[2011] UKUT 131 (TCC)
Reference No: FTC/71/2010

INPUT TAX – Capital goods scheme – Adjustment – Decrease in use of capital item in making taxable supplies – College makes educational supplies – College incurred capital expenditure on building extension to premises – College leased premises to tenant company – Opted to tax premises – College took lease back from tenant company – After initial period tenant company struck off register and lease became bona vacantia – No rent paid after initial period – Whether adjustment to relief for input tax required by change of use – Appeal dismissed – VAT Act 1994 s24(1) and reg 115(2) of Gen Regs

THE UPPER TRIBUNAL
FINANCE AND TAX CHAMBER

GATESHEAD TALMUDICAL COLLEGE **Appellant**

- and -

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

Tribunal: SIR STEPHEN OLIVER QC

Sitting in public in London on 22 February 2011

David Jamieson, counsel, instructed by Berwin Leighton Paisner LLP, solicitors, for the Appellant

Phillip Moser, counsel, instructed by the solicitor to HMRC, for the Respondents

DECISION

1. This is an appeal by Gateshead Talmudical College ("Gateshead") against the Decision of the First-tier Tribunal ("the Tribunal") dated 1 June 2010 to uphold assessments raised by the Respondents.

2. The case concerns the operation of the "Capital Goods Scheme" ("CGS") contained in Part XV of the VAT General Regulations 1995. Gateshead's premises at 88 Windermere Street ("the Premises") was a "capital item" for the purposes of the CGS. The Tribunal held that an adjustment under the CGS was required because of "the decrease in the making of taxable supplies": see paragraph 20 of the Decision.

3. The case for Gateshead, in essence, is that any decrease in the value of taxable supplies is irrelevant; the relevant question being the extent to which the capital item, i.e. the Premises, is used in making taxable supplies. Gateshead contends that there has been no change in use and therefore no adjustment arises under the CGS. It is common ground that Gateshead had made a valid election to waive the exemption in respect of the Premises. On that basis, say Gateshead, there could be no change in the use of the premises for the purposes of the CGS.

4. The decisions of HMRC to assess were recorded in the letters dated 10 September 2008 and 9 January 2009. HMRC based the assessments on what they saw as Gateshead's failure to make the appropriate adjustments under the CGS in accordance with Regulation 115(2) and (6) of the VAT General Regulations.

5. The Tribunal upheld the assessments on the basis that "Regulation 115(2) is engaged because of the decrease in the making of taxable supplies by [Gateshead] and where the decrease is to nil then the full adjustments are called for" (see paragraph 20 of the Decision).

The facts as stated in the Tribunal's Decision

6. Gateshead is a Yeshiva, and as such its main activity is the provision of education, amounting to exempt supplies for VAT purposes.

7. On 1 November 1996 Gateshead granted a lease ("the Lease") to Starburst Properties Ltd ("Starburst") of the Premises.

8. On the same day, Starburst granted a sublease ("the Sublease") in respect of the Premises to Gateshead.

9. Gateshead registered for VAT with effect from 16 September 1996 having described its business as that of "property letting" in its application to register.

10. Both Gateshead and Starburst elected to waive the exemption (or opted to tax) the Premises in accordance with Schedule 10 of VAT Act 1994.

11. Gateshead took credit for the input tax on its construction costs (relating to the Premises) and that led to a VAT repayment to Gateshead.

12. Up to the prescribed accounting period ending August 1998, Gateshead accounted for output tax in respect of rent received under the Lease and Starburst accounted for output tax in respect of rent received under the Sublease. After that date, if not before, Gateshead and Starburst ceased to pay each other rent under the Lease and Sublease.

13. Starburst was dissolved and struck off the company register on 20 July 1999.

14. Gateshead took no action to forfeit the lease, the benefit of which became vested in the Crown, following the striking off of Starburst, as bona vacantia,

15. It is not in dispute that the arrangements between Gateshead and Starburst had been put in place to secure repayment of input tax incurred on the building of the Premises.

16. The hearing of the Tribunal on 20 March 2010 was informed by Gateshead's representative that Starburst had been restored to the register "about two or three weeks before". That was more than a year after the appeal was brought. It appears that the reinstated company had had to change its name because another company called itself "Starburst Properties Ltd" had been incorporated in the meantime. The Tribunal was also informed that Starburst had remained dissolved (and thus did not in fact exist) for the entire remainder of the ten year CGS period.

17. It was common ground that, for the initial period until the striking off of Starburst, actual rent had been paid between Gateshead and Starburst under the Lease. There thus existed not only an initial input tax sum properly reclaimed in relation to the construction of the Premises but also subsequent output tax relating to that input tax within the CGS period.

18. The Tribunal found as a fact that Gateshead had made no further rent payments after about August 1998. The Tribunal found as a fact that Gateshead had had no intention of ever making any further such payments under the Lease and Sublease scheme. See paragraph 7 of the Decision which reads as follows:

> "… the lease was no longer of any relevance and so it simply ignored it for practical purposes, though it did wish to take advantage of its continued existence in law so as to avoid having to make the capital goods scheme adjustments."

19. HMRC had conceded, prior to the hearing before the Tribunal, that as a matter of English land law the Lease had continued to subsist, despite the fact that no rent had been paid and despite the fact that Starburst had been struck off. This was on account of the principle of bona vacantia which arises in England and Wales by virtue

of the Royal Prerogative, i.e. at common law. As such, on Starburst's dissolution in 1999, the Lease vested in the Crown until some date in 2010 when Starburst was restored to the register and the Lease re-vested in it.

The Tribunal's Decision

20. In paragraphs 15, 16 and 18 the Tribunal had summarised HMRC's case. HMRC had argued, first, that the making of taxable supplies had reduced to nil once Starburst had been dissolved, as it could not have been the recipient of any supplies and, second, that a cessation in the making of taxable supplies had given rise to the requirement to make a CGS adjustment. Gateshead submitted that the lease had continued to exist as a matter of law and therefore taxable supplies had been made (paragraph 19).

21. Gateshead's submission that the lease had continued to exist had been rejected by the Tribunal because Starburst did not exist and the parties to the Lease had stopped abiding by its terms. The Tribunal also recorded Gateshead's submission that it had not made any exempt supplies of the Premises, but had found this irrelevant. In paragraph 20 the Tribunal had held:

> "Regulation 115(2) is engaged because of the decrease in the making of taxable supplies by the College and where the decrease is to nil then the full adjustments are called for".

The Law

22. The statutory provisions relevant to this appeal are set out in the Appendix to this decision. It was, I note, and remains common ground between the parties that the UK Regulations implement the relevant EU legislation. On that basis the UK's CGS legislation is to be interpreted purposively.

The case for Gateshead

23. Gateshead submits that the Tribunal erred in law in concluding that no supplies were made under the Lease because the parties had stopped abiding by its terms and one of the parties had ceased to exist. Gateshead had, it was contended, continued to make supplies under the Lease notwithstanding its failure to seek payment of rent. It was then argued that the Tribunal had wrongly concluded that an adjustment under the CGS should have been made because of a decrease in the making of taxable supplies. In this latter respect Gateshead submits that CGS adjustments are triggered, not by a reduction in the value of taxable supplies, but rather by a change in the extent of use of the capital item for making taxable, as distinct from exempt, supplies. In the present circumstances the only use that the Premises could have been put to under the Lease was a taxable use. Moreover, it was argued, it is not permissible to take a global view of the transactions and look at Gateshead's use of the Premises as sub-tenant under the Sublease.

Conclusions

24. This matter comes down to two related issues. The first is whether, once the initial period had come to an end, there was a total cessation of supplies of the Premises by Gateshead to Starburst. Gateshead's argument, that the continued existence in law of the Lease meant that taxable supplies continued to be made after the initial period, was rejected by the Tribunal in paragraph 19 of the Tribunal's Decision. I quote:

> "That argument will be difficult to support where both parties to the Lease had in fact stopped abiding by its terms and were behaving as if it did not exist but where one of those parties had itself also ceased to exist the argument is completely untenable."

The second question is whether, following termination of the initial period, there had been a change in use requiring, as HMRC have contended, the making of adjustments under the CGS scheme.

25. Regarding the first question, it is not in dispute that there was a relevant supply in the initial period. Gateshead were registered for VAT, rent was paid by Starburst, as lessee, to Gateshead in respect of the initial period and the lessee under the Lease promised to pay rent in the future. There was a grant by Gateshead to Starburst of the right to occupy the Premises for an agreed period as if it were owner and to exclude any other person.

26. The Tribunal concluded, at paragraph 18, that "once Starburst had been dissolved it could not be the recipient of any supply". Its conclusion was reinforced by the finding (in paragraph 18) that, while rent had been paid by and to Starburst under the Lease and the Sublease only up to August 1998 "once Starburst had been struck off the parties had failed to abide by the terms". Gateshead observed that, save for the finding that no rent had been paid after the initial period, the Tribunal had made no findings of fact that other terms of the Lease had not been followed.

27. The absence of any such findings is, I think, explained by the circumstances of the appeal. It was not until shortly before the hearing that Starburst was restored to the register. The absence of any finding about the compliance or non-compliance with other terms of the Lease after the striking off of Starburst does not prove anything. Still less does it displace the evident facts that educational supplies were being made throughout the whole of the Premises notwithstanding the striking off of Starburst. We recognise that in law the Lease continued to exist as an item of bona vacantia such that it was held by the Crown for the remainder of the ten year CGS period. But that does not alter the facts as found by the Tribunal that no further rent had been paid or claimed between Gateshead and the Crown (as successor to Starburst) and no further output tax was accounted for by either Gateshead or the Crown in relation to the Premises. Moreover, as a matter of fact, Gateshead never again intended, after 1998, that there should be any further regard to the Lease or any

of the Lease obligations after the "interval" ending in 1998 (i.e. after the initial period).

28. We mention in this connection an argument for Gateshead that the decision of the European Court of Justice in *Sinclair Collis v HMRC* (Case C-275/01, [2003] STC 898), with particular reference to paragraphs 25-27 of that decision, that the lease established and continued to establish throughout the ten year CGS period a supply of services by Gateshead. I do not accept this. I note that in paragraph 26 of the Court's judgment there is a holding that:

> "… in order to determine the nature of a taxable transaction, regard must be had to all the circumstances in which the transaction in question takes place in order to identify its characteristic features."

That I think confirms the approach to the facts and the law taken by the Tribunal in its decision. Further, of immediate relevance to this case, the Court goes on to make it clear what the necessary characteristics of a Lease are for EU law purposes, and in the specific context of the VAT Directive, states in paragraph 25:

> "It is also settled that the fundamental characteristic of a letting of immoveable property for the purposes of Article 13B(b) of the Sixth Directive lies in conferring on the person concerned, for an agreed period and for payment, the right to occupy property as if that person were the owner and to exclude any other person from enjoyment of social right."

In the absence of payment, it would appear, the relevant "Community lease" definition is not fulfilled (and as the Court makes clear, at paragraph 23, these provisions must be strictly construed); and the situation here is, if anything, clearer. Here it has been established in "all the circumstances" that payment was made once (i.e. in one period) and then never again. Indeed the relevant payment of rent should have been per annum, and not once. Thus the annual rent obligation was effectively overlooked.

28. For those reasons I have concluded that the Tribunal was correct in deciding that, after the end of the initial period, no supplies had been made by Gateshead to Starburst (and consequently no supplies had been made under the Sublease to Gateshead).

29. I turn now to deal with the issue of whether, once the initial period had ended, there had been any relevant change of use. In this connection Gateshead had argued that only if the Premises had been used in the making of exempt supplies would there have been a change of use: the question of the amount of taxable supplies was therefore irrelevant. Gateshead say that the only use of the Premises had been in connection with the Lease and that any supply made under the Lease would have been taxable because Gateshead had elected to waive the exemption in accordance with Schedule 10 of VAT Act 1994.

30. The Tribunal, say Gateshead, had misunderstood the applicable test set out in Regulation 115(2) of the VAT General Regulations. The Tribunal's error had been to focus on the value of taxable supplies during the relevant period, rather than to have looked at the use of the asset in the context of making taxable or exempt supplies during that period. The question of use under Part XV of the Regulations, argued Gateshead, is determined by Part XIV which in turn is headed "input tax and partial exemption". Part XIV is concerned with the extent of the recovery of VAT where such inputs are linked to taxable and/or exempt supplies. The question of use under Part XV is therefore a question of being attributable to taxable or exempt supplies in accordance with Part XIV. It was, as I have already observed, the finding of the Tribunal that the consequence of all the relevant facts was that whilst this is a relevant supply for the initial period for CGS purposes, there was then a total cessation of such supply (and any accounting for output tax) in a subsequent interval. For the reasons that follow it is, I think, as a consequence of those findings that the adjustments under the CGS scheme and the assessments for input tax repayments were properly made.

31. Regulation 115(2) has to be read and interpreted as part of the overall scheme for determining what input tax can be attributed to taxable supplies. The object of the scheme is to afford relief by reference to the use to which the capital item in question has been put in making taxable supplies. Regulation 115(1) sets out how deductions are to be calculated where there is an increase in use in making taxable supplies in subsequent years; Regulation 115(2) provides for the converse case, i.e. where there is a decrease in use in making taxable supplies in subsequent years. The latter was the case here, as the Tribunal found in paragraph 20 of its Decision. The calculation in Regulation 115(2) refers back to the same method used in Regulation 115(1), which formula includes the "adjustment percentage". That, in turn, is defined in Regulation 115(5). Where the decrease is total, that difference will be 100%, as the Tribunal found to have been the case here.

32. Gateshead asserts, on the strength of Regulations 116(1) and 101 that the total input tax would be attributed to taxable supplies in the circumstances of this case. I cannot accept this because those circumstances were that Gateshead had made no taxable supplies in the relevant year (or in any subsequent interval for Regulation 115 purposes) and Gateshead had had no intention to make any such supplies in the future. Nonetheless, as I understand the argument, it follows that all the input tax must in any event be attributed to taxable supplies because the capital item (the Premises) was not used in making exempt supplies; this follows from the existence of Gateshead's option to tax the Premises. I cannot accept this. The circumstances of Gateshead's case and the facts found by the Tribunal simply do not support the conclusion that the input tax was used in making taxable supplies after the termination of the initial period.

33. There are, I think, two possible and acceptable analyses of the present situation. One is that Gateshead (after the initial period) did not seek to make any taxable use; consequently Regulation 101(2)(b) cannot apply and taxable supplies for the purposes of the standard method calculation would be zero pursuant to Regulation

101(2)(d). The other is that Gateshead occupied the premises in delivering its own exempt educational supplies (and thus Regulation 101(2)(b) cannot apply and taxable supplies for the purposes of the standard method calculation would be zero pursuant to Regulation 101(2)(c)). Either way Regulation 116(1) does not assist Gateshead to avoid the consequences of Regulation 115(2) in the present case.

34. Reverting to the question of whether there was a change of use within Regulation 115, I am satisfied that there was. As a matter of fact supplies were made under the Lease during the initial period; but after 1998 there was no supplies under the Lease and it is, in this respect, completely untenable (as the Tribunal held) to maintain otherwise. The facts are that the Premises were occupied by Gateshead and physically used on a day-to-day basis for its main activity. The parties to the Lease had stopped abiding by the Lease, the single most important term of which, namely the payment of rent, had been abandoned completely. Gateshead's argument that the Premises were used exclusively for leasing supplies, despite there being no actual rental charges or payment nor any intention of any being made, cannot therefore be sustained.

35. In my view the Tribunal reached the correct decision. I therefore dismiss the appeal. At the hearing neither party made any application for costs. If there is to be an application, this should be made within 28 days.

SIR STEPHEN OLIVER QC

RELEASE DATE: 15 April 2011

The Appendix

The method of adjustment is contained in Regs 101, 115 and 116(1). VATR 1995, Part IV, Regulation 101 sets out what input tax can be attributed to taxable supplies. Thus, Reg 101(1) stated in relevant part that:

> "[…], the amount of input tax which a taxable person shall be entitled to deduct provisionally shall be that amount which is attributable to taxable supplies in accordance with this regulation."

This refers to the so-called "standard method" for calculating deductible input tax. As also set out at paragraph 26 of the Appellant's Skeleton. Reg. 101(2) then provides:

> "[…] (b) there shall be attributed to taxable supplies the whole of the input tax on such of those goods or services as are used or to be used by him exclusively in making table supplies,
> (c) no part of the input tax on such of those goods or services as are used or to be used by him exclusively in making exempt supplies, or in carrying on any activity other than the making of taxable supplies, shall be attributed to taxable supplies, and
> (d) there shall be attributed to taxable supplies such proportion of the input tax on such of those goods or services as are used or to be used by him in making both taxable and exempt supplies as bears the same ratio to the total of such input tax as the value of taxable supplies made by him bears to the value of all supplies made by him in the period."

Under the Regulations a proportion of input tax incurred for both taxable and exempt supplies is attributed to taxable supplies. This proportion is determined by the standard method calculation set out in Regulation 101(2)(d). The formula to be used can be summarised as:

$$\frac{\text{Value of taxable supplies in the period (excluding VAT)}}{\text{value of all supplies in the period (excluding VAT)}} \times 100$$

This gives the claimable percentage of non-attributable input tax.

Part XV, Regs 115 and 116 then provided in relevant part;

> "Method of adjustment
>
> 115 –
>
> (1) Where in a subsequent interval applicable to a capital item, the extent to which it is used in making taxable supplies increases from the extent to

which it was so used in the first interval applicable to it, the owner may deduct for that subsequent interval an amount calculated as follows –

(a) where the capital item falls within regulation 114(3)(a) or (b) –

$$\frac{\text{The total input tax on the capital sum}}{5} \text{ x the adjustment percentage}$$

(b) where the capital item falls within regulation 114(3)(c) –

$$\frac{\text{The total input tax on the capital sum}}{10} \text{ x the adjustment percentage}$$

(2) Where in a subsequent interval applicable to a capital item, the extent to which it is used in making taxable supplies decreases from the extent to which it was so used in the first interval applicable to it, the owner shall pay to the Commissioners for that subsequent interval an amount calculated in the manner described in paragraph (1) above.

[…]

(5) For the purposes of this regulation –

"the total input tax on the capital item" means, in relation to a capital item falling within –

(a) regulation 113(a) or (b), the VAT charged on the supply to, or on the importation or acquisition by, the owner of the capital item, other than VAT charged on rent (if any)

(b) regulation 113(c) or (d), the VAT charged on the supply which the owner is treated as making to himself under paragraph 1(5) or 6(1) of Schedule 10 to the Act, as the case may require,

(c) regulation 113(e) or (f), the aggregate of the VAT charged on the supplies described in regulation 113(e) or (f), as the case may require, other than VAT charged on rent (if any),

and shall include, in relation to any capital item, any VAT treated as input tax under regulation 111 which relates to the capital item, other than such VAT charged on rent (if any); and for the purposes of this paragraph references to the owner shall be construed as references to the person who incurred the total input tax on the capital item;

"the adjustment percentage" means the difference (if any) between the extent, expressed as a percentage, to which the capital item is used (or is regarded as being used) in making taxable supplies in the first interval applicable to it, and the extent to which it is so used […] in the subsequent interval in question.

(6) […] a taxable person claiming any amount pursuant to paragraph (1) above, or liable to pay any amount pursuant to paragraph (2) above, shall include such amount in a return for the second prescribed accounting period next following the interval to which that amount relates, except where the Commissioners allow another return to be used for this purpose, […]"

"Ascertainment of taxable use of a capital item

116 …

(1) […], for purposes of this part, an attribution of the total input tax on the capital item shall be determined for each subsequent interval applicable to it in accordance with the method used under Part XIV for that interval and the proportion of other input tax thereby determined to be attributable to taxable supplies shall be treated as being the extent to which the capital item is used in making taxable supplies in that subsequent interval."