Appeal number: FTC/72/2010
[2011] UKUT 240 (TCC)

VAT – 13th Directive – Refund of tax to non-EU claimant – Whether VAT would be input tax of claimant were it a taxable person in the UK – Whether evidence supports claim – Yes – Decision of First-tier Tribunal set aside – Decision reversed in favour of claimant – EC 13th Directive (86/560 EEC) and VAT Regs 1995 (SI 1995/2518) reg 186

UPPER TRIBUNAL
TAX AND CHANCERY CHAMBER

SRI INTERNATIONAL **Appellant**

- and -

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

TRIBUNAL: SIR STEPHEN OLIVER QC

Sitting in public in London on 18 May 2010

David Ewart QC, instructed by Simmons & Simmons, for the Appellant

George Peretz, counsel, instructed by the General Counsel to HM Revenue and Customs, for the Respondents

DECISION

1. SRI, the Appellant, ("SRI" which stands for Stanford Research Institute) appeals against a decision of the First-tier Tribunal (Judge Cornwell-Kelly and Mr M Hossain) ("the Tribunal") dismissing its appeal against the refusal of a VAT refund application. The application was made by SRI under EC 13th Council Directive of 17 November 1986 (EC 86/560/EEC) and reg 186 of the Value Added Tax Regulations 1995. The Tribunal's Decision was released on 27 August 2009, set aside on 19 October 2009 and re-released without amendment on 28 April 2010.

The facts

2. The facts are taken from the Tribunal's Decision. The Tribunal drew its findings of fact from the oral evidence of Mr Byron Rovegno, the treasurer of SRI, and from documentation put in evidence.

3. SRI is a not-for-profit corporation incorporated in California. Throughout the period to which this appeal relates it conducted research and development activity in areas such as computing, engineering, health sciences, life sciences and pharmaceuticals for government agencies, commercial businesses and other organisations. Ninety per cent of this work was for the US government which commissions it by means of distinct orders or contracts in respect of each exercise. The rest was for commercial businesses and organisations. SRI has been paid for this work by its clients and any surplus over expenses to be re-invested in SRI's activities.

4. SRI has also (to use the words of the Tribunal) derived "revenue from the commercial exploitation of its research work by "spinning off" companies incorporated for that purpose". Those spin-offs were financed in part by the venture capital market which would take up shareholdings in such companies. SRI has maintained close links with the spin-offs through board representation.

5. Atomic Tangerine was such a spin-off company. It was set up as a joint venture in 1999 to take advantage of the growth in web-based services as an e-business venture consulting firm. Although based in the US, Atomic Tangerine had a branch office in Japan and in 2000 it intended to open a branch in the UK.

6. SRI entered into a number of contracts with Atomic Tangerine pursuant to which it agreed to provide services to Atomic Tangerine. The main three contracts were:

(i) a contract for the provision of services to support Atomic Tangerine's Information Security University development project;

(ii) a contract to provide reports on Energy and Security Policies for the Central Research Institute of Electric Power Industries in Japan; and

(iii) a contract to research and report on the role of nuclear power in the US.

The total value of these contracts to SRI was in excess of $600,000. In addition, SRI leased property to Atomic Tangerine in California. The rent was $475,000 in 2000 and $527,000 in 2001.

7. In June 2000, Atomic Tangerine identified premises in Cavendish Square, London, as a potential headquarters for its UK business. The landlord was unwilling to let the premises to a new venture without a guarantee from an established and creditworthy entity. SRI agreed to provide the guarantee. SRI did this with the intention of generating income from further contracts with Atomic Tangerine and further work in the UK referred to it by Atomic Tangerine. For those reasons, SRI conceived it to be in its own interests to guarantee the rent on Atomic Tangerine's lease. To quote from the Tribunal's decision (paragraphs 69-71):

> "… the taking of the premises in Cavendish Square was intended to be the opportunity for a further income stream, namely through fees charged to Atomic Tangerine for technology related consulting services provided by SRI and as a source of referral work from the United Kingdom, expanding SRI's client base there.
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> Accordingly, SRI conceived it to be in its own interests to guarantee the rent on a fifteen year lease of 33 Cavendish Square, as the lessor of the premises was unwilling to accept the covenant of a newly formed company alone. The lease was thus entered into by Atomic Tangerine on 4 September 2000, with SRI as guarantor of the rent. … . Mr Rovegno stated that the giving of the guarantee was part of the routine action taken to support start-up companies, though he accepted in cross-examination that he knew of no other cases in which such a guarantee had been given."

8. On 4 September 2000, a lease was entered into between the landlord, Atomic Tangerine and SRI (as guarantor) for a term expiring on 10 August 2015 ("the lease").

9. Atomic Tangerine ceased to trade in September 2001 before it had occupied the premises. As guarantor, SRI made rent payments for approximately three years while it sought another tenant. This was unsuccessful and SRI therefore sought to be released from its obligations under the Lease. SRI was released under the deed of release of guarantor executed on 23 July 2004. SRI paid the sum of £1,500,000 plus VAT of £262,500 to the landlord in consideration of the release of its obligations as guarantor under the Lease.

The law

10. Article 2 of the EC 13th Directive provides:

> "1, Without prejudice to Articles 3 and 4, each Member State shall refund to any taxable person not established in the territory of the Community, subject to the conditions set out below, any value added tax charged in respect of services rendered or moveable property supplied to him in the territory or the country by another taxable person … so far as such goods and services are to be used for the purposes of the transactions referred to in Article 17(3)(a) and (b) of Directive 77/388/EEC …"

The transactions referred to in Article 17(3)(a) and (b) are:

> "(a) transactions relating to the economic activities referred to in Article 4(2), carried out in another country, which would have been deductible had they been performed within the territory of the country;
> (b) transactions which are exempt pursuant to Article 14(10)(g) and (i), 15, 16(1)(B)(C)(D) or (E) or (2) or 28C(A) and (C)."

Article 4(2) provides:

> "2. The economic activities referred to in paragraph 1 shall comprise all activities of producers, traders and persons supplying services including mining and agricultural activities and activities of the professions. The exploitation of tangible or intangible property for the purpose of obtaining income therefrom on a continuing basis shall also be considered an economic activity."

11. These provisions have been implemented in the UK by regulation 186 of the Value Added Tax Regulations 1995:

> "186. Subject to the other provisions of this Part a trader shall be entitled to be repaid VAT charged … on supplies made to him in the United Kingdom if that VAT would be input tax of his were he a taxable person in the United Kingdom."

"Input tax" defined in VATA 1994 section 24(1) as being:

> "… the following tax, that is to say –
>
> (a) VAT on the supply to him of any goods or services;
> …

being (in each case) goods or services used or to be used for the purposes of any business carried on or to be carried on by him."

The Tribunal's Decision

12. The Tribunal dismissed SRI's appeal on the basis that the evidence was not adequate to enable it to find that SRI had carried on any business at all. Their conclusion is expressed (in paragraphs 95 and 96 of the Decision) as follows:

> "… For want of adequate evidence, we have not been able to find that SRI carried on a business, as understood in both Community and the national legislation, at all; and there has been no evidence to throw light on the relationship between any business it might have been shown to be carrying on and that of SRI Consulting. And although counsel for the Appellant argued strenuously that we should draw appropriate inferences from the overall circumstances, the fact remains that there was no evidence that the release premium was paid for any specific purpose beyond that of liquidating an open-ended liability on the part of SRI.
>
> It must be borne in mind that the burden of proof lies on the Appellant, and that both the Community and the national legislation make it very clear that the Commissioners are entitled to be demanding in relation to it. Our conclusion therefore is that there is no evidence of a relevant intention, subjective or otherwise, on the part of SRI in making the premium payments; and there is no evidence that the payment was in fact made for the purpose of a business carried on by them; and that no direct and immediate link has therefore been established between the services supplied in exchange for that payment and the business carried on by any person who, if he were in the United Kingdom, would be a taxable person."

13. The Tribunal's observation on the absence of evidence to "throw light on the relationship between any business [SRI] might be shown to be carrying on and that of SRI Consulting" relates back to findings in paragraphs 80-84.

14. The finding in paragraph 81 of the Decision that the "conventional economic activity" had been carried on by SRI Consulting is accepted by both parties to have been an error of law as being a finding that had not been open to the Tribunal on the evidence. In this connection will be noted earlier findings of the Tribunal that are consistent only with SRI itself having carried on the activities in question. Paragraphs 53 and 54 of the Decision contain the findings of activities of SRI undertaken for government agencies, commercial businesses and other organisations in connection with spin-off operation through Atomic Tangerine from which SRI derived revenue.

15. The question whether the Tribunal's decision was correct in law must therefore be approached on the basis that SRI alone derived the revenue from the "commercial exploitation of its research work" from spin-off companies that included Atomic Tangerine. Moreover, to the extent that paragraph 80 points to there having been a duality of intention between pursuit of the "general economic activity" and the "essentially academic and research-related work", the fact that SRI, to the exclusion of any other company, sought to exploit the spin-off companies excludes "duality" as a relevant consideration.

16. The remaining primary facts leading to the Tribunal's conclusion that the evidence was not in its view adequate to enable it to find that SRI had carried on any business at all are set out in paragraphs 2 to 9 above. It will be noted that in paragraph 71 of the Decision, the Tribunal records Mr Rovegno's evidence that giving of the guarantee had been "part of the routine action taken to support start-up companies."

The Tribunal's approach to the law

17. The Tribunal correctly stated the "basic requirement" as that found in regulation 186. This required the claimant to show that the tax sought to be relieved "would be input tax of his were he a taxable person in the UK". The goods or services in question must have been those falling within section 24(1) VATA, i.e. those "used or to be used for the purposes of any business carried on in the UK". The Tribunal then (in paragraph 88 of the Decision) identified, as the nature of the connection that must be shown "between input tax whose deduction is sought and the purpose for which the supply which gives rise to it is used", the "direct and immediate link". That test had been developed by the ECJ in cases such as Case C/94 BLP [1995] ECR 1-983 at paragraph 19 and in *Customs and Excise Commissioners v Midland Bank Plc* [2000] All ER (EC) 673.

18. In paragraph 96 of the Decision the Tribunal reaches its conclusion as follows:

> "Our conclusion therefore is that there is no evidence of a relevant intention, subjective or otherwise, on the part of SRI making the premium payment; that there is no evidence that the payment was in fact made for the purpose of a business carried on by them; and that no direct and immediate link has therefore been established between the services supplied in exchange for that payment and a business carried on by any person who, if he were in the United Kingdom, would be a taxable person."

19. To the extent that the Tribunal based its decision on the "direct and immediate" test, this was not correct. That test is appropriate to the situation where the recovery of VAT is sought by a trader who is registered in the UK, but it is not a requirement of regulation 186 of the 1995 Regulations. There are two stages to the recovery of VAT paid by a trader who is registered for VAT in the United Kingdom. The first stage is to determine whether the VAT in question is "input tax". This is

determined in accordance with section 24(1) VATA. VAT is "input tax" if it is used, or to be used, for the purposes of any business carried on by the trader. It is well established that the UK Courts apply a subjective test in deciding whether goods or services are used for the purposes of a business: see e.g. *Ian Flockton Developments v CCE* [1987] STC 394.

20. The second stage is to attribute the input tax to either taxable or exempt supplies made by the trader: section 26 VATA. The "direct and immediate link" test is relevant to this attribution (see the *Midland Bank Plc* decision). This can be seen by the answer given by the European Court of Justice to the first question referred. If there is a direct and immediate link with wholly taxable transactions then the input tax is wholly deductible. By contrast, if there is a direct and immediate link with wholly exempt transactions then none of the input tax is deductible. In any other case, the input tax will be part of the trader's general costs (see *Midland Bank* at paragraph 31). There will, therefore, be a direct and immediate link with the trader's business as a whole and the input tax will be allowable under the method prescribed by regulations 101-2 of the VAT Regulations.

21. The first of those stages appears in the provisions in the VAT regulations which govern the recovery of VAT paid by a trader who is not registered for VAT in the UK. In order to be recoverable, regulation 186 requires the VAT to be "input tax" on the assumption that the trader is a taxable person in the UK. It is not necessary to move to the second stage and demonstrate a direct and immediate link between the release of the guarantee and any specific supplies made by SRI. This would only have been relevant had SRI been a registered person in the UK making exempt supplies.

22. It follows that the only requirement under regulation 186 is that the VAT would be "input tax" if the trader was a taxable person in the UK. If that requirement is satisfied, all of the VAT is recoverable.

The case for HMRC

23. HMRC accept that, if the guarantee were given by SRI for the purposes of its business, the premium paid on release from the obligations under the lease would also be for the purposes of SRI's business. HMRC say that the Upper Tribunal cannot on the facts as found conclude that the guarantee was entered into for the purposes of a business carried on by SRI. The test to be applied from the judgment in *Customs and Excise Commissioners v Rosner* [1994] STC 228 is "whether there is a real connection, a nexus, between the expenditure and the business". And where, as here, the claimant relies on an intention to commence economic activities, that intention must be supported by objective evidence: see the decision of the European Court of Justice in Case C-396/98 *Scholss Strasse* [2000] ECR 1-4279, paragraph 41. The evidence, say HMRC, has satisfied neither test. If anything the evidence has pointed to SRI having guaranteed the lease to Atomic Tangerine for an investment motive.

Conclusion

24. For the reasons to be given, the Tribunal has in my opinion erred in law. It applied the wrong legal test and it took account of facts (particularly the position of SRI Consulting) that were not open to the Tribunal.

25. The key facts as found by the Tribunal are that:

> "69. … The taking of the premises in Cavendish Square was intended to be the opportunity for a further income stream, namely through fees charged to Atomic Tangerine for technology related consulting services provided by SRI and as a source of referral work from the United Kingdom, expanding SRI's planned base there.
>
> 70. Accordingly, SRI conceived it to be in its own interest to guarantee the rent on the fifteen year lease of 33 Cavendish Square, as the lessor of the premises was unwilling to accept the covenant of a newly formed company alone. The lease was thus entered into by Atomic Tangerine on 4 September 2000, with SRI as guarantor of the rent."

In this connection, the evidence shows that SRI had carried out work for Atomic Tangerine in return for payment. This demonstrates that the expectation of referral work was more than a mere hope on the part of SRI, it was a reality.

26. Those are findings as to the purpose of the business and consequently of the intention behind the grant of the guarantee. HMRC accept that, if the guarantee had been entered into in the first place for the purposes of SRI's business, the payment to release SRI from the liability would also be for the purposes of its business.

27. We can therefore see no other conclusion than that the payment by SRI to obtain release from the liability was incurred for the purposes of its business. The VAT on the payment, to use the words of regulation 186, would have been input tax of SRI had it been a taxable person in the United Kingdom. The Tribunal erred in law in concluding otherwise.

28. I do not see the position of the guarantee as a transaction in the nature of an investment. Atomic Tangerine was intended to be a spin-off company in which other parties would subscribe for shares. A 100% guarantee, as happened here, would favour such outside shareholders at SRI's expense. This indicates that the true purpose of the parties was to generate business for SRI. Overall, I think, the nexus between the guarantee (and the eventual discharge of SRI's liability under the lease) was real and was sufficient to establish the necessary connection between the expenditure and the business.

29. On that basis the Tribunal erred in law. The right course is, I think, to apply section 12(2)(a) of Tribunals Courts and Enforcement Act 2007 and set the Decision

aside. Findings of fact enable me to remake the decision under section 12(2)(b)(ii). The decision as remade is that all the VAT which SRI bore in respect of the release of the guarantee is recoverable under regulation 186.

30. The appeal is allowed. The parties are at liberty to make submissions as to costs.

SIR STEPHEN OLIVER QC
JUDGE OF THE UPPER TRIBUNAL

RELEASE DATE: 10 June 2011