurred by the Respondent. The Respondent incurred the relevant VAT on fees paid by it in connexion with a successful takeover bid by the Respondent of a target company. For reasons we make clear below, although the Respondent is now called BAA Limited, after a change of name, we shall refer to the Respondent bidder company as "ADIL" and to the target company as "BAA". After the takeover, ADIL joined the same VAT group as BAA. The representative member of that VAT group claimed recovery of the VAT as input tax as part of the group's general overheads. The Commissioners contended that no recovery was available for that VAT and raised an assessment in respect of the same in the sum of approximately £6.7 millions. ADIL appealed against that assessment and its appeal was upheld by the First-tier Tribunal (Tribunal Judge Peter Kempster and Mrs Joanna Neill) in a decision dated 28 January 2010 [2010] UKFTT 3 (TC).

3. The Commissioners appeal, with the permission of this Tribunal, the decision of the First-tier Tribunal on the ground that it erred in law in holding that ADIL was entitled to recover the said VAT as input tax. ADIL seeks to uphold the decision for the reasons given by the First-tier Tribunal. It has also submitted a cross-appeal to the effect that one factual finding of the First-tier Tribunal (regarding ADIL's intentions to join BAA's VAT group prior to completing the take-over) should be set aside and effectively reversed because it was contrary to the evidence before the Tribunal and thus an error of law. Permission for the cross-appeal has also been granted by this Tribunal.

Introduction

4. In the spring of 2006, an investment consortium led by the Spanish infrastructure group, Ferrovial, launched a takeover bid for the United Kingdom airport operator, BAA plc, which was at that time listed on the London Stock Exchange. The vehicle for the intended acquisition was the Respondent, a special-purpose vehicle called Airport Development and Investment Limited ('ADIL'). Although the initial bid was contested by BAA plc, a revised bid was subsequently recommended by the board of BAA and, in July 2006, the target company became a wholly-owned subsidiary of ADIL.

5. In the spring and summer of 2006, ADIL incurred significant fees payable to investment banks, solicitors and others in respect of the takeover. Those fees carried VAT. In September 2006, following the acquisition, ADIL joined the BAA plc VAT group. The representative member of the VAT group then reclaimed that VAT as input tax of the group, attributable to the general overheads of the group.

6. The Commissioners disputed the claim for recovery of input tax and raised an assessment to VAT in the sum of approximately £6.7 millions. It is against that assessment that the representative member of the VAT group (also the successful bid company), ADIL, appealed to the First-tier Tribunal.

7. As is made clear in paragraphs 5 and 164 of, and the schedule to, the decision of the First-tier Tribunal, several of the companies involved in the relevant transactions have changed or exchanged their names in the intervening period. At the time of the takeover, the target company was called BAA plc (being the company registered under number 1970855). The vehicle for the intended acquisition of BAA was incorporated as FGP Bidco 1 Limited on 27 March 2006. After several changes of name, it became known as Airports Development and Investment Limited – that is to say, ADIL – on 6 April 2006. In August 2006, the target company, BAA plc, became BAA Limited. In October 2008, BAA Limited became BAA Airports Limited and ADIL became BAA Limited. For the avoidance of confusion and consistent with the approach adopted in the decision of the First-tier Tribunal, the target company shall be referred to in this judgement as 'BAA' and the acquisition vehicle (the Respondent to this Appeal) shall be referred to as 'ADIL'. The various name changes of the several companies were summarised in an appendix to the decision of the First-tier Tribunal and that appendix we respectfully adopt.

The Issue

8. It is convenient to set out the issue. Put shortly the main question is whether the VAT incurred by ADIL on the professional services supplied to ADIL have a sufficiently direct and immediate link to taxable supplies made by ADIL (or which may be attributed to ADIL) in the course of an economic activity. If so, and to that extent, the appeal fails (and the VAT incurred by ADIL is recoverable). If not (again to that extent), the Commissioners' appeal succeeds. ADIL also pleads that the application of specific provisions (Regulation 111 of the VAT Regulations) demands that ADIL recover the relevant VAT.

Evidence

9. The evidence before the First-tier Tribunal consisted of several agreed bundles of documents. In addition, the taxpayer led evidence from three witnesses, namely Mr Juan Bullón (legal director of Ferrovial Aeropuertos SA and, in the spring and summer of 2006, one of the in-house lawyers advising Ferrovial on the proposed takeover of BAA), Mr José Leo (chief financial officer of the BAA group from October 2006) and Mrs Susan Warren (indirect tax manager of the BAA group at the time of the takeover). No witnesses were called by the Commissioners. The First-tier Tribunal found all of the witnesses to be completely credible and reliable. No appeal is made against that finding. During the course of ADIL's submissions on the cross-appeal, ADIL made an application to lead further evidence from Mr Bullón, which application the Commissioners resisted. Ultimately ADIL did not pursue this application and we say no more about it.

The Facts

10. Although the parties did not prepare a statement of agreed facts, either for the hearing before the First-tier Tribunal or for the hearing before the Upper Tribunal, much of the factual background was not disputed.

11. In March 2006, BAA was listed on the London Stock Exchange. It was the holding company of a group that operated Heathrow, Gatwick and Stansted airports. The operation of these airports was regulated by the United Kingdom Civil Aviation Authority. In addition to the regulated airports, BAA also operated several other, non-regulated airports, such as Southampton.

12. ADIL was incorporated (under a different name) on 27 March 2006. Ultimate ownership (via intermediaries) was with Ferrovial (as to 61.06%) and two other members of the consortium established to make the takeover bid for BAA. The total equity subscribed was some £5.1 billions. The memorandum of association of ADIL was in standard form for a general commercial company. Ferrovial was (and is) a large infrastructure group headquartered in Spain. It was founded as a private company in 1952 and became a public company in 1999.

13. On 28 March 2006, ADIL entered into an engagement letter with the London branch of Macquarie Bank Limited ('Macquarie'). At or about the same time, it also engaged a team of professional advisers, including the solicitors, Freshfields Bruckhaus Deringer ('Freshfields'). The engagement letter with Macquarie contained the following passage:

> *Macquarie's Role – The Acquisition – Macquarie is engaged by* [ADIL] *in connection with the Acquisition to act as co-financial adviser to* [ADIL] *with* [Citigroup]*...The services to be provided under this engagement in connection with the Acquisition may include, amongst other things, advice and services as set forth in Schedule 1.*

Schedule 1 contained a two-page list of tasks arranged under the following sub-headings: business plan and financial modelling; due diligence; valuation; capital structure in connection with the acquisition facilities; and execution. The engagement letter also contained the following passage:

> *Macquarie's Role – The Refinancing – Within 24 months of completion of the Acquisition, the Consortium and/or* [ADIL] *and/or* [BAA] *intend to implement a debt strategy that will involve the following (i) a refinancing of* [BAA's] *existing financial facilities (including its public debt) and (ii) a full refinancing of the facilities used by the Consortium or* [ADIL] *to fund the transaction… Macquarie is engaged by* [ADIL] *in connection with the acquisition to act as its financial adviser in connection with* [both (i) and (ii)]*…The services to be provided under the engagement for the Refinancing may include, amongst other things, advice and services as set forth in Schedule 2.*

Schedule 2, which was headed 'Services which may be provided in connection with the refinancing', contained a one-page list of tasks arranged under the following sub-headings: objectives and strategy;

process; model and sensitivity; fund raising; and structuring, documentation and hedging. The passages in the engagement letter relating to fees were in the following terms:

> *Fees – Completion fee –* [ADIL] *shall pay Macquarie a fee (the Completion Fee) of £30 million for its services as co-financial adviser in connection with the Acquisition. The Completion fee will become due and payable on completion of the acquisition...*
>
> *Fees – Refinancing fee – If the Refinancing is implemented within 36 months following completion of the Acquisition* [ADIL] *shall pay Macquarie a fee of £20 million for its services hereunder.*

The terms relating to the completion fee included provisions to cover the situation of a minority acquisition, and a break fee in the event of an abortive bid. The terms relating to the refinancing fee included provisions to permit extension of the thirty-six month period, but no break fee. There was a clause stating all amounts to be exclusive of VAT.

14. On 7 April 2006, ADIL entered into agreements with a syndicate of banks for senior and subordinated debt facilities totalling some £8.7 billions. On the same date, ADIL announced a firm intention to make an offer for BAA. The senior facilities comprised two facilities: facility A was approximately £4.7 billions and facility B was £2.0 billions.

15. Clause 3 of the senior facilities agreement (which runs to some 240 pages) describes the 'purpose' of the facilities – that is to say, how the funds must be applied. At that time several methods of effecting the takeover were anticipated but singling out that which actually occurred (cash purchase of shares):

> *Each Borrower shall apply all Facility A Loans in or towards…(i) financing the acquisition of* [BAA] *Shares to be acquired by* [ADIL] *pursuant to the Share Offer…and/or (vii) (in the case of a member of the* [BAA] *Group) refinancing its own Financial Indebtedness which is outstanding at the first Utilisation Date and in or towards the payment of any break funding costs, redemption premia and other costs payable in connection with such refinancing.*
>
> *Each Borrower shall apply all amounts borrowed by it under Facility B: (i) towards funding Capital Expenditure incurred by members of the* [BAA] *Group and/or refinancing such amounts to the extent they were initially funded from other sources…and/or (ii) in the case of* [ADIL] *towards funding the cost of interest incurred by it* [in certain circumstances]…

The subordinated facility totalled £2.0 billions and clause 3 of the subordinated facility agreement (some 200 pages) required the borrower to apply monies borrowed under the subordinated facility towards financing the acquisition of BAA shares and transaction costs.

16. On 20 April 2006, ADIL made its formal offer. BAA recommended in its defence document issued on 3 May 2006 that the offer be rejected because it 'does not begin to reflect BAA's true value'. Nevertheless, on 13 June 2006, ADIL made a revised, and this time recommended, offer. The recommended final offer document (which consisted of over 250 pages) contained the following passages:

> From BAA's Chairman (p. 9): [ADIL] *has indicated that it is committed to the long term ownership and continued development of BAA's business and to its investment needs in the future.*
>
> Page 29: *Investment plans* – [ADIL] *has ensured that financing will be available to undertake the published capital expenditure programme of BAA in the UK. The need for terminal and runway capacity has been highlighted in the White Paper and* [ADIL] *recognises the importance of implementing the CAA's recommendations for the future development of the airports in South-East England in particular. To assist in this process,* [ADIL] *has arranged a £2.0 billion capital expenditure facility which is capable of being drawn for a five-year period. Should this funding source be fully utilised,* [ADIL] *is confident it will be able to raise additional capital expenditure facilities to assist in funding further investment.*
>
> Page 29: *Refinancing – Shortly after the completion of the acquisition of BAA,* [ADIL] *intends to refinance the Senior Acquisition Facilities with a longer term financing structure based upon proven techniques adopted by other regulated companies. This process is intended to provide the medium and long-term financing required to support the investment needs of BAA.*

Acceptances of the recommended offer became unconditional on 26 June 2006, whereupon ADIL became the owner of the BAA group.

17. In the period from July to October 2006, ADIL paid fees to Macquarie, Freshfields and other persons in connexion with the takeover, and incurred VAT thereon. The fees that gave rise to the VAT that is in dispute, together with extracts from the relevant narrative were as follows:

- *Macquarie:* 'Project Berlin – Completion fee...for its services as co-financial adviser in connection with the acquisition of [BAA]' – £30 millions plus disbursements plus VAT;
- *Freshfields:* 'Project Berlin – Professional services incurred in advising in connection with the offer for [BAA] by [ADIL]' – €9.7 millions plus disbursements plus VAT;
- *Salisbury Associates:* Shareholder communications – an appointment letter dated 19 May 2006 provides for a fee of £549,000 plus a success fee of £215,000 plus disbursements plus VAT (although only the first instalment invoice was produced to the First-tier Tribunal);
- *Computershare Investor Services plc:* 'BAA plc takeover on behalf of [ADIL]' – aggregate £560,000 plus disbursements plus VAT;
- *KPMG:* 'Project Berlin' – £225,000 plus disbursements plus VAT;
- *The Gate:* Advertising – £20,000 plus VAT; and
- *FT:* Advertising – £8,000 plus VAT.

In the bundles provided to the First-tier Tribunal were other invoices disclosed during the pre-trial disclosure process, which both parties confirmed did not need to be considered by the Tribunal. The evidence of Mr Leo (which was accepted by the First-tier Tribunal) was that all of the acquisition transaction costs were accounted for under the relevant international accounting standard as part of the investment in BAA. In the consolidated financial statements the cost of the investment was set off against the fair value of net assets of the BAA group acquired, resulting in goodwill as the difference between the cost and the fair value. This goodwill was included in the 'intangible assets' caption in the consolidated balance sheet.

18. Importantly, the First-tier Tribunal found that the fees for the services provided by Macquarie were concerned mainly with the takeover albeit that the resulting work produced continuing benefits beyond the takeover (see paragraph 84 of the First-tier Tribunal decision). Furthermore, the First-tier Tribunal found that the purpose of ADIL's acquisition of BAA was not to acquire the BAA shares as an end in itself but as a first, necessary step in long term large investment in UK airport infrastructure (see paragraph 80 of the First-tier Tribunal decision).

19. Following the acquisition of BAA, the evidence of Mr Bullón (accepted by the First-tier Tribunal) was that ADIL provided management of the BAA airports business from the top as a holding company, including provision of directors' services. Corporate governance was at the level of ADIL and was provided both to those airports that were regulated (namely Heathrow, Gatwick and Stansted) and to those that were not regulated. Intra-group financing

arrangements were run through ADIL. ADIL operated currency-hedging arrangements on behalf of the whole group and provided governance and direction and was 'the single brain in the group'. The Tribunal found that there was no evidence of an intention on the part of ADIL to charge for its intra-group services prior to the takeover but that ADIL did have such an intention as from the takeover completion (albeit no such charges were ever made: see paragraphs 81, 86 of the First-tier Tribunal decision).

20. The refinancing was effected in July 2008 by means of sophisticated arrangements including a securitisation issue. The documentation, including a bank presentation given within three weeks of the takeover offer becoming unconditional, was voluminous and the First-tier Tribunal felt it necessary to note only that the refinancing did take place within a two-year period stated in the bank presentation and within the thirty-six-month period stated in the Macquarie engagement letter, and that some members of the professional advisory team had also been involved on the takeover bid.

21. Mrs Warren's evidence (accepted by the First-tier Tribunal) was that the BAA VAT group comprised over fifty companies, many of which were dormant. It included everything in the BAA group (except for certain duty-free retail sales operations). From early July 2006 – that is to say, immediately following the takeover – she discussed with the head of tax at BAA the VAT position of ADIL, proposing that ADIL should be included in the BAA VAT group. This was, she said, the easiest course of action administratively and dealt with ADIL in the same manner as almost all other members of the group. Following discussions with Ferrovial's head of tax, it was confirmed that ADIL (and three other holding companies) would join the VAT group. On 21 September 2006, ADIL (and other companies) made an application to the Commissioners to join the VAT group. The Commissioners initially declined to accept admission of ADIL to the group because they believed that ADIL lacked a fixed place of establishment in the UK. This objection, which is not material to the matters that are the subject of the present appeal, was resolved and, in an e-mail dated 18 January 2007 (and confirmed in a letter dated 31 January 2007), the Commissioners agreed that ADIL should be admitted to the BAA VAT group with effect from 22 September 2006.

22. It is the circumstances of ADIL joining the BAA VAT group which are the subject of the cross-appeal. The First-tier Tribunal found that there was no evidence of ADIL having an intention to join the BAA VAT group prior to the completion of the takeover (see paragraph 82 of the First-tier Tribunal's decision). ADIL says that there was such evidence and cross-appeals the First-tier Tribunal's finding, which ADIL says should be reversed on *Edwards v Bairstow* [1956] AC 14 grounds. The Commissioners disagree and support this finding by the First-tier Tribunal. We deal with the cross-appeal below.

23. In addition to confirming admission to the BAA VAT group, the Commissioners' letter dated 31 January 2007 went on to challenge the deduction claimed in respect of the VAT incurred by ADIL, stating:

> *A detailed examination of the invoices and information relating to the invoices has been undertaken. From this examination it is clear that the costs incurred relate to the acquisition of the BAA business as a whole. These costs of ownership are investment costs that have been incurred by* [ADIL] *in raising finance to acquire the BAA group. There is no direct and immediate link between the supplies on which this VAT was incurred and any taxable supplies made (or to be made) by the BAA VAT group.*

On 21 February 2007 HMRC issued a VAT assessment in the amount of £6,676,733 pursuant to section 73(2) of the Value Added Tax Act 1994 ('VATA'). It was the taxpayer's appeal against that assessment that gave rise to the present appeal.

European and Domestic Legislation

24. In this judgment, references to EC directives are to those extant at the time of the relevant transactions, rather than the principal VAT directive 2006/112/EC which came into force on 1 January 2007.

25. Article 2 of EC Council Directive 67/227 ('the First Directive') establishes the general features of the tax:

> *The principle of the common system of value added tax involves the application to goods and services of a general tax on consumption exactly proportional to the price of the goods and services, whatever the number of transactions which take place in the production and distribution process before the stage at which tax is charged.*
>
> *On each transaction, value added tax, calculated on the price of the goods or services at the rate applicable to such goods or services, shall be chargeable after deduction of the amount of value added tax borne directly by the various cost components.*
>
> *The common system of value added tax shall be applied up to and including the retail trade stage.*

Article 17 of EC Council Directive 77/388 ('the Sixth Directive') states (so far as relevant):

> *1. The right to deduct shall arise at the time when the deductible tax becomes chargeable.*
>
> *2. In so far as the goods and services are used for the purposes of his taxable transactions, the taxable person shall be entitled to deduct from the tax which he is liable to pay:*
>
> *(a) value added tax due or paid within the territory of the country in respect of goods or services supplied or to be supplied to him by another taxable person…*

Article 17(5) of the Sixth Directive covers the position commonly known in the UK as partial exemption:

> *As regards goods and services to be used by a taxable person both for transactions covered by paragraphs 2 and 3, in respect of which value added tax is deductible, and for transactions in respect of which value added tax is not deductible, only such proportion of the value added tax shall be deductible as is attributable to the former transactions.*

In the current case this complication does not arise. The Commissioners say that none of the input tax is recoverable but this does not depend on the nature of the outputs of the BAA Group. If the input tax is recoverable then the calculation will be by reference to the BAA Group's input tax reclaim status in relation to its overhead expenditure incurred on its general business dealings. This had been agreed as fully recoverable, pursuant to BAA's partial exemption special method. Thus the current case does not concern a denial of part or all of an amount of input tax because of the partial exemption principle in article 17(5) (and given effect in UK domestic law by Part XIV of the Value Added Tax Regulations 1995 SI 1995/2518 ('the Regulations') made under section 26 of the VATA).

26. Turning to the UK domestic legislation, section 24 (1) of the VATA provides:

> *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;*
>
> *(b) VAT on the acquisition by him from another member State of any goods; and*
>
> *(c) VAT paid or payable by him on the importation of any goods from a place outside the member States,*
>
> *being (in each case) goods or services used or to be used for the purpose of any business carried on or to be carried on by him.*

Section 26 of the VATA provides (so far as is relevant):

> *(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 (that is input tax on supplies, acquisitions and importations in 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;*
>
> *(b) supplies outside the United Kingdom which would be taxable supplies if made in the United Kingdom;*
>
> (*c*) *such other supplies outside the United Kingdom and such exempt supplies as the Treasury may by order specify for the purposes of this subsection.*

27. Section 43 of the VATA is also relevant to this appeal. Section 43(1) provides:

> ***Groups of companies***
>
> *(1) Where under the following provisions of this section any bodies corporate are treated as members of a group, any business carried on by a member of the group shall be treated as carried on by the representative member, and –*
>
> *(a) any supply of goods or services by a member of the group to another member of the group shall be disregarded; and*
> *(b) any supply which is a supply to which paragraph (a) above does not apply and is a supply of goods or service by or to a member of the group shall be treated as a supply by or to the representative member; and*
> *(c) any VAT paid or payable by a member of the group on the acquisition of goods from another member State or on the importation of goods from a place outside the member States shall be treated as paid or payable by the representative member and the goods shall be treated –*
>
> *(i) in the case of goods acquired from another member State, for the purposes of section 73(7); and*
>
> *(ii) in the case of goods imported from a place outside the member States, for those purposes and the purposes of section 38,*

as acquired or, as the case may be, imported by the representative member;

and all members of the group shall be liable jointly and severally for any VAT due from the representative member.

[s43(1AA) and s43(1AB) were also cited to us but we do not think it necessary to reproduce them here.]

(2) An order under section 5(5) or (6) may make provision for securing that any goods or services which, if all the members of the group were one person, would fall to be treated under that section as supplied to and by that person, are treated as supplied to and by the representative member.

28. Finally, it is convenient to set out at this point Regulation 111 of the Regulations, on which the taxpayer bases one of its submissions in relation to its so-called 'Route 3' (see further below):

(1) Subject to paragraphs (2) and (4) below, on a claim made in accordance with paragraph (3) below, the Commissioners may authorise a taxable person to treat as if it were input tax—

(a) VAT on the supply of goods or services to the taxable person before the date with effect from which he was, or was required to be, registered…

29. To summarise the uncontroversial propositions of law from these provisions, on which the parties agree:

(1) To recover VAT incurred on the acquisition of goods or services (in this appeal we are concerned entirely with ADIL's acquisition of professional services), the payer must have incurred that VAT in the course of an economic activity and be a taxable person (that is a person who is, or is required to be, registered for VAT purposes): Article 17.1, 17.2 of the Sixth Directive; VATA, ss.24(1), s. 26(1) [*we ignore the possible application of Regulation 111 for the time being*];

(2) The relevant services must be attributable to onward taxable supplies made by the taxable person who consumes those services: Article 17.1, 17.2 of the Sixth Directive; VATA ss.24(1), s.26(1). That is, VAT incurred by a taxable person, to be recoverable, must have a direct and immediate link to that person's onward taxable supplies: see *Faxworld*,

paragraph 20 citing *Abbey National plc v CEC*, Case C-408/98 (although there are cases, such as *Faxworld* [*see below*] where one person's supplies may be attributed to another);

(3) It is common ground that the test for the attribution of VAT incurred to onward taxable supplies, for the VAT to be recoverable, is that the VAT incurred must have a direct and immediate link to those onward taxable supplies: *BLP*, Case C-4/94. We occasionally use the shorthand that the VAT incurred must be "attributable" to onward taxable supplies, by which we simply mean that the relevant direct and immediate link between the VAT and onward supplies exists;

(4) The VAT grouping provisions treat supplies made by any member of a VAT group (taxable or exempt) as supplies made by the VAT group representative member (so here after ADIL joined the BAA VAT group, BAA's supplies were, from that time on, treated as being made by ADIL): VATA s.43(1)(a);

(5) VAT incurred by a taxable person may be recoverable in respect of pre-registration VAT: Regulation 111.

First-tier Tribunal's findings and Conclusions

30. The first-tier Tribunal's findings of fact were set out in paragraphs 80 to 86 of its decisions, which paragraphs we shall set out in full.

> *80. The purpose of ADIL was not only to acquire the BAA shares but also to provide high level strategic governance of the ongoing group. As stated in its formal offer document (see paragraph 41 above) ADIL saw the takeover not as an end in itself but instead as the first, necessary step towards long term, large investment in UK airport infrastructure. Transport infrastructure was already the main business of Ferrovial, who comprised over 60% of the consortium. The senior B debt facility raised by ADIL was specifically earmarked to fund BA's £2 billion capital expenditure projects. The fact of the refinancing and the post-transaction internal re-organisations were evidence of strategic input by ADIL. (See, in particular, the evidence of Mr Bullón.)*
>
> *81. From the completion of the takeover in late June 2006 (when Mrs Warren and her colleagues became involved) it was expected that ADIL would charge its subsidiaries fees for its services. However, no such charges were ever levied. (See, in particular, the evidence of Mrs Warren, the application form and covering letter, and BAA's letter to HMRC dated 8 December 2006.) It is not clear whether there was prior to the completion of the takeover an intention to make intra-group charges. The point may not have been considered, or not*

thought sufficiently important to warrant any deliberation. In any event, there was no evidence before the Tribunal that such an intention was formed prior to the completion of the takeover.

82. From the completion of the takeover in late June 2006 (when Mrs Warren and her colleagues became involved) it was intended that ADIL should become a member of the BAA VAT group, in common with almost every company in the BAA group. Delays in submission of the application form were due to administrative delays arising from the non-availability of executive signatories. (See, in particular, the evidence of Mrs Warren and the application form.) Again, there was no evidence before the Tribunal that such an intention was formed prior to the completion of the takeover.

83. HMRC's initial refusal of the grouping application was because of an issue not pertinent to this appeal (whether ADIL possessed a fixed place of establishment in the UK). Once that issue was resolved, HMRC agreed the application with retrospective effect and made no other objection to ADIL becoming a member of the BAA VAT group.

84. The services provided by Macquarie under schedule 1 of their engagement letter were concerned mainly with the takeover but the resulting work product did have continuing benefit beyond the takeover. The financial plans and business plan were used in the presentations launching the refinancing, albeit there was supplemental work on those plans post-takeover. It was not the case that the services were exhausted by the close of the takeover; some benefits carried on directly (such as the refinancing) or indirectly (the BAA group was now open to the strategic management plans of ADIL). Although not determinative, the accounting treatment of capitalising the transaction costs, rather than writing them off, points to the perceived continuing benefit of that expenditure. (See, in particular, the evidence of Mr Leo and Mr Bullón.)

85. It is artificial to attempt to impute the actions of ADIL to the consortium members as distinct entities. ADIL is not a 'look-through'; it is the entity formed by the consortium for the purposes of holding and overseeing the BAA group. ADIL contracted on its own behalf with counterparties such as Macquarie and Freshfields; ADIL was the bidder for the BAA shares; ADIL executed the debt facilities and initiated the refinancing.

86. Although ADIL had no employees (apart perhaps from its director officers) the employment method of the BAA group was to have a single employer entity (BAA) and there would then be intra-group management accounting to allocate costs. ADIL made no charge for its services; that is not uncommon for a group holding company, although it may be relevant in relation to the VAT law.

31. After a detailed analysis of the legal issues and the relevant case law, and the submissions of the parties in respect of those issues, the First-tier Tribunal set out its conclusions at paragraphs 151 to 162 of its decision, which paragraphs we shall again set out in full. The section headings appear in the decision.

> *Did ADIL carry on an Art 4 economic activity?*
>
> *151. We conclude that, given our finding of fact at paragraph 80 above, ADIL did carry on an economic activity (within the meaning of art 4 of the Sixth Directive) from its inception, with one very important caveat. That caveat is that (as accepted by both parties) ADIL never made an actual taxable output supply in its own right. We address that caveat below but putting it aside for the moment, we conclude that the activities of ADIL went beyond 'the mere acquisition and holding of shares' (Kretztechnik). ADIL did not '[confine] its activities to managing an investment portfolio in the same way as a private investor' (Wellcome). Its activities met both the functional and structural criteria put forward by the Advocate General in BBL. Its holding of the BAA shares was 'accompanied by direct or indirect involvement in the management of the companies in which the holding has been acquired, without prejudice to the rights held by the holding company as shareholder' (Polysar). Those activities went beyond 'activities…concerned solely with the holding of shares in subsidiary companies and with the exercise of the rights connected therewith, or which do not go beyond the internal structure (of the holding or subsidiary company)…' (Advocate General in Polysar). The Advocate General in Cibo noted that '…it cannot be for the court to provide an exhaustive list of all conceivable (economic) activities that may in principle fall within arts 2 or 4(2) of the Sixth Directive. Rather, it is for the national court to determine whether the criteria provided by the court are applicable to the actual facts of the case before it.' We determine that on the facts of the current appeal ADIL carried on an economic activity from its inception.*
>
> *152. Without limiting the generality of our conclusion on this point, we refer to the fact that the debt facilities negotiated and procured by ADIL included a £2 billion capital expenditure facility (the senior B facility) for the BAA group. We consider that ADIL's putting that in place and its subsequent draw down in full by the subsidiaries (see Mr Leo's evidence) constituted making capital available to its subsidiaries as conceived in Floridienne. Mr Anderson* [for the Commissioners] *contended that the BAA group either already had or could have obtained such finance in its own right, and that in Floridienne 'making capital available' means making loans, not just facilitating for banks to lend money. We see no reason to take that restrictive view; the arrangement and negotiation of group finance facilities is an important role of a group holding company, and was performed actively and strategically by ADIL.*

153. HMRC had suggested that it was possible to divide ADIL's activities into pre-acquisition and post-acquisition categories, with the former being in the nature of a final consumer and only the latter constituting an economic activity. However, we determine that it is not the case that ADIL pursued one activity from inception until completion of the takeover, and then switched to a different activity. Rather, from inception ADIL was conceived as and operated as the highest level of strategic and financial direction for the UK airports business within the BAA group. Accordingly, it is not the case that VAT incurred by ADIL can or should be allocated between two accounts labelled 'pre-acquisition' and 'post-acquisition' activities. Instead there is just one pool of VAT that includes, for example, the VAT on both the schedule 1 and schedule 2 charges made by Macquarie.

Was there an intention to make taxable supplies?

154. Turning to the caveat, there can be no economic activity without taxable supplies: 'It is clear…that direct or indirect involvement in the management of subsidiaries must be regarded as an economic activity within the meaning of art 4(2) of the Sixth Directive where it entails carrying out transactions which are subject to VAT by virtue of art 2 of that Directive…' (Cibo – at paragraph 22 – emphasis added). It was accepted by both parties that ADIL never made an actual taxable output supply in its own right. An intention to make taxable supplies is sufficient (even if subsequently thwarted by circumstances outside the taxpayer's control: Ghent Coal) but from our finding of fact at paragraph 81 above, the Tribunal had no evidence of any such intention prior to the completion of the takeover. Thus there was no evidence of ADIL having an intention to make taxable supplies as at the time it received the disputed supplies of advisory services.

155. Mr Southern [for the taxpayer] *contended that an intention to join an existing VAT group could amount to an intention to make taxable supplies, in that s 43 VATA, he maintained, equates the supplies made by the representative member of the group and the other group members; thus ADIL could look to the taxable supplies of the representative member as if they were its own. Without expressing a view on that analysis, even if it is correct our finding of fact at paragraph 82 above – that the Tribunal had no evidence of any intention prior to the completion of the takeover for ADIL to join the BAA VAT group – means that, again, there was no evidence of ADIL having an intention to make taxable supplies as at the time it received the disputed supplies of advisory services.*

Does Faxworld extend the situation?

156. Faxworld allows consideration of the intention to make taxable supplies by reference not just to the person incurring the VAT but also, in certain circumstances, another person. The Advocate General in Faxworld clearly recognised that the result argued for (successfully)

by the taxpayer in that case did strain certain tenets of VAT law: '…it is necessary…for there to have been an intention to make such supplies, and Faxworld GbR appears to have had no intention to make such supplies itself.' (at paragraph 42) '…is it possible to attribute Faxworld AG's intention to make taxable supplies also to Faxworld GbR, so that the conditions for the latter to enjoy a right to deduct are met? Certain provisions of the legislation and indications in the case law might appear to militate against such attribution.' (paragraphs 46 & 47). However, those reservations were overwhelmed by the need for neutrality of taxation: 'If input VAT borne by the assets of a transferred business could not be deducted, there would be not inconsiderable distortion of competition, in comparison with other businesses.' (paragraph 50).

157. Is that reasoning confined, as Mr Anderson submitted, to a situation peculiar to a (German) TOGC, or can it, as Mr Southern submitted, be read into a grouping of two companies? In Faxworld there was VAT incurred by GbR in connection with a business prepared (but never carried on) by GbR, which was then transferred to AG. The transfer itself was a non-event for VAT purposes, being ignored under the German domestic rules for a TOGC (which were enacted pursuant to the permissive provisions of art 5). GbR and AG were treated as transferor and transferee of an economic activity. GbR was entitled to take advantage of the taxable transactions of AG. Thus GbR was regarded as a taxable person within the meaning of the Sixth Directive.

158. In the current appeal there was VAT incurred by ADIL in connection with an economic activity it expected to carry on and (bar actually making a taxable supply in its own right) it did carry on. Performing that economic activity (involvement in the management of the BAA companies) in the context of the BAA VAT group was a non-event for VAT purposes, being ignored under the UK domestic rules for grouping – s 43(a) VATA – (which were enacted pursuant to the permissive provisions of art 4). ADIL and the BAA companies were treated as part of a single entity for VAT purposes. Accordingly, our conclusion is that it follows that ADIL is entitled to take advantage of the taxable transactions of the BAA VAT group, and thus be regarded as a taxable person within the meaning of the Sixth Directive.

159. While sharing the reservations expressed by the Advocate General in Faxworld, the Tribunal considers that the fundamental principle of neutrality of taxation (Rompelman) requires, by the same process as adopted by the ECJ in Faxworld, that the taxable supplies of the BAA VAT group should be imputed to ADIL, so that the caveat referred to above is removed. To quote again Lord Hope in Svenska (already cited) on the grouping provisions: 'This conclusion is not easy to grasp if regard is had to what was happening in the real world. But the statutory scheme does not always follow the real world. The

guiding principle as to relief for input tax as against output tax is that of fiscal neutrality (see Rompelman…). It is satisfactory to find that the various statutory rules which must be applied in this case have produced a result which is consistent with that principle.'

To what output supplies is the input tax linked?

160. Following Faxworld there should be a direct and immediate link to the output supplies taken into consideration in determining the existence of an economic activity (see paragraph 51 of the Advocate General's opinion). Given that ADIL is a member of the BAA VAT group the direct and immediate link is to the outputs of the representative member of that group (s 43(b) VATA).

161. Mr Anderson submitted that the VAT incurred by ADIL could not have been incurred for the purposes of the BAA group's business because it related to advice given in connection with a takeover bid that was, at least initially, hostile. However, the Tribunal considers that if a commercial dispute arises between two members of a VAT group and each company takes independent legal advice then the VAT on the fees of both advisers would be input tax of the representative member of the VAT group, notwithstanding that the protagonists and their respective advisers had directly opposite interests in the dispute. Both lots of input tax would be recoverable by the representative member in the normal manner. That is merely an artefact of the grouping provisions and, while it may appear an odd result, it is entirely consistent with the scheme of the grouping provisions.

162. Absent a group situation the direct and immediate link is with general overheads: Cibo (at 476), quoted at paragraph 118 above. We consider that the same result should follow in a VAT group, so that the direct and immediate link is with the general overheads of the representative member of the group. We note that that conclusion is not inconsistent with the views of HMRC expressed in their publications referred to at paragraphs 145 and 146 above.

On the basis of these findings and conclusions, the First-tier Tribunal allowed the taxpayer's appeal against the assessment.

The Commissioners' Grounds of Appeal

32. The Commissioners contended that, in upholding ADIL's entitlement to recover as input tax the VAT in question, as having a direct and immediate link to onward taxable supplies made by (or alternatively attributed to ADIL) the First-tier Tribunal erred in law. They advanced three principal grounds of appeal, namely:

- first, that the Tribunal failed to analyse the *capacity* of ADIL as an acquisition vehicle which did not intend to make and which did not at any stage actually make taxable supplies of its own, when it incurred the VAT in order to determine whether or not it was carrying out an economic activity;

- secondly, the Tribunal failed to heed its own findings of fact that ADIL neither made nor intended to make taxable supplies in light of the principle that in order for VAT to be deductible as input tax it must be used for onward taxable supplies in the sense of having a direct and immediate link with such supplies; and

- thirdly, that the Tribunal relied on an analogy with *Finanzamt Offenbach am Main-Land v. Faxworld Vorgründungsgesellschaft Peter Hünninghausen und Wolfgang Klein GbR* ('*Faxworld*') (Case 137/02) **[**2005] STC 1192, which was misconceived because the facts of the present appeal are materially different from those in *Faxworld* and because, even if *Faxworld* can be said to apply by analogy, there were no underlying supplies which were deemed by the grouping provisions not to have occurred and which can be assimilated to the provisions of German law at issue in *Faxworld*.

ADIL's Response and Cross-Appeal

33. ADIL sought to uphold the decision of the First-tier Tribunal for the reasons given in its decision. In its skeleton argument, ADIL identified four ways – or 'routes' – any one of which it submitted would be sufficient to dispose of the appeal by confirming the decision of the Tribunal. Broadly speaking, these four routes were as follows.

- *Route 1:* The First-tier Tribunal's findings as to the intentions of ADIL in acquiring BAA, which had a wholly taxable business, and thereafter to manage the BAA group as a whole, meant that ADIL had demonstrated a direct and immediate link between the VAT incurred by ADIL and onward taxable supplies which ADIL intended to make (in ADIL's submission, both prior to and after completion) and these findings are sufficient for recovery.

- *Route 2:* Even if the Tribunal's express findings did not hold that ADIL had an intention to make taxable supplies both pre and post completion of the takeover, the objective facts found by the Tribunal are sufficient to reveal ADIL's relevant intentions, without enquiring into the subjective intentions of ADIL incurring the input tax. In other words, says ADIL, what matters is what was being done in terms of economic activity and

how the inputs were in fact used. In this regard, ADIL refers in its skeleton argument to the following facts (and in this extract, references to numbered paragraphs, which appear in the original, are references to the correspondingly numbered paragraphs in the decision of the Tribunal):

> *(i) from its inception, ADIL was engaged in a course of conduct aimed at actively managing the affairs of the corporate BAA group [paras 80, 151];*
>
> *(ii) pre-takeover, ADIL incurred input tax in respect of inputs which were of an enduring nature, and whose usefulness in fact would enure to the benefit of the VAT group after the takeover [para 84];*
>
> *(iii) after the takeover, it did manage the group, [paras 151, 152] and indeed joined the VAT group that it was managing. The inputs did enure to the Group's benefit; and*
>
> *(iv) only taxable supplies have been made by the BAA VAT group.*

Accordingly, ADIL submitted that this route leads to the conclusion that ADIL was entitled to recover the relevant VAT because objectively the VAT incurred by ADIL had a direct and immediate link to intended onward taxable supplies to be made by ADIL in relation to its management of the BAA group. Alternatively that the VAT incurred by ADIL had a direct and immediate link to BAA's taxable supplies which were, said ADIL, attributed to ADIL by the VAT grouping provisions in a manner which allowed recovery.

- *Route 3:* Regulation 111 of the VAT General Regulations (SI 1995/2518) provides a complete code for recovery of pre-registration input tax. It is (ADIL submits) a sufficient basis for the VAT group to make an input-tax claim in respect of input tax incurred by ADIL. Moreover, it was submitted that the regulation expressed an underlying principle of recoverability on the facts of the current appeal, which underpins the other routes to recovery.

- *Route 4:* This final route depends upon ADIL's cross-appeal. That appeal is against the finding (referred to in paragraph 155 of the decision of the Tribunal) that there was no evidence of any intention prior to the completion of the takeover for ADIL to join the VAT group and that there was no evidence of its having an intention to make taxable supplies as at the time it received the disputed supplies of advisory services before the completion of ADIL's takeover of BAA. ADIL says that: (*i*) there was evidence of such an intention; (*ii*) in any event, the test of intention is an objective one and the objective facts give rise to the conclusion that ADIL had always intended to join the VAT group and (*iii*) such an intention to join the VAT group prior to the takeover of BAA by ADIL either

reinforces ADIL's submissions on Routes 1 and 2 or alternatively provides a ground for recovery in its own right.

The Commissioners' Submissions in Detail

Ground 1: Capacity

34. The Commissioners stated that only taxable persons have the right to deduct VAT and a taxable person is anyone who engages in 'economic activity' as defined in Article 4 of the Sixth Directive. They submitted that where the issue is whether someone was engaged in economic activity such that a right to deduct input tax arises, the question must be decided at the time the supplies are received. We were directed towards the opinion of the Advocate General in *Lennart v. Finanzamt München III* (Case C-97/90) [1995] STC 514 and towards the decision of the European Court of Justice ('ECJ') in *Waterschap Zeeuws Vlaanderen v. Staatsecretaris Financiën* (Case C-378/02) [2005] STC 1298, in support of this proposition.

35. The Commissioners submitted that, at the time when the supplies were received, ADIL was not itself engaged in any economic activity of managing BAA. They maintained that their submissions as to the status of ADIL were incorrectly recorded at paragraph 153 of the decision of the First-tier Tribunal but that those submissions were correctly recorded at paragraph 112 thereof, where it is stated:

> *The authority of Articles 2 and 4 and all the relevant caselaw was that an economic activity for VAT purposes must involve effecting transactions that are themselves taxable supplies. ADIL never fell into that category. Neither the intention to buy shares not the intention to join a VAT group constituted an economic activity. None of ADIL's activities created outputs against which any inputs could be deducted. ADIL never intended to make any taxable supplies; was not eligible to be registered in its own right; and was never a taxable person.*

Based on this submission, the Commissioners contended that the capacity in which ADIL obtained the supplies was solely as a corporate acquisition vehicle for the purposes of the takeover. The capacity of an acquirer who purchases services just to make an acquisition did not, said the Commissioners, carry with it the notion of making onward taxable supplies to which the services which helped facilitate the acquisition are attributable.

36. Furthermore, the Commissioners submitted that, as a contested takeover, ADIL could not reasonably have been considered to have been acting in any capacity other than solely as the acquirer of BAA. The services were provided to ADIL, it was said, so as to ensure the takeover of the BAA group against the wishes of the BAA group. The BAA group, so the argument ran, cannot therefore have been the recipient of the services provided to ADIL. Had the takeover not gone through, BAA could not, of course, have been able to recover the VAT paid as input tax. The position cannot be dependent, however, upon the success or otherwise of the bid.

Ground 2: Absence of Taxable Supplies

37. The Commissioners relied upon the fact (as was common ground) that ADIL did not make taxable output supplies and upon the fact (as the First-tier Tribunal found) that there was no evidence of ADIL's having an intention to make taxable supplies as at the time it received the supplies of advisory services. The fact that there were no taxable supplies made at all by ADIL should, the Commissioners submitted, have driven the Tribunal to the conclusion that ADIL was not engaged in economic activity at all rather than to the conclusion that this absence of intention to make taxable supplies pre-completion of the BAA takeover and the absence of any actual taxable supplies by ADIL were somehow "caveats" to the conclusion that ADIL had instead carried on an economic activity from its inception.

38. The Commissioners submitted that the jurisprudence of the ECJ makes clear that nothing short of making taxable supplies will serve to provide a right of deduction for a holding company which incurs professional costs even where it engages directly or indirectly in the management of one or more of its subsidiaries. For VAT purposes, it was submitted, active involvement in the management of a subsidiary does not constitute an economic activity unless there are transactions entered into for consideration. We were directed to the decision of the ECJ in *Cibo Participations SA v. Directeur régional des impôts du Nord-Pas-de-Calais* ('*CIBO*') (Case C-16/00) [2002] STC 460, which held that a holding company with no involvement in a subsidiary is not engaging in economic activity and therefore is not a taxable person entitled to deduct input tax. The court stated (at paragraph 18) that this had been 'consistently' held by the ECJ. We were directed, in particular, to paragraph 22 of the decision, in which the ECJ stated:

> *The involvement of a holding company in the management of companies in which it has acquired a shareholding constitutes an economic activity within the meaning of Article 4(2) of the Sixth Council Directive...where it entails carrying out transactions which*

are subject to value added tax by virtue of Article 2 of that Directive, such as the supply by a holding company to its subsidiaries of administrative, financial, commercial and technical services.

In this regard, we were also directed to *Floridienne SA and another v. Belgian State* (Case 142/99) [2000] STC 1044 for the proposition that the making available of capital – for example, by advancing capital by way of interest-bearing loans – is not of itself a taxable activity.

39. It was submitted on behalf of the Commissioners that the First-tier Tribunal's finding that ADIL made no supplies should have caused it to find that it had failed the test of what constitutes the undertaking of an economic activity set out in *CIBO*, so that the First-tier Tribunal should have concluded that ADIL was not undertaking an economic activity at any stage either pre or post completion of the BAA takeover.

40. The Commissioners also relied upon the fact that ADIL made no charges for its management of the BAA group. The requirement for there to be consideration in order for there to be a VAT supply was, we were told, fundamental. In this regard, we were directed towards the decision in *Staatsecretaris van Financien v. Hong Kong Trade Development Council* (Case 89/81) [1982] ECR 1277. As noted in that case, tax is no longer deductible when the chain of transactions has come to an end, at which point it is charged to the final consumer. In paragraph 10 of the *Hong Kong Trade Development* case, the ECJ noted that where a person's activities consist exclusively of providing services for no direct consideration, there is no basis of assessment and the free services are therefore not subject to VAT. In those circumstances, the person providing the services must be assimilated to a final consumer. In the light of this, the Commissioners submitted that there was no chain of transactions that followed the supplies made to ADIL through which the VAT paid by ADIL flowed: the supplies made to ADIL were consumed in the acquisition of BAA and could not have been cost components of any onward supplies. We were also directed towards the decision in *Securenta Gottinger Immobilienanlagen und Vermogensmanagement AG v. Finanzamt Gottingen* (Case C-437/06) [2008] STC 3473 to demonstrate that where there is no link between VAT incurred and output transactions then the right to deduct does not arise.

41. The fact that ADIL later became a member of a VAT group did not have any bearing, in the Commissioners' submission, on the recoverability of the VAT incurred on the professional fees. In this regard, the Commissioners repeated their submissions in relation to the question of ADIL's capacity and also directed us to the decision in *Investrand BV v. Staatsecretaris van Financien*

(Case C-435/05) [2008] STC 518, in which the appellant had incurred costs after it had become a taxable person in relation to a transaction that had taken place before it was a taxable person. The transaction to which the costs related was outside the scope of VAT. At paragraph 38, the ECJ held that:

> *...art 17(2) of the Sixth Directive is to be interpreted as meaning that the costs for advisory services which a taxable person obtains with a view to establishing the amount of a claim forming part of his company's assets and relating to a sale of shares prior to his becoming liable to VAT do not, in the absence of any evidence establishing that the exclusive reason for those services is to be found in the economic activity, within the meaning of that directive, carried out by the taxable person, have a direct and immediate link with that activity and, consequently do not give rise to a right to deduct the VAT charged on them.*

We were also referred in this regard to *Schemepanel Trading Limited v. Customs and Excise Commissioners* [1996] STC 871 at 879.

Ground 3: The Analogy with Faxworld is Misconceived

42. The First-tier Tribunal applied *Faxworld* so as to attribute BAA's taxable supplies to ADIL (so that ADIL's VAT had, in the Tribunal's view, a direct and immediate link to BAA's taxable supplies which permitted recovery of that VAT by ADIL). The Commissioners submitted that the First-tier Tribunal's reliance upon the decision in *Faxworld* was misconceived. It is convenient at this point to summarise the facts on which the decision in *Faxworld* was made: we do so by quoting from the ECJ's decision reported in **[**2005] STC 1192 at 1205*ff,*

> 11. [Faxworld Vorgründungsgesellschaft Peter Hünninghausen und Wolfgang Klein GbR ('Faxworld GbR')] *is a civil-law partnership founded on 1 October 1996 with the sole object of setting up the company Faxworld Telefonmarketing Aktiengesellschaft ('Faxworld AG').*
>
> *12. As the national court explains, the establishment of an Aktiengesellschaft (German company limited by shares) may, as in the case before the national court, be preceded by a Vorgründungsgesellschaft. A Vorgründungsgesellschaft is based on a preliminary agreement between the founders of the company to co-operate with a view to establishing the Aktiengesellschaft. Therefore, if that company, once established, wishes to assume the assets, rights and obligations of the Vorgründungsgesellschaft, which are not*

transferred to it automatically, they must be transferred by way of a separate legal transaction.

13. Thus, as a Vorgründungsgesellschaft, Faxworld GbR rented office premises, acquired fixed assets and had fixtures and fittings installed in the office premises. It also sent introductory mailings and engaged in advertising for the company to be established. After Faxworld AG was established by notarial act of 28 November 1996, Faxworld GbR ceased activities and transferred to Faxworld AG all the previously acquired assets at their book value, for a price of just under DM 90,000. Faxworld AG was thus able to take up its commercial activities in the offices rented and equipped for its purposes by Faxworld GbR, without having to take any additional measures.

14. Therefore, in performing its sole object, Faxworld GbR effected no output transactions other than the transfer of the assets it had acquired to Faxworld AG.

Under German law, the transfer of assets from the GbR to the AG was not a taxable supply (analogous to the UK concept of a transfer of a going concern, or 'TOGC').

43. The GbR sought to reclaim the VAT it had incurred and the national court ruled in its favour on the grounds that the GbR was an undertaking and, as such, was entitled to deduct the input tax because the principle of neutrality of VAT required that deduction, even though the GbR never intended to use the input services procured in order to effect taxable transactions itself.

44. Returning to the decision of the ECJ (at 1209*ff*):

…in contrast to the facts of the case giving rise to the judgment in Abbey National, the taxable person in the case before the national court, namely Faxworld GbR, as a Vorgründungsgesellschaft, did not even intend to effect itself taxable operations, its sole object being to prepare the activities of the Aktiengesellschaft (limited company). None the less, the VAT which Faxworld GbR wishes to deduct relates to supplies acquired for the purpose of effecting taxable transactions, even though those transactions were only the planned transactions of Faxworld AG.

42. In those precise circumstances, and in order to ensure the neutrality of taxation, it must be held that, where the member state has exercised the options provided for in arts 5(8) and 6(5) of the Sixth Directive, as a result of the fact that, according to those provisions, the recipient shall be treated as 'the successor to the transferor', a

Vorgründungsgesellschaft, as the transferor, must be entitled to take account of the taxable transactions of the recipient, namely the Aktiengesellschaft, so as to be entitled to deduct the VAT paid on input services which have been procured for the purposes of the recipient's taxable operations.

43. Accordingly, the answer to the question referred by the Bundesfinanzhof must be that a partnership established for the sole purpose of founding a capital company is entitled to deduct the input tax paid on supplies of goods and services where its only output transaction in the performance of its object was to effect by formal act the transfer for consideration of the supplies obtained to that company once founded and where, because the member state concerned has exercised the options provided for in arts 5(8) and 6(5) of the Sixth Directive, a transfer of a totality of assets is not deemed to be a supply of goods or services.

45. The First-tier Tribunal also felt it useful to quote from the opinion of the Advocate General at paragraphs 36 to 51, as do we.

36. Next, I should state that the result favoured by the German authorities appears to me to be inconsistent with the principle of the neutrality of VAT, in so far as it denies any right to deduct the input tax in issue, whether for Faxworld GbR or for Faxworld AG.

37. From an economic point of view, it seems clear, a single business has been set up, going through various preparatory stages before becoming operational. The continuity of the business from preparatory to operational stages—the continuity of its identity as a *business—does not appear to be in any doubt. The normal operation of the VAT system requires that input tax on supplies acquired by a business at both preparatory and operational stages be deductible from its output tax (see in particular the case law cited in para 12 above).*

38. Any deviation from that normal operation, and therefore from the principle of neutrality, can in my view be accepted only where there is clear authorisation in the legislation, as interpreted where appropriate by the court.

39. In the present case, from a legal point of view the preparatory and operational stages were carried out by two separate entities, a partnership and a limited company. (Although it seems plausible that the two partners in the partnership are also the (only) two shareholders in the company.) It is on that separation that the German authorities base their arguments.

40. The partnership was not set up for the purpose of effecting taxable output transactions, it did not effect any and there was at no stage any intention that it should do so. Its sole actual or intended output transaction was to sell the embryo, as yet non-operational, business to the limited company. By virtue of the German legislation implementing art 5(8) of the Sixth Directive, that transaction was not taxable. (It may be noted that under the German legislation such transactions 'are not subject to turnover tax' whereas art 5(8) authorises member states to 'consider that no supply…has taken place.' It is important none the less that a distinction be drawn between exempt supplies and those which are deemed not to have taken place (see para 10 above and para 49 below.)

41. None the less, I agree with the Commission that Faxworld GbR falls within the definition of taxable person in art 4(1) of the Sixth Directive. Its activities were undoubtedly economic in nature and neither the purpose nor the result of those activities is relevant. In that context, I consider the German government to be mistaken in its reference to Lennartz v. Finanzamt München III (Case C-97/90) [1995] STC 514, a case which concerned acquisition for private use of goods subsequently used for taxable transactions. In the present case it is not questioned that the input supplies were acquired for business purposes and not for private consumption.

42. Furthermore, the right to deduct is not lost because no taxable output supplies were in fact made—see INZO (Case C-110/94) [1996] STC 569, paras 19 and 20 of the judgment and Belgium v. Ghent Coal Terminal NV (Case C-37/95) [1998] STC 260, paras 17 and 24 of the judgment—but it is necessary according to that same case law for there to have been an intention to make such supplies, and Faxworld GbR appears to have had no intention to make such supplies itself.

43. None the less, although the partnership and the limited company in the present case are two separate legal persons, there is not only a perceptible economic continuity between them but also a degree of legal continuity.

44. Article 5(8) requires that, if no supply is considered to have taken place, the recipient should be treated as the 'successor' to the transferor. In the German version of art 5(8), the comparable word 'Rechtsnachfolger' is used. The German implementing legislation speaks of 'an die Stelle treten' (taking the place of) while German law also appears to recognise a 'Fußstapfentheorie' (see para 31 above). The French and some other language versions of art 5(8) speak of 'continuing the personality' of the transferor.

45. As I said in paras 46 and 49 of my opinion in Zita Modes Sàrl v. Administration de l'Enregistrment et des Domaines (Case C-497/01) [2005] STC 1059, the various formulations clearly recall the notion of universal succession, in which one person takes over all of the rights

and obligations of another (limited in this context to all of the VAT rights and obligations in relation to the business transferred), so that the transferee acquires, with the business, any outstanding VAT debts and the right to deduct any input tax not already deducted against output tax on taxable transactions. (It appears however that the VAT rules in some member states require the transferor to settle all outstanding VAT accounts prior to the transfer, so that the 'succession' in such cases is confined to adjustments pursuant to art 20 of the Sixth Directive.) In Abbey National plc v. Customs and Excise Comrs (Case C-408/98) [2001] STC 297, para 38 of the opinion I suggested, using the common metaphor of a chain of transactions for VAT purposes, that whilst one link in the chain is deemed not to exist, the result is not—as would be the case for an exempt transaction—a break and a recommencement of the chain but rather a continuing sequential relationship between the links on either side.

46. In that light, is it possible to attribute Faxworld AG's intention to make taxable supplies also to Faxworld GbR, so that the conditions for the latter to enjoy a right to deduct are met?

47. Certain provisions of the legislation and indications in the case law might appear to militate against such attribution. Under art 17(1) of the Sixth Directive, the right to deduct arises at the time when the deductible tax becomes chargeable—that is to say when input supplies are acquired—and the court stated in Lennartz v. Finanzamt München III (Case C-97/90) [1995] STC 514, para 8 of the judgment that 'only the capacity in which a person is acting at that time can determine the existence of the right to deduct'. At the time of acquisition, Faxworld GbR was acting as a taxable person (see para 41 above), but the supplies were not intended for taxable outputs of its own.

48. None the less, I am of the view that the 'succession' provision in art 5(8) not only justifies but requires the drawing of a significant distinction between the situation with which it is concerned and other, more usual situations.

49. It must be borne clearly in mind that the effect of applying the option in art 5(8) of the Sixth Directive cannot be to create an exempt transaction. (In para 10 I have outlined the undesirable effects which such transactions may entail.) Had that been the legislator's intention, the provision would have been included in Title X of the Directive, concerning exemptions, and not in Title V, on the definition of taxable transactions. An indication of the actual purpose is given in the explanatory memorandum to the Commission's Proposal for a Sixth Directive (see the Bulletin of the European Communities, Supplement 11/73, p 10; what is now the first sentence of art 5(8) was art 5(4) in the original proposal), in which the option was described as being available 'in the interests of simplicity and so as not to overburden the resources of the undertaking'. The point is thus to avoid often large sums of tax being invoiced, paid to the state and then recovered by way

of deduction of input tax. A further advantage is to protect the revenue authorities from loss of tax if the transferor is insolvent. (See for a somewhat fuller consideration, paras 19 to 32 of my opinion in Zita Modes Sàrl v. Administration de l'Enregistrment et des Domaines (Case C-497/01) [2005] STC 1059.)

50. If input VAT borne by the assets of a transferred business could not be deducted, there would be not inconsiderable distortion of competition, in comparison with other businesses. And, as the court reiterated in Abbey National plc v. Customs and Excise Comrs (Case C-408/98) [2001] STC 297, para 24 of the judgment, the deduction system is meant to relieve the trader entirely of the burden of the VAT payable or paid in the course of all his economic activities, ensuring complete neutrality of taxation of all economic activities, whatever their purpose or results, provided that they are themselves subject in principle to VAT.

51. In the present case, the assets transferred were acquired by Faxworld GbR for the future purposes of taxable output transactions to be made by Faxworld AG, and thus form cost components of those transactions. There is, moreover, a direct and immediate link between the input supplies and the taxable output transactions which give rise to the right to deduct (see Abbey National, para 25 of the judgment, and the case law cited there) since, by the operation of art 5(8), no intervening transaction is deemed to have taken place between the acquisition of those supplies and their use for the purposes of the output transactions. Faxworld AG is the successor—or 'continues the person'—of Faxworld GbR. At the time when the right to deduct arose—that is to say, when the input tax became chargeable—Faxworld GbR was acting as a taxable person within the meaning of art 4(1) of the Sixth Directive. The conditions for deduction are thus in my view met.

46. The Commissioners submitted that the scheme of the European legislation does not support the proposition that A can reclaim, as input tax, VAT on supplies made to him that he neither uses nor intends to use for taxable supplies. Furthermore, they submitted that the legislation does not support the imputation to A of another person's taxable supplies or intention to make those taxable supplies. The Commissioners relied on *Abbey National plc v. Customs and Excise Commissioners* (Case C-408/98) [2001] STC 297 at paragraphs 32 to 35 for this proposition. It was submitted that the First-tier Tribunal decided contrary to this legislative scheme that ADIL could reclaim the input tax because ADIL's inputs could be imputed to BAA's taxable outputs on the basis of the reasoning in *Faxworld*. It was further submitted that the Tribunal's decision in this respect was an express extension of the reasoning in *Faxworld* to cover a different factual and legal scenario.

47. The Commissioners' analysis of *Faxworld* was that a transaction between A and B that was deemed for VAT purposes to be a non-supply ("a non-event" for VAT purposes) and thus outside the scope of the tax was ignored where A incurred VAT-bearing costs for the purpose of setting up a business and then transferring the business to B. In such circumstances, the ECJ held that B's intention to make taxable supplies using those costs could be imputed to A such as to provide for the recovery of input tax for A despite the fact that the transaction through which the input tax might otherwise have flowed had to be ignored. In order, in the words of the Commissioners' skeleton argument, 'to bridge the gap' between the person who incurred the input tax and the person who made the output, the ECJ relied on the economic and legal relationship in which the two entities found themselves for tax purposes.

48. For *Faxworld* to apply to attribute BAA's intention to make taxable supplies to ADIL, to give ADIL a right of recovery for VAT incurred by ADIL, the Commissioners submitted that two conditions must be satisfied:

- First, ADIL was in some sense carrying on an economic activity.

- Secondly, that the transactions between ADIL and the person to whose taxable transactions it was proposed to impute the input tax incurred by ADIL were a non-event because of the VAT grouping rules (since it was the TOGC rules which were the subject of the decision in *Faxworld*).

49. The Commissioners' submissions as regards the first step (in their view ADIL had no economic activity at any stage) have already been recorded.

50. As to the second step, it was submitted on behalf of the Commissioners that the reason why ADIL's activities in relation to the subsidiaries of the BAA group were a 'non-event' for VAT purposes had nothing to do with the VAT grouping rules but rather arose out of the fact that there was no consideration for ADIL's management activities. There was no transaction between ADIL and BAA which was a non-event because the VAT grouping rules applied. The Commissioners pointed out that the Tribunal's analysis of *Faxworld*, in which it described 'the transfer itself [as] a non-event for VAT purposes, being ignored under the German domestic rules for a TOGC' (paragraph 157) referred to the transfer of a business which was a TOGC. In other words, the 'non-event' must, to attract *Faxworld* treatment, be a transaction that, but for the TOGC rules, would have been a transaction for VAT purposes. Here there was no such "non-event".

51. The Commissioners also submitted that the decision of the First-tier Tribunal was a significant extension of, and departure from, the decision in *Faxworld* for the further following reasons.

- First, there was no analogous transfer of a business that might otherwise have been an output. The transaction between ADIL and BAA in respect of which costs were incurred was not an output of ADIL but rather an input, being the purchase of the BAA group shares by ADIL.

- Secondly, the activities of the person incurring the input tax did not amount to 'transactions' at all and would not have been 'supplies' even if the disregard provisions relating to grouping did not exist because there was no consideration for the management activity.

52. The Commissioners argued that the context of the present appeal is materially different from the specific context of the German law at issue in *Faxworld*. They did so on the following grounds.

- ADIL and BAA were not part of a single economic unit and there was no continuity of identity of the business. The economic separation of ADIL and BAA is demonstrated by reference to the fact that both ADIL and BAA had their own separate advisers.

- There was nothing in the legislation that placed ADIL and BAA in a legal relationship for VAT purposes (and the First-tier Tribunal found that there was no evidence of any intention on the part of ADIL to join the BAA VAT group prior to the takeover).

- Neither the economic nor the legal relationship in which the precursor partnership and the subsequent company found themselves in *Faxworld* finds any analogue in the facts of the present appeal.

The Commissioners also contended that *Faxworld* should not be extended beyond the precise circumstances of that case. In this regard, we were directed towards paragraph 42 of the judgment, where the entitlement to recovery was upheld in a paragraph that begins 'In these precise circumstances...'

53. The Commissioners argued that it should be wholly irrelevant that the taxpayer had joined a VAT group and that it is illegitimate to rely upon the VAT grouping provisions to create an entitlement to recover input tax where otherwise there would be no such right. Grouping is, in the Commissioners' submission, merely an administrative measure to simplify accounting and collection of VAT. It does not detract from the correct operation of the system of VAT as a whole. Furthermore, if ADIL had not joined the VAT group at all there would have been no entitlement to recovery of VAT on its costs. The fact that it subsequently joined the group should not make any difference, the Commissioners contended, to the position, even if (contrary to the Tribunal's findings) ADIL had an intention to join the VAT group at the time it incurred the costs.

54. In response to submissions made by ADIL (see below), the Commissioners submitted that the decision of the House of Lords in *Customs and Excise Commissioners v. Svenska International plc* [1999] STC 406 does not alter that analysis. In *Svenska*, a Swedish bank ('Bank') had in the UK both a branch ('Branch') and also a subsidiary company ('Sub-Co'). Sub-Co provided management services to Branch and charged for them. Sub-Co was registered for VAT in the UK but Branch was not. After Sub-Co had incurred costs relevant to the management services it was to provide to Branch but before Branch was invoiced for those management services, Branch became a member of Sub-Co's VAT group. The Customs and Excise Commissioners denied Sub-Co a deduction for the part of its input tax, relying in part on an anti-avoidance provision ('Regulation 34') that is not relevant to the current appeal. The House of Lords found for the Customs and Excise Commissioners. Lord Hope of Craighead (one of the majority) stated (at 415, substituting the new statutory reference):

> *…[section 43] states that, where any bodies are treated as members of a group, any business carried on by a member of the group shall be treated as carried on by the representative member. [Sub-Co] brought with it into the group registration the amounts which had been credited to it as input tax which had been attributed to supplies which were not yet treated as taxable, and [Branch] brought into the group the value of the continuous supply of services for which it had not yet paid and not yet been issued with a tax invoice.*
>
> *The question raised by [Regulation 34] as to whether, after the group registration, these supplies were used or appropriated for use in making an exempt supply must be answered by applying the rule which [section 43] lays down, that any business carried on by any member of the group must be treated as carried on by the representative member. For the purposes of this exercise the business carried on by [Branch] must be treated as carried on by [Sub-Co] as the representative member. As that business involved the making of exempt supplies outside the group to customers of [Branch], [Sub-Co] as the*

representative member must be treated as having used at least part of the supplies which were attributed to an intended taxable supply for the purpose of obtaining credits of input tax in making exempt supplies. So the requirements of [Regulation 34] are satisfied, with the result that [Regulation 34] under which the assessments were made becomes applicable.

I think that the tribunal put the point correctly when it said that this reconstruction of the transactions for VAT purposes, so that inward supplies from outside actually made to [Sub-Co] may be looked at with regard to the outward supplies actually made by [Branch], follows from the effect of [section 43]…

This conclusion is not easy to grasp if regard is had to what was happening in the real world. But the statutory scheme does not always follow the real world. The guiding principle as to relief for input tax as against output tax is that of fiscal neutrality (see Rompelman…). It is satisfactory to find that the various statutory rules which must be applied in this case have produced a result which is consistent with that principle.

55. In the present appeal, the Commissioners submitted that the House of Lords' decision in *Svenska* does not alter the proper analysis of the position. Sub-Co was at all material times a taxable person. The costs that it incurred were properly treated as 'input tax' on the basis that it intended to make taxable supplies. The VAT borne by it was accordingly deducted or recovered by it on that basis. The issue in *Svenska* was whether Regulation 34 required that 'input tax' recovery position to be revisited. Therefore, the Commissioners contended, *Svenska* was concerned not with the conditions necessary for the initial deduction of input tax but rather with whether there had been use for exempt purposes prior to the making of any taxable supply. Regulation 34 had no application in this Appeal. They contended that the case is not authority for a general proposition that the entitlement to input tax recovery is determined not at the time the input tax is incurred but rather when supplies by a fellow VAT group member are made.

ADIL's Submissions in Detail

56. ADIL's submissions were summarised in its skeleton argument in the following terms (in which the emphasis appears in the original):

(1) The only true and reasonable conclusion from the primary facts is that ADIL was carrying on an <u>economic activity</u>, namely, the

acquisition, central direction and operation and financing of the BAA UK airports business.

(2) That economic activity was carried on from inception, i.e. 27 March 2006, because all acts preparatory to carrying on economic activity also constitute economic activity.

(3) Thereby [ADIL] *acquired the right to recover the input VAT which it incurred.*

(4) The acquisition of the shares did not give rise to a chain breaking effect or constitute an act of consumption. There was no break in the causal chain.

(5) After 22 September 2006 [ADIL] *made taxable supplies as a member of the BAA VAT group. Accordingly, the 'direct and immediate link' test was satisfied by reference to the VAT group, ADIL's inputs being a cost component of the group's taxable profits.*

(6) Further, the fact that ADIL intended to group means that ADIL's inputs can be directly linked to the BAA VAT group's outputs.

(7) Over and above these matters (which are sufficient to establish the right to recovery) the business continuity brought the circumstances within the principle adumbrated by the ECJ in Faxworld.

(8) This is a sensible and just result, which accords with the legislative purpose of achieving fiscal neutrality.

These outline submissions were expanded upon in a manner summarised as follows.

Relevant Economic Activity

57. In relation to the issue of whether or not ADIL carried on a relevant economic activity, ADIL referred to the following findings of fact, namely:

- that '[a]fter acquisition ADIL assumed direction and leadership of the BAA group as a whole' and that '[f]rom inception, ADIL was conceived as and operated as the highest level of strategic and financial direction for the UK airports business within the BAA group' (decision of the First-tier Tribunal at paragraphs 57, 58, 68 and 153);

- that the financing arrangements showed strategic input by ADIL: '[t]he purpose of ADIL was not only to acquire the BAA shares but also to provide high level strategic governance of the ongoing group' (paragraph 80); and

- that '[f]rom the completion of the takeover in late June 2006...it was intended that ADIL should become a member of the BAA VAT group' (paragraph 82).

ADIL characterised this as a long-term business undertaking and as a single overall transaction – that is to say, that the takeover was not an end in itself but rather a means to an end. This was, in ADIL's submission, an economic activity and/or the preparation for taxable activities.

Scope of the inputs

58. ADIL submitted that ADIL's business plan, the work of the professional advisers (Macquarie and Freshfields), and the financial arrangements inevitably covered both the acquisition and subsequent management development. The business plan and financial model put together by Macquarie were the key planning tools both pre- and post-acquisition. The invoice raised by Freshfields concerned service provided pre-, during and post-acquisition. The financing arrangements spanned acquisition. The funds raised (both by way of equity and debt) were intended to be used and were used: (*i*) to acquire the BAA issued shares for cash; (*ii*) to refinance BAA's existing debt to enable the airport business to carry on; (*iii*) to finance a capital expenditure programme of £2 billions to enable the airport business both to continue its existing function and to improve the prospects for the business for the future; and (*iv*) to supplement working capital.

Policy of the Law

59. ADIL made submissions relating to the general policy of the law in respect of the recoverability of input tax. It submitted that the ECJ has 'thrown the net of deduction' widely and has taken a 'broad and inclusive approach (where exempt and private use is absent) to ensure full recovery by businesses of VAT, and so full neutrality'. Adopting a purposive approach, ADIL submitted that the VAT system 'brooks no obstacles to [its] attainment' of the clear objectives of the VAT system. Putting it another way, the taxpayer submitted (relying, in this regard, on, *inter alia*, *Société Générale des Grandes Sources d'Eaux Minérales Françaises v Bundesamt für Finanzen* (Case C-361/96) [1998] STC 981 at 995) that the detailed rules as to deductibility of input tax 'serve rather than govern or curtail the over-arching principle'. That over-

arching principle, it was submitted, was the principle of neutrality – that is to say, the principle that traders are meant to get a deduction for all VAT that they incur. The fundamental distinction is between traders and private consumers. The choice in the present case was (so ADIL submitted) between seeing ADIL as a trader that was registrable and engaged in economic activity (though short of making actual supplies) at the time the inputs were incurred (and which was duly registered when the deductions were later claimed) or a private consumer. If the former, then it should recover its VAT; if the latter, then it should not – but, in that case, it should not have been allowed to join the BAA VAT group.

Economic Activity

60. ADIL accepted that whether or not a person is carrying on an economic activity is a question of law but submitted that the question is highly fact-sensitive. It also accepted that economic activity is a precondition to chargeability to VAT but submitted that there are two essential criteria of such activity, namely 'a functional criterion relating to activity but also and above all a structural criterion relating to organisation' (*Banque Bruxelles Lambert SA v. Belgian State* (Case C-8/03) [2004] STC 1643 at 1647. Although ADIL accepted (following *Wellcome Trust Limited v. C & E Commissioners* (Case C-155/94 [1996] STC 945) that the mere holding of shares in a company is not an economic activity, it did submit that such holding when accompanied by direct or indirect involvement in the management of the company which entails the making of taxable supplies is an economic activity. ADIL also submitted that the First-tier Tribunal was right to hold that ADIL was an 'active' rather than a 'passive' management company – that is to say, that its holding of the shares was accompanied by direct or indirect involvement in the management of the companies in question.

61. It was further submitted by ADIL that the principle of fiscal neutrality dictates that a person who does acts preparatory to the making of taxable supplies is entitled to deduct VAT charged on supplies that he intends to use for the purposes of his taxable supplies. In this regard, we were directed towards the decision in *Rompelman v. Minister van Financiën* (C-268/93) [1985] ECR 655 at 663. It was further submitted that this principle is so even though the person in question has not yet made any taxable supplies and even if he never actually does so. In this regard, we were referred to the decision in *Belgium v. Ghent Coal Terminal NV* (Case C-37/95) [1998] STC 260. In other words, it was submitted that '[o]nce the entitlement to deduct has arisen, it is retained and can be exercised, even if the trader never makes taxable supplies'. In this regard, ADIL sought to extend the principle (relying on *Faxworld*) to the proposition that a person who does acts preparatory to the making of taxable

supplies not by himself but by 'another person who continues his activities as his successor' is a taxable person entitled to deduct VAT charged on supplies of goods or services intended to be used for the purpose of the successor's taxable supplies.

Grouping

62. ADIL submitted that the analysis in *Faxworld* must also apply where the taxpayer joins a VAT group the members of which are treated by virtue of Article 4(4) of the Sixth Directive as a single taxable person. On joining the VAT group, the taxpayer becomes, for the purposes of VAT, part of, and is thereby succeeded by, a single taxable person represented by the representative member. In this regard, the taxpayer relied in particular on the *Svenska* case. It submitted that, by preparing and engaging in economic activity combined with grouping with the BAA VAT group, ADIL had done all that it needed to do to become entitled to recover VAT. Furthermore, ADIL relied on *Svenska* (supra) for the proposition that the right to recover VAT was tested not at the time when the VAT was incurred, but rather, when the payer was part of a VAT group, when the [deemed attributed] supplies made by the VAT group representative member were made.

Business Continuity Principle

63. ADIL further submitted that it is helpful to focus on certain aspects of VAT grouping. Common to these aspects is business continuity. It was submitted that case law shows that a person (A) may attribute his inputs to the supplies of another person (B) in at least four situations, namely:

- where there is a transfer of a going concern from A to B;
- where A becomes a member of the (A + B) group, and inputs incurred by A are related to the (A + B) business;
- where in a reconstruction substantially the same business in carried on in the same ownership; and

- where a claim to recover input tax incurred pre-registration is made post-registration in accordance with regulation 111 of the VAT General Regulations.

64. In the case of ADIL, ADIL submitted that there was continuity of the type described by the Advocate General (at paragraph 37) in *Faxworld* as 'the continuity of a business from preparatory to operational stages'.

Direct and Immediate Link

65. ADIL accepted that the test for recoverability for VAT incurred was that there be a direct and immediate link between the goods and services received and onward taxable supplies. But ADIL submitted that this required link is a flexible case-law concept. To satisfy the test so as to be recoverable, input VAT must be either (*i*) used for the purposes of making taxable supplies ('directly attributable VAT'); or (*ii*) a 'cost component' of a taxable person's general costs and so attributable to the person's economic activity as a whole ('overheads VAT'). In this regard, we were directed in particular to the opinion of the Advocate General in *Abbey National plc v. Customs and Excise Commissioners* [2001] STC 297 at 305:

> *What matters is whether the taxed input is a cost component of a taxable output, not whether the most closely-linked transaction is itself taxable. As the Commission submitted at the hearing, the question to be asked is not what is the transaction with which the cost component has the most direct and immediate link but whether there is a <u>sufficiently</u> direct and immediate link with a taxable economic activity…The need for a 'direct and immediate link' thus does not refer exclusively to the very next link in the chain but serves to exclude situations where the chain has been broken by an exempt supply.* [emphasis added]

ADIL submitted that there was no chain-breaking transaction: the acquisition of the shares was not, in its submission, an intervening transaction because it did not involve a supply. No consumption occurred because ADIL was carrying on an economic activity (or taking steps preparatory to carrying on an economic activity) and the supplies were made to ADIL to be used in that business.

ADIL's Cross Appeal

66. As we have observed above, ADIL submits that the First-tier Tribunal was wrong to hold, as it did, in paragraph 155 of its decision, that ADIL had no intention to join the BAA VAT group prior to the completion of its takeover of BAA (albeit that the First-tier Tribunal also found that ADIL had the intention of joining the BAA VAT group as from the date of the completion of the BAA takeover and any delay was essentially administrative: see paragraph 82 of the Tribunal's decision). The import of ADIL's submission is, as we understand it, that if ADIL did indeed have an intention to join BAA's VAT group prior to the completion of the takeover of BAA, this demonstrates:-

(i) that the circumstances of this appeal are to that extent made closer to those which obtained in *Faxworld*;
(ii) that the acquisition of the shares in BAA by ADIL were preparatory to the taxable supplies made by BAA which are attributable to ADIL (on an anticipated basis since ADIL was always intending to join the BAA group);
(iii) that such an intention conclusively engages Regulation 111 so as to entitle ADIL to recovery of the relevant VAT.

67. The First-tier Tribunal nowhere records evidence either supporting or militating against the factual proposition that ADIL had, as from its inception, an intention to join the BAA VAT group. Certainly there is no analysis of evidence which leads to a conclusion based on either accepting or rejecting various items of evidence one way or the other that there was any such intention on the part of ADIL at the time that it incurred the VAT on the acquisition of the various professional services which are the subject of this appeal. This is not surprising, as the Tribunal records, as we have already observed, that there was simply "no evidence" which supported the notion that ADIL did have such an intention, prior to the completion of the BAA takeover. In other words the Tribunal records that there is no evidence either way as to this pre-completion period. ADIL relied on the Tribunal recording, at paragraph 143 of its decision, that "*… the fact that ADIL intended to group when acquiring the BAA shares meant that in VAT terms ADIL should be treated as buying the business of BAA*" presupposed that it was accepted by both parties (and therefore should have been accepted by the First-tier Tribunal) that ADIL did have an intention to join the BAA VAT group prior to completion. We note that Mr Southern's submission, as recorded in paragraph 133 of the First-tier Tribunal's decision, looks at the point in time "*when [ADIL was] acquiring the BAA shares*", rather than any period of time before the point of acquisition. And in any event, the Commissioners made it clear that there was no formal concession, either below, before the First-tier Tribunal, or before us, that there was any such intention. In the circumstances, it is, we consider, impossible for ADIL to require a positive finding on our

part that ADIL had the relevant intention to join the BAA VAT group at the time when ADIL incurred the relevant VAT, or indeed, at any time prior to the completion of the takeover of BAA. There is no record of any submission by ADIL below (based on any such presupposition or otherwise) of any such pre-completion period on the face of the Tribunal's decision.

68. We have already observed that ADIL initially made an application before us to lead further evidence (from Mr Bullón) as to ADIL's pre-completion intentions but (this application having been resisted by the Commissioners) ultimately withdrew that application. In the circumstances we say no more about that application.

69. We record that we dismiss ADIL's cross-appeal.

Discussion and Conclusions on the Commissioners' Appeal

Summary of submissions

70. The submissions made by the parties in this appeal (and by ADIL in particular) were self-evidently wide-ranging, as we have recorded. We intended no disservice to either party by recording that we find it convenient to summarise their respective positions as we see it:-

(i) It is common ground between the parties that the application of the Sixth VAT Directive, Article 2, Article 4, Article 17, VATA 1994, Section 24, Section 25 and Section 26 means that VAT is only recoverable by ADIL to the extent that ADIL can attribute the VAT it incurred to onward taxable supplies made in the course of an economic activity made either by ADIL or, alternatively, somehow attributed to ADIL, with which onward taxable supplies the relevant VAT has a direct and immediate link. We also do not understand the Commissioners to quarrel with ADIL's observation that VAT incurred on supplies attributable to activities preparatory to onward taxable supplies by a taxable person, made in the course of an economic activity, is recoverable.

(ii) ADIL says that the VAT ADIL incurred for the relevant professional services was made in the course of an economic activity conducted by ADIL (the acquisition of the BAA shares with a view to actively

managing the BAA group as an investment), where ADIL had an intention to make taxable supplies (the provision of management services for a consideration) both before and after the takeover of BAA, to which intended taxable supplies the relevant VAT can be attributed (and therefore recovered); the Commissioners say that the acquisition of the BAA shares and the intention to manage the BAA group did not constitute an economic activity at all but rather the fulfilment of a passive holding company activity which conclusively bars any recovery of the relevant VAT by ADIL. And the Commissioners also say that in this appeal, in any event, the First-tier Tribunal expressly found that ADIL quite simply had no intention to make taxable supplies prior to its takeover of BAA. Further, the Commissioners say that ADIL is wrong to say (relying on a combination of VATA, s.43, *Faxworld* and *Svenska*) that the correct time to assess whether there is a sufficient direct and immediate link between the services acquired by ADIL and the VAT ADIL incurred in BAA's onward taxable supplies is when those onward supplies were deemed to be made by ADIL by reason of VATA, s.43. Rather, the Commissioners maintain that the correct time to assess whether or not there is such a direct and immediate link is when ADIL incurred the VAT. Further, the Commissioners say that the failure to provide any actual taxable supplies by ADIL reinforces the absence of any intention on ADIL's part to make taxable supplies. Thus, say the Commissioners, there are no onward taxable supplies made or intended to be made by ADIL to which the VAT incurred by ADIL can be attributed.

(iii) Alternatively, says ADIL, the services acquired by ADIL were acquired in the course of preparatory acts of ADIL to make onward taxable supplies, in that ADIL intended to make supplies of management services to the BAA group when ADIL acquired the services which bore the relevant VAT. Or else, says ADIL, ADIL's pre-takeover activities which led to its acquisition of the BAA group, at the time when ADIL incurred the relevant VAT, are properly equated to preparatory acts on ADIL's part to make the taxable supplies made by BAA, because a combination of the VAT grouping provisions and the ECJ's approach in *Faxworld* meant that ADIL's intended takeover of BAA amounted to an intention on ADIL's part to make BAA's taxable supplies, which meant, in turn, that anything done by ADIL to acquire BAA (which required ADIL to acquire the services which bore the relevant VAT) was, for VAT purposes, activities preparatory to the making of onward taxable supplies by ADIL. The Commissioners say, as we have already recorded, that ADIL's own actual and intended activities do not amount to an economic activity let alone to an intention to make taxable supplies. And the Commissioners dispute ADIL's submissions as to the application of the VAT grouping provisions and *Faxworld*, which the

Commissioners say do not attribute BAA's taxable supplies to ADIL at the relevant time (when ADIL incurred the VAT).

(iv) ADIL says that VAT neutrality requires the same VAT consequences to follow for the acquisition of a taxable business and the acquisition of the shares in a company which conducts a taxable business. The Commissioners also prayed the principle of VAT neutrality in aid, on the basis that VAT neutrality would be offended, as it would be in *Faxworld*, if ADIL did not obtain recovery of the relevant VAT. The Commissioners, however, say that the acquisition of shares in a company, albeit a company which conducts a taxable business, is a different transaction to the acquisition of a business and it is unsurprising that the two types of transaction attract different VAT consequences.

(v) In relation to Regulation 111, ADIL says that Regulation 111, in providing that the Commissioners "may" give a taxable person recovery of VAT, effectively means that the Commissioners "must" allow ADIL recovery, since ADIL was indeed a "taxable person" once it joined the BAA group (being the representative member of the BAA VAT group which made taxable supplies) and that is the end of the matter. The Commissioners say that Regulation 111 simply permits pre-registration VAT to be recovered by a taxable person, to the extent that that pre-registration VAT is attributable to onward taxable supplies made by a taxable person; the Commissioners say, for the reasons we record above, that ADIL is not a taxable person and certainly did not make taxable supplies to which the relevant VAT had a direct and immediate link.

ADIL has an economic activity

71. If ADIL, at the time at which ADIL incurred the relevant VAT, did not have an economic activity, the appeal succeeds. But it did. As we have observed above, the purpose of ADIL's acquisition of BAA was not an end in itself (contrary to the Commissioners' submissions) but was expressly recorded by the Tribunal as being the first step of an onwards investment, which involved management. That management included the provision of services by ADIL to the BAA group. Those were findings of fact made by the First-tier Tribunal and we see no basis to disturb those findings of fact. The Tribunal found that that was an economic activity and again we find no basis to disturb that.

The professional services supplied to ADIL had no direct and immediate link to any onward taxable supplies made by ADIL

72. However, although ADIL could be said to have acquired the BAA shares in the course of an intended economic activity, there are no onward taxable supplies made by ADIL itself (ignoring the application of VATA s.43 for the time being), at the time that ADIL incurred the relevant VAT, to which those professional services have a direct and immediate link. As we have already observed, ADIL was found by the Tribunal to have an intention to provide taxable services to BAA only from the time of completion of the BAA takeover (not before, when the VAT was incurred). ADIL was not found to have any such intention prior to then.

73. The *Macquarie* fee was, as we have observed, expressly found by the Tribunal to be mainly concerned with the takeover and not for any services to be provided for ADIL to BAA (or any other company in the BAA group) post takeover albeit the *Macquarie* services had a continued beneficial effect on the ADIL/BAA group after the takeover. The First-tier Tribunal was silent about the other fees as to any allocation between the takeover itself and post-takeover activities and we do not make any observation in relation to the other fees. Any continuing indirect benefit (for example, "being open to strategic management": see paragraph 84 of the First-tier Tribunal decision) is too remote to provide a direct and immediate link to taxable supplies by ADIL, even if it were established (as it has not been) that those management services had been intended taxable supplies before the takeover.

74. Thus we cannot attribute any of the fees (or the VAT incurred by ADIL) to any post-completion activity or supply made by ADIL at all. In other words none of the costs incurred by ADIL can be considered to be cost components of a taxable supply by ADIL itself or attributed to ADIL by reason of the VAT grouping provisions which means there is no direct or immediate link between ADIL's VAT and any onward taxable supply.

75. However we should say that we also agree with the Commissioners that the time to test the recoverability of VAT is at the time at which the relevant VAT is incurred. This is clear from Article 17.1 and 17.2 of the Sixth Directive and from *Waterschap,* paragraphs 38-41. What matters is the intention to make taxable supplies at that time, so that an absence of an intention to make taxable supplies at the time at which the relevant VAT is incurred precludes recovery (see *Waterschap*, paragraph 40). Equally a change of intention to no longer make taxable supplies does not prohibit recovery, if the change is because of events beyond the payer's control: *Ghent Coal* (para. 24). That preparatory acts of a taxable person may attract VAT recoverability does not affect that conclusion, since those preparatory acts must, at the time at which they attract the payment of VAT, have a direct and immediate link, of a sufficient

strength, to an onward taxable supply. *Svenska* does not affect the position. The reasoning in *Svenska* can be summarised as follows (we cite from [1999] STC 406; see in particular the speech of Lord Hutton at 423, with whom all of their Lordships, except Lord Lloyd, who dissented, agreed):

(i) Svenska incurred *prima facie* recoverable VAT as the VAT was attributable (there being a direct and immediate link) to onward taxable supplies of management services to a branch of a Swedish parent company.

(ii) But the VAT (General) Regulations 1985/886, Regulation 23(1) deferred the time of those onward supplies for VAT purposes to the earlier of receipt of payment by or issue of a VAT invoice by Svenska to the branch; it is in that particular context that Lord Hope, at 415, observes that at the time at which Svenska was deemed to have made outward supplies by reason of the VAT grouping provisions, "Svenska had brought with it into the group registration amounts which had been credited to it as input tax which had been attributed to supplies which were not yet [because of the deferred time of supply rules in Regulation 23] treated as taxable, and the...branch brought into the group the value of the continuous supply of services for which it had not yet [when Svenska joined the VAT group] paid [Svenska] and had not yet been issued with a tax invoice".

(iii) By the time Svenska issued an invoice to branch, Svenska was already a member of the same VAT group as the branch.

(iv) So the only onward supplies to which the VAT incurred by Svenska were attributable were the heavily potentially exempt supplies by the branch, treated as made by Svenska by reason of what is now VATA, s.43.

(v) Thus the "clawback" provisions in the VAT (General) Regulations, Regulation 34(1) which denied recovery for *prima facie* recoverable VAT if the relevant supplies for which recovery had been initially given were "used" for making onward taxable supplies were triggered, resulting in a clawback of Svenska's initially recoverable VAT by reference to the exempt supplies treated as being made by Svenska by reason of the VAT grouping provisions in what is now s.43.

76. Counsel for the Respondent referred us to the analysis of *Svenska* in *Royal & Sun Alliance Insurance Group Plc v. C & E Commissioners* [2003] STC 832. However the observations of the members of the House of Lords in that case are entirely consistent with our approach to both *Svenska* and *Faxworld*: see especially paragraphs 50-51 (Lord Hoffmann) and 75-85 (Lord Walker). These passages support the proposition that time is key in the use of input supplies in a grouping situation. Sub-co did not issue an invoice to branch prior to joining the VAT group. Thus at the time it was deemed to make the supplies pursuant to the regulations the only onward supplies were the exempt

branch supplies made by the branch but deemed (because of the grouping provisions) to be made by Svenska. As Lord Hoffmann said, the grouping provisions "do not re-write history". It seems to us that this is precisely what the Respondent is asking us to do.

77. The reasoning in *Svenska* has no application in this Appeal. ADIL, unlike *Svenska*, had no intention to make onward taxable supplies at the time when ADIL incurred the VAT. Regulation 34 of the VAT (General) Regulations qualifies the general rule that the recoverability of VAT is tested by ignoring the payer's intentions when the payer incurs the VAT by revisiting the VAT incurred at the time when onward supplies to which the relevant VAT is attributable are made and denying recoverability if those onward supplies are not taxable supplies. These "clawback" rules which operate in relation to the consequences of VAT grouping, which is voluntary, do not affect the proposition that the absence of making taxable supplies by an intending supplier does not preclude VAT recovery where the failure to make taxable supplies is outside the control of the intending [taxable] supplier. But there are no "reverse clawback" provisions which apply (by reason of VAT grouping or otherwise) to make *prima facie* irrecoverable VAT recoverable.

78. Neither do we consider that BAA's taxable supplies can be attributed to ADIL by reason of the VAT grouping provisions or by an application of *Faxworld*. It is true that the VAT grouping provisions treat all supplies made by group members as being made by the VAT representative member. But that is only from the time at which all of the relevant companies are members of a single VAT group. At the time at which ADIL incurred the relevant VAT, ADIL was not a member of the BAA group (and was found to have no intention of joining the VAT group prior to completion of the BAA takeover, as we have determined in dismissing ADIL's cross-appeal on this point). The VAT grouping provisions are not in any sense retrospective. Thus ADIL's takeover of BAA cannot be viewed as a preparatory act to make the supplies to be attributed to ADIL by reason of s.43 of VATA, since the absence of any intention to join the BAA VAT group pre-completion entails an absence of any intention to make supplies only later attributed to ADIL under s.43 (that is after completion of the takeover and well after ADIL incurred the relevant VAT).

79. As for *Faxworld*, the essence of the ECJ's decision is that where a Member State's domestic provisions which are analogous to the United Kingdom's transfer of a going concern regime treats a transferor and a transferee of a business as a single fiscal unity, it makes sense to attribute the taxable supplies of the latter to the former, so as to secure a direct and immediate link between VAT incurred by the transferor and the taxable supplies of the transferee (paragraphs 41, 42 of the judgment of the ECJ).

80. While the partnership entity, Faxworld GbR, in *Faxworld* apparently expended the relevant VAT before the establishment of Faxworld AG, to which the business and assets were transferred (see paragraphs 11 and 13 of the ECJ's judgment) the ECJ was careful to point out that Faxworld GbR was established solely to establish, in turn, Faxworld AG (see paragraph 11) and importantly that Faxworld GbR incurred VAT "paid on input services which have been procured for the purposes of Faxworld AG's taxable operations" (paragraph 42, emphasis added). And that in circumstances in which the German provisions analogous to the United Kingdom transfer of a business as a going concern were engaged, so that the transferor and transferee were, for VAT purposes, conflated (paragraph 42).

81. Thus it is easy to see why the ECJ considered that the principle of VAT neutrality would be offended unless the taxable supplies of Faxworld AG were attributed to Faxworld GbR. Faxworld GbR incurred the relevant VAT at a time when it was found to have the express intention of establishing Faxworld AG, which would make taxable supplies precisely because Faxworld GbR had paid for the services bearing VAT. Faxworld GbR was to transfer to Faxworld AG the business which was to generate those taxable supplies under provisions which made that transfer a non-event for VAT. The input services were "procured for the purposes of the recipient's taxable operations" (paragraph 42).

82. There is in those circumstances ("those precise circumstances": paragraph 42) a self-evident direct and immediate link between VAT on services incurred by Faxworld GbR and Faxworld AG's taxable supplies when the former acquired the relevant services and incurred VAT for the very purpose of enabling Faxworld AG to undertake taxable supplies.

83. In this appeal, the nature of the fees incurred by ADIL (which mainly concerned the takeover, certainly in the case of the Macquarie fees) cannot, as we have observed, be described as fees incurred to allow BAA to undertake taxable supplies, which BAA was already making, both prior to and after the takeover.

84. And although we agree with ADIL that the VAT grouping provisions effectively render ADIL and BAA as a single fiscal unity as from the time that ADIL joined the BAA VAT group so as to attribute BAA's taxable supplies to ADIL, the VAT grouping provisions have no effect before then. Certainly not to deem BAA's supplies to be made by ADIL at the time that ADIL incurred the relevant VAT. Again, in the circumstances in which ADIL was found by the First-tier Tribunal to have no intention of joining the BAA VAT group at the time at which ADIL incurred the relevant VAT, ADIL cannot, we consider, claim by analogy to *Faxworld*, that the relevant VAT was incurred at a time when that VAT could or must be attributed to BAA's taxable supplies,

which are in turn attributed to ADIL. Put another way, ADIL cannot by way of any analogy to *Faxworld*, say that ADIL was established in order to enable BAA to make taxable supplies. Nor can ADIL say that the VAT grouping provisions have effect so that the VAT ADIL incurred, on the facts of this appeal, was VAT incurred by ADIL for the purpose of taxable supplies deemed to be made by ADIL, when ADIL had no intention of joining BAA's VAT group at the time at which ADIL acquired the relevant services and incurred the relevant VAT.

85. Neither does the principle of fiscal neutrality otherwise assist ADIL. Share transactions are entirely different transactions to the sale or acquisition of a trade or business assets. So the sale of shares is an exempt transaction, albeit that the ultimate aim of the selling-holding company was to repay the debts of a taxable business: *BLP* (Case C-4/94, paragraph 27). Equally we consider that a share acquisition is different to and distinct from the acquisition of a trade or business assets (so that to acquire the BAA shares is a different transaction to the acquisition of BAA's business). VAT neutrality demands, we consider, all share acquisitions to be treated similarly (see *BLP*, paragraph 26) whatever the business of the acquired target company. And fiscal neutrality does not require the application of provisions which recognise that entities may be part of a fiscal whole so as to ignore supplies inter se and to attribute the intentions of one part of that fiscal unity to another to have retrospective effect. In *Faxworld*, GmbH incurred the relevant costs at a time when it was already a putative fiscal unity with AG (in the sense that it was established in order to create AG) with the intention of transferring the business GmbH acquired to AG under the German continuity of business provisions. Not before. And the business was to be transferred to AG which reinforced the fiscal whole. Compare and contrast this case, where ADIL acquires shares in BAA but incurs the relevant VAT at a time before it joins (or intended to join) the BAA VAT group, where the costs were (certainly in the case of *Macquarie*) mainly to do with the acquisition of the BAA shares and not to do with the ongoing costs of running a business.

86. For these reasons, we find that there is no direct and immediate link between the supplies made to ADIL on which the relevant VAT was incurred by ADIL and any onward taxable supplies either made to ADIL or attributed to ADIL.

Regulation 111

87. Regulation 111 simply does not apply in this case. Quite apart from its permissive nature (the Commissioners "may" allow VAT recovery as opposed to being in a position where they "must" allow recovery), at a time when

ADIL was a taxable person, it incurred VAT which was not, for all the reasons we give above, attributable to onward taxable supplies. That is the end of the matter. Regulation 111 does not provide a code when VAT which is not attributable to onward taxable supplies (and with which the relevant services have no direct and immediate link) becomes recoverable; it merely relaxes the condition that a taxable person must be registered before obtaining VAT recovery. Regulation 111 presupposes that an economic actor may be a "taxable person" without being registered and allows VAT recovery in those circumstances if the Commissioners so permit. This is not, of course, an appeal where it is suggested that the Commissioners have behaved somehow abusively so that the Commissioners' refusal to allow recovery under Regulation 111 is subject to judicial review.

Disposal of the Appeal and the Cross appeal

88. We allow the appeal. We dismiss the cross-appeal.

MRS JUSTICE PROUDMAN

JULIAN GHOSH

UPPER TRIBUNAL JUDGES

RELEASE DATE: 22 JUNE 2011