[2020] UKUT 0132 (TCC)

Appeal number: UT/2019/0094

VAT – Partial exemption - whether costs of staging productions have a direct and immediate link to taxable supplies of catering and ice creams – no - appeal allowed - Articles 1,168 &173 Principal VAT Directive - ss 24, 25 and 26 VATA 1994

UPPER TRIBUNAL
TAX AND CHANCERY CHAMBER

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS

Appellants

- and -

ROYAL OPERA HOUSE COVENT GARDEN FOUNDATION

Respondent

TRIBUNAL: Mr Justice Morgan
Judge Timothy Herrington

Sitting in public at The Royal Courts of Justice, Rolls Building, London EC4A 1NL on 5-6 March 2020

Matthew Donmall, Counsel, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Appellants

Peter Mantle, Counsel, instructed by Crowe UK LLP, for the Respondent

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DECISION

Introduction

1. This is an appeal from the decision of the First-tier Tribunal (Tax Chamber) (Judge John Brooks) (the "FTT") released on 24 May 2019. By that decision (the "Decision") the FTT allowed the appeal in part of the taxpayer, the Royal Opera House Covent Garden Foundation (the "ROH"), which is now the Respondent in the Upper Tribunal to an appeal brought by HM Revenue and Customs ("HMRC"), against certain findings of the FTT which remain in dispute following the issue of the Decision. The appeal to the FTT was against HMRC's denial of a claim by the ROH to recover VAT input tax associated with the cost of staging productions (the "Production Costs") at The Royal Opera House Covent Garden (the "Opera House").

2. Although admission to the opera or ballet is an exempt supply for VAT purposes by virtue of the provisions of Group 13 of Schedule 9 to the Value Added Tax Act 1994 ("VATA") it is common ground that the ROH also makes a number of taxable supplies such as programme sales and production specific commercial sponsorship to which the Production Costs have a direct and immediate link. As a result of that link, the ROH is able to recover a proportion of the input tax associated with the Production Costs which is also attributable to the taxable supplies.

3. In its appeal to the FTT, the ROH contended that there was a direct and immediate link between the Production Costs and (i) the taxable catering supplies of the ROH in its bars and restaurants (ii) sales of ice cream (iii) shop sales (iv) commercial venue hire and (v) production work for other companies. The FTT concluded that there was a direct and immediate link between the Production Costs and the first two of those items. It found no direct and immediate link between the Production Costs and the other items, save for production specific commercial venue hire and shop sales of recordings of ROH productions.

4. There is no appeal against the FTT's findings in respect of items (iii), (iv) and (v) detailed above. HMRC applied to the FTT for permission to appeal against the FTT's findings in respect of items (i) and (ii) which was granted by Judge Brooks on 27 July 2019. Accordingly, we are only concerned on this appeal with the question as to whether the FTT erred in law in finding that the Production Costs have a direct and immediate link with items (i) and (ii), which we will henceforth refer to as the "Catering Supplies".

Relevant legislation

5. Article 1 of the Principal VAT Directive ("PVD"), EU Directive 2006/112/EC sets out the basic principle that VAT is charged on the basis of the value added to the various cost components of the supply. It provides insofar as material as follows:

"… On each transaction, VAT, calculated on the price of the goods or services at the rate applicable to such goods or services, shall be chargeable after deduction of the amount of VAT borne directly by the various cost components."

6. Article 168 PVD sets out the right to deduct input tax, the basic principle being that input tax is only deductible from the output tax payable insofar as the goods or services to which the input tax relates are used for the purposes of taxable supplies made by the taxable person in question. It provides insofar as material as follows:

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

7. Article 173(1) PVD sets out the principle of attribution as follows:

> "In the case of goods or services used by a taxable person both for transactions in respect of which VAT is deductible pursuant to Articles 168, 169 and 170, and for transactions in respect of which VAT is not deductible, only such proportion of the VAT as is attributable to the former transactions shall be deductible.
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> The deductible proportion shall be determined, in accordance with Articles 174 and 175, for all the transactions carried out by the taxable person."

8. Articles 174 and 175 PVD, which deal with apportionment of input tax where supplies are used by a taxable person for both its taxable supplies and its exempt supplies are implemented in domestic law by ss 24 - 26 of VATA.

9. Section 24(1) VATA insofar as is material provides that:

> "… "input tax", in relation to a taxable person, means the following tax, that is to say–
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> (a) VAT on the supply to him of any goods or services;
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> …
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> 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".

10. Section 25(2) VATA provides that a taxable person is:

> "… entitled at the end of each prescribed accounting period to credit for so much of his input tax as is allowable under section 26, and then to deduct that amount from any output tax that is due from him."

11. Section 26(1) and (2) VATA deal with the amount of input tax for which a taxable person is entitled to credit. These provisions allow credit to be given for "so

much of the… input tax on supplies, acquisitions and importations as is allowable by or under regulations as being attributable to … taxable supplies …".

12. The "standard method" of apportionment where a person makes both taxable and exempt supplies is prescribed by Regulation 101(2)(d) of the Value Added Tax Regulations 1995 (the "Regulations"). It provides insofar as is material as follows:

> "where a taxable person does not have an immediately preceding longer period … there shall be attributed to taxable supplies such proportion of the residual input tax 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."

13. The central issue in this case is whether the Production Costs can be said to be "attributable" to the Catering Supplies, as required by Article 173 (1) PVD and s 26 VATA. As we shall see later, when considering some of the many authorities on this point, the case law establishes that input tax is "attributable" to a given output if it has a "direct and immediate link" with that output.

The Facts

14. The FTT's factual findings are set out at [44] to [64] of the Decision. So far as relevant they can be summarised as follows (references to numbers in square brackets are to numbered paragraphs of the Decision).

15. A visit to the Opera House was described as being "a fully integrated visitor experience", beginning when booking a ticket on the website, by telephone or in person to the night of a performance. Unlike a West End show, "where there might be a cramped bar or just ice creams available", the facilities of the Opera House were a key element for anyone attending a performance who, at the time of booking would be offered the opportunity to purchase champagne, ice cream and programme vouchers which resulted in considerable advance sales of champagne (£250,550 in 2010-11 and £171,990 in 2011-12) : [46].

16. The income from catering and retail sales, in addition to box office receipts and funding from Arts Council England, was required to support the artistic output of the ROH, the Production Costs enabling the ROH to generate the necessary income from all sources - including box office and catering/retail: [47].

17. The Production Costs are the costs related to each production which include the fees for guest performers and conductors, creative teams, music costs, the cost of sets, props, costumes, transportation, extras and actors. They do not include the costs of the ROH permanent staff or its fixed overhead costs: [48] and [49].

18. The Opera House has extensive catering facilities, including a number of restaurants serving full meals as well as bars serving champagne and other drinks and bar snacks. The FTT found that these locations are crucial to offering food and beverages to members of the audience attending performances: [50].

19. The Opera House opens its doors 90 minutes before performances and to give ticket holders an opportunity to arrive at their leisure and have access to the bars and restaurants both before a performance and during the intervals. The proximity of the bars and restaurants to the auditorium enables audiences to have convenient access to their seats which results in most staying within the building during intervals rather than leaving to purchase drinks and snacks from nearby establishments: [51].

20. The Opera House has a 2,204 seat auditorium, but with a much smaller overall dining capacity of between 265 – 365. The restaurants, which are open before and during a performance to those who have purchased tickets, are not always filled to capacity. Customers who have booked a ticket are sent details of the various catering options including restaurant menus and recommendations: [52].

21. Once booked, a table is made available for the entire evening. This enables a customer to dine around the performance. For example, if attending the ballet, which will typically have two 25 minute intervals, he or she could have a first and second course before the performance, dessert in the first interval and tea/coffee in the second interval. There is some limited theming of food and drink to the production concerned: [53] and [54].

22. The Opera House repertoire was chosen by the ROH for artistic reasons and not to maximise catering revenue: [56].

23. As in most theatres, ice creams are sold during intervals at front of house and near entrances to the auditorium: [64].

The authorities

24. It is, in our view, helpful to examine a number of the key authorities that were cited to us in order to understand how the jurisprudence regarding the "direct and immediate link" test has developed.

25. A number of these authorities were the subject of an extensive review by Lord Hodge in his judgment in the recent Supreme Court case of *HMRC v Frank A Smart & Son Limited* [2019] UKSC 39 ("*Frank A Smart*"), which was released after the FTT's decision in this case. We refer to Lord Hodge's review as appropriate when examining the individual cases.

26. A general statement of the reasons for allowing the deduction of input tax against VAT payable on a taxable supply can be found in the judgment of the European Court of Justice ("CJEU")[1] in Case 268/83 *Rompleman v Minister van Financien* [1985] ECR 655 as follows:

> "16. As the court pointed out in its judgment of 5 May 1982 in case 15/81 (*Schul v Inspecteur Der Invoerrechten En Accijnzen*, (1982) ECR 1409), a basic element of the vat system is that vat is chargeable on each transaction only after

[1] We use the term "CJEU" to include the Court of Justice of the European Union where the context requires.

deduction of the amount of the vat borne directly by the cost of the various components of the price of the goods and services and that the deduction procedure is so designed that only taxable persons may deduct the vat already charged on the goods and services from the vat for which they are liable.

…..

19. From the provisions set forth above it may be concluded that 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. The common system of value-added tax therefore ensures that all economic activities, whatever their purpose or results, provided that they are themselves subject to vat, are taxed in a wholly neutral way."

27. The requirement that only the amount of the VAT borne directly by the cost of the various components of the price of the goods and services supplied was first made the subject of the formulation of a test in Case C - 4/94 *BLP Group v Customs and Excise Commissioners* [1995] STC 424 ("*BLP"*). The question in that case was whether the taxpayer could deduct input tax which it had incurred on professional services in connection with the sale of shares in a German subsidiary. The share sale was an exempt transaction but the deduction of input tax was claimed on the basis that the purpose of the sale was to raise money to pay off debts that had arisen as a result of various taxable transactions. The legal question turned on the interpretation of the predecessors of Articles 1 (2), 168 and 173 of the PVD and in particular the words "goods and services are used for the purposes of his taxable transactions".

28. The CJEU held that the input tax was not deductible because there had to be a direct and immediate link in the chain of supplies between the inputs and the transaction on which the output tax was payable. It held at [19] of its judgment:

"The use…of the words 'for transactions' shows that to give the right to deduct…, the goods or services in question must have a direct and immediate link with the taxable transactions, and that the ultimate aim pursued by the taxable person is irrelevant in this respect."

29. The CJEU went on to say at [25]:

"It is true that an undertaking whose activity is subject to VAT is entitled to deduct the tax on the services supplied by accountants or legal advisers for the taxable person's taxable transactions and that if BLP had decided to take out a bank loan for the purpose of meeting the same requirements, it would have been entitled to deduct the VAT on the accountant's services required for that purpose. However, that is a consequence of the fact that those services, whose costs form part of the undertaking's overheads and hence of the cost components of the products, are used by the taxable person for taxable transactions."

30. Thus a distinction was drawn between goods or services linked to a particular taxable transaction, in which case, viewed objectively, the goods or services must have a direct and immediate link with that taxable transaction, and goods and services which form part of an undertaking's general overheads where it must be shown that

the goods and services are cost components of the goods or services which the undertaking in question supplies. As we shall see later, in the case before us, the parties were agreed that we need only consider whether the first situation applies: whether the Production Costs have a direct and immediate link to the Catering
5 Supplies. The parties were agreed that the Production Costs were not in the nature of overheads in relation to the whole economic activity of the ROH.

31. In *BLP*, the objective character of the transactions was that the services were used for an exempt transaction, namely the sale of shares in a subsidiary by its holding company. Therefore, as the CJEU held at [28]:

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> "… except in the cases expressly provided for… where a taxable person supplies services to another taxable person who uses them for an exempt transaction, the latter person is not entitled to deduct the input VAT paid, even if the ultimate purpose of the transaction is the carrying out of a taxable transaction."

32. The deductibility of VAT incurred on supplies used by a taxable person for an
15 exempt transaction and a transaction outside the scope of VAT was considered by the CJEU in Case C-408/98 *Abbey National plc v Customs and Excise Commissioners* [2001] STC 297. This concerned a claim to deduct the VAT on professional fees incurred in connection with the sale of various leasehold interests. Because the sale was treated as a transfer of a going concern, which was a transaction outside the scope
20 of VAT, no VAT was payable on the sale price. To overcome this difficulty, Abbey National sought to recover the VAT as residual input tax on general overheads of the business.

33. At [3] of his opinion, Advocate General Jacobs referred to the chain of transactions built up in most transactions within the scope of the VAT system as
25 follows:

> "The deduction system is designed to avoid a cumulative effect where VAT has also been levied on goods and/or services used in order to produce those supplied – that is to say, to avoid VAT being levied anew on VAT already charged. By its operation, a chain of transactions builds up, in which the net amount payable in
30 respect of each link is a specified proportion of the value added at that stage. When the chain comes to an end, the total amount levied will have been the relevant proportion of the final price."

34. We emphasise the point that the Advocate General makes about the right to deduct being limited to VAT levied on goods and/or services *used in order to produce*
35 the goods or services supplied.

35. At [35] of his opinion, Advocate General Jacobs stated his view that what mattered was whether the taxed input is a cost component of a taxable output, not whether the most closely-linked transaction is itself taxable. He said that the conclusion to be drawn from *BLP* was that the question to be asked is not what is the
40 transaction with which the cost component has the most direct and immediate link but whether there is a sufficiently direct and immediate link with a taxable economic

activity. He then referred to the effect of an exempt transaction in the supply chain as follows:

> "…it remains clear from *BLP* that the "chain-breaking effect" which is an inherent feature of an exempt transaction will always prevent VAT incurred on supplies used for such a transaction from being deductible from VAT to be paid on a subsequent output supply of which the exempt transaction forms a cost component. 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."

36. Thus, whilst it was clear from this reasoning that VAT incurred on supplies used by the taxable person for an exempt transaction could not be deducted from VAT paid on a subsequent output supply by that person, where, as on the facts of that case, the supplies were used for a transaction outside the scope of VAT, the chain between the supply to the taxable person and that person's subsequent taxable economic activity was not broken. Accordingly at [38], [42] and [46] of his opinion, the Advocate General concluded that one was required to look beyond the immediate transaction to see whether the supply, in respect of which a claim to deduct VAT was made, formed a cost component of some other taxable transaction, including in the form of general overheads.

37. It is helpful to adopt the terminology of Lord Hodge referred to at [32] of *Frank A Smart* of referring to the transaction on which the supply was used, such as the sale of the subsidiary in *BLP* and the transfer of the premises in *Abbey National* as the "initial transaction" and the taxable person's subsequent transaction or transactions, of which he asserts the relevant supplies are cost components, as "the downstream transaction."

38. As Lord Hodge observed at [33] of *Frank A Smart,* the CJEU in its judgment in *Abbey National* did not expressly adopt the Advocate General's distinction between the chain-breaking effect of the use of the supply in an initial transaction which is an exempt transaction and the absence of that break in an initial transaction outside the scope of VAT, but he observed that the CJEU's reasoning was consistent with the Advocate General's approach.

39. The principle that the supplies made under the initial transaction must be used in order to produce the supplies made under the downstream transactions, as set out at [3] of the Advocate General's opinion in *Abbey National*, is well illustrated by the case of *CEE v Southern Primary Housing Association Limited* [2004] STC 209. In that case, the taxpayer purchased land intending to sell it as developed land. It paid VAT on the price of the land as the vendor had elected to waive exemption from VAT for sales of land. The company then sold the land to a housing association and entered into a development contract with the housing association under which the taxpayer was to build housing for the housing association on the land. It was common ground that those transactions were commercially connected and that the supply of land by the taxpayer to the housing association was considered a supply of goods. The question was whether the land purchased by the taxpayer was "used for the purposes

of the taxpayer's taxable transaction", namely the development contract thus allowing the input tax paid on the purchase of the land to be recoverable.

40. The Court of Appeal held that the input tax on the cost of the land was not a cost of the development contract. The fact that they were commercially linked land transactions did not mean that those transactions were directly linked to the costs of the development contract.

41. Jacob LJ, who gave the only substantive judgment, said that the court below had fell into error by applying a test of attribution for which there was no authority, namely whether the input enabled the taxpayer to make a taxable supply and had failed to appreciate that the taxpayer's use of the land was exhausted on its sale and the land could not thereafter be attributed to construction works carried out thereafter. His reasoning was as follows:

> "32.…The land purchase transaction was commercially necessary to make its performance commercially possible, but it was not a cost component of the contract itself in the same way as the costs of materials used. There is a link with the contract but the link was not direct and immediate. The development contract would not have been made but for the associated land purchase and sale. But "but for" is not the test and does not equate to the "direct and immediate link" and "cost component" test.
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> ….
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> 35.Again if one applies the "fundamental principle" that "VAT applies to each transaction by way of production or distribution of deduction of the VAT directly borne by the various cost components" … one is driven to ask whether the land purchase price is a cost component of the development contract – which to my mind it is obviously not. … the test is whether the expenditure on the land purchase was part of the costs of the development contract which used the land acquired. It did not. The carrying out of the development was on the land acquired, but did not utilise the land, whose ownership was irrelevant…"

42. This case is therefore authority for the proposition that the mere fact that "but for" the input cost in question taxable supplies would not have been made is not enough to establish the requisite "direct and immediate link" between the input cost and the taxable supplies.

43. *Mayflower Theatre Trust Ltd v HMRC* ("*Mayflower*") [2007] STC 880 is a case which has a number of similarities with the case before us. The taxpayer was a charitable trust which ran a theatre. The trust did not produce its own performances but bought in productions from independent production companies. Consideration was paid to the production companies who bore the costs of the production including a proportion of the marketing expenses. The cost of financing the purchase of productions was financed mainly by the sale of tickets which, as in the current case, were exempt supplies for VAT purposes. The trust also made taxable supplies of programmes, confectionery and drinks, sponsorship rights, corporate entertainment

and advertising. The trust claimed that some of the production services were used in making taxable supplies and that, accordingly, a proportion of the input tax paid on the services was deductible pursuant to Regulation 101 (2) (d) of the Regulations.

44. The trust argued that the programme used the production and that there was therefore a direct and immediate link between them. However, HMRC contended that the production costs were not direct cost components of the programmes; the mere fact that they contained information about a performance did not create a direct and immediate link as what was being "used" was the commercial opportunity which arose out of the existence of an audience that had paid for the right to see the performance. The Tribunal, which considered the taxable supplies as a whole, accepted HMRC's argument that, as patrons could choose whether to purchase a programme, confectionery etc., the prior purchase of a ticket would break any link with the consideration the trust paid to the production company because of the exempt nature of the supply of the ticket.

45. The Court of Appeal disagreed with the Tribunal, agreeing with Hart J who had allowed HMRC's appeal in the High Court. Carnwath LJ, who gave the leading judgment concluded at [40] to [43] as follows:

> "40. By dealing compendiously with all these items, the tribunal has, in my view, failed adequately to address the particular characteristics of the programme sales, as distinct from the other items, for example, sales of confectionery and drinks. Rightly in my view, the Trust has not sought in this court to claim a sufficient link between such sales and the production services. Such sales are the same in character whether they are in an ordinary shop, a theatre kiosk, or a railway station. As with the bar sales in the *Royal Agricultural College* case (cited in *Dial-a-Phone*, see above), any link with the activities of the particular location is "indirect and not immediate". The programme sales were distinguishable, because of the necessary link between the contents of a programme and the particular production for which it was sold. The question for the tribunal was whether this link was "sufficiently close" to meet the *BLP* test. Failure by the tribunal to recognise and address this distinction was in my view itself an error of law, which entitles us to reconsider the primary facts.
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> 41. One can extract four more specific points from the tribunal's reasoning: (i) The selling price of the programmes was not related to the consideration paid to the production companies, but was arrived at by fixing an appropriate mark-up on the cost of materials used; (ii) There was no support in the company's accounts for a relationship between the sales of programmes and the consideration paid to the production company; (iii) The programmes were bought separately from tickets, and patrons could choose whether to buy them; (iv) Prior purchase of a ticket would "break the link" (if any) because of the exempt nature of the ticket supply.
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> 42.Without disrespect to the tribunal, I find none of these points persuasive.

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(i)The lack of a direct relationship between the price of the output supply and the consideration paid for the input is not determinative. I would adopt Hart J's comment (see [2006] STC 1607 at [44]), based on *Dial-a-Phone*:

> "…, in finding that… the *BLP* test was satisfied in that case, no reliance was placed either by the Tribunal or the higher courts on any finding that the price charged for the insurance intermediary services had been calculated by reference to the cost of the advertising and marketing inputs. These were nonetheless found to have been "used for" supplying those services. A sufficient nexus existed without it being necessary to show that those inputs were a "cost component" of the price charged for the relevant outputs in the very narrow sense adopted by the Tribunal in the present case."

(ii)The company's accounts may be of some relevance, but they are unlikely to be conclusive. Their purpose is to give a fair view of the business, not of the relationships between particular inputs and outputs for VAT purposes. (iii) That the patron has a choice whether to buy is true of any retail sale, but seems to me irrelevant to the question of attribution. That might have been relevant to an argument (which has not been advanced) that there was one composite supply of the ticket and the programme, but not to the nature of the link within any particular supplies. (iv) The tribunal seems to have misunderstood the "breaking the chain" rule. That would only come into play if the two transactions were links in the same chain, in the sense that one was "a cost component" of the other…. However, the ticket sales and the programme sales are not linked in that way; they are separate transactions. The mere fact that one precedes the other in time, as Miss Hall accepts, is not enough. The question is, not whether they are links in the same chain, but whether each of them has a sufficiently direct link with the production supplies to satisfy the *BLP* test. The misapplication of the "breaking the chain" rule was another error of law, which entitles us to re-open the tribunal's conclusion.

43.On this point I accept the Trust's submissions. …I think we are entitled to draw our own inference from the primary facts which are not in dispute. I would in any event be prepared to go further, if necessary, and say that, applying the *BLP* test correctly, the only reasonable view is that there was a direct and immediate link between the production services and the programmes. It is true that the production companies were not directly responsible for the programmes, other than the provision of information. But the productions for which they were responsible, and which provided the subject-matter of the contracts, also provided the subject-matter of the programmes. To that extent, they were as much part of the raw material used in preparing the programmes, as the paper and ink from which they were physically made. That in my view is an objective link, sufficiently close to satisfy the test."

46. We observe that Carnwath LJ found that the downstream transactions consisted of two parallel transactions, namely an exempt supply of tickets and a zero rated supply of programmes and that the production services were a cost component of each

separately rather than the supply of tickets being a cost component of the supply of programmes. The initial transaction was, however, a cost component of both downstream transactions and had a direct and immediate link to both. On that basis, the "breaking the chain" rule identified by Advocate General Jacobs in *Abbey National* had no application.

47. It is also worthy of note that at [33] Carnwath LJ rejected the trust's submission that the nature of a "direct and immediate link" encompasses a spectrum of possibilities from direct attribution of a given output to a given output at the one end, to overheads of the business attributable to the whole of the business activity at the other. He said that "the metaphor of a "spectrum" is unhelpful; a "slippery slope" might be more apt" and that the special treatment of "overheads" or "general costs" served a particular limited purpose in the VAT system which should not be extended. It was clear that in this paragraph Carnwath LJ was only referring to the special treatment of overheads and emphasised at [34] that *Mayflower* was not about overheads but about specific attribution and he rejected the "overheads analysis".

48. The essence of ROH's case is that the Production Costs, viewed objectively, on an economically realistic view, in all the circumstances, were incurred and used, in part, by ROH to bring customers to its restaurants and bars and consume the taxable supplies of catering offered in the Opera House. In support of this analysis, Mr Mantle relied on two cases which have considered whether expenses incurred in order to attract customers to purchase taxable supplies can be regarded as cost components of those supplies. The argument is that the Production Costs can be regarded as being in the nature of costs incurred in order to market the attractions of the Catering Supplies, in the context of the findings of the FTT that a visit to the Opera House was "a fully integrated visitor experience."

49. The first of these cases is Case C–126/14 *Sveda UAB v VMI ("Sveda")* [2016] STC 447. As Lord Hodge observed at [50] of *Frank A Smart*, this case vouches the direct and immediate link between an input incurred in the context of an initial transaction, which is not an economic activity, and the taxable person's general economic activity and downstream transactions.

50. Sveda, a Lithuanian company, entered into an agreement with the Lithuanian Ministry of Agriculture in which it undertook to construct a recreational path and to offer it to the public free of charge. The Ministry undertook to pay 90% of the construction costs and Sveda was to pay the balance. Sveda undertook to provide the path to the public free of charge for five years. Sveda sought to deduct as input tax VAT which it paid on the acquisition or production of capital goods for the construction of the path. The Lithuanian tax authorities refused to allow the deduction and Sveda appealed that decision. On appeal the Supreme Administrative Court found that Sveda intended to carry out economic activities in the future as it would sell food or souvenirs to visitors to the recreational path. It referred to the CJEU the question (as re-formulated by the CJEU) whether article 168 of the PVD must be interpreted as granting a taxable person the right to deduct input VAT paid for the production or acquisition of capital goods, for the purposes of a planned economic activity related to

rural and recreational tourism, which (i) are directly intended for use by the public free of charge, and (ii) may be a means of carrying out taxed transactions.

51. The principal issue considered by Advocate General Kokott in her Opinion is whether the taxable supplies acquired by Sveda as part of the construction project could be said to be used for the purpose of its later economic activity in the form of the making of the taxable supplies referred to above. It was not a case where there were both exempt and taxable supplies made or where the fairness of an apportionment was in issue. No charge was made for entry and, for that reason alone, the provision of the recreational facility to the public was not taxable. The issue, as the Advocate General put it at [31] of her Opinion, was:

> "The acquisition or production of capital goods therefore has two different purposes. Firstly, we see the availability of the recreational trail to the public free of charge (primary use) which does not, under Article 168 of the VAT Directive, confer any right to deduct input tax. Secondly, we see however, use of the recreational trail as a means of supplying to visitors services which are liable to tax (secondary use), from which the right to deduct input tax arises. Which of these two purposes is then decisive in the context of Article 168 of the VAT Directive?"

52. At [32] the Advocate General referred to the "direct and immediate link" test established in *BLP*. But she then goes on:

> "33. However, the Court has further developed its case-law since that case. It still remains the case that for Article 168 of the VAT Directive to apply a direct and immediate link must have been found between a given input transaction under examination and a particular output transaction or transactions giving rise to the right of deduction. Such a link may nevertheless also exist with the economic activity of the taxable person as a whole if the costs of the input transactions form part of the general costs of the taxable person and are therefore cost components of all goods or services delivered or provided by him.
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> 34. According to recent case-law, the decisive factor for a direct and immediate link is consistently that the cost of the input transactions be incorporated in the cost of individual output transactions or of all goods and services supplied by the taxable person. This applies irrespective of whether the use of goods or services by the taxable person is at issue.
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> 35. Consequently, there is a right of deduction in the present case if the cost of acquiring or manufacturing the capital goods of the recreational path is incorporated, in accordance with case-law, in the cost of the output transactions, taxed under the VAT Directive."

53. At [41]-[47] of her Opinion the Advocate General addressed specifically the question whether the existence of a direct link between the input costs of the initial transaction and the downstream transactions depends in any way on the incorporation of those costs in the price charged for the output supply. She said that was not the case: at [44] she said that all input transactions which objectively belong to the cost

component of the output transactions also confer entitlement to deduct input VAT. She went on to say at [45] to [47]:

> "45. The existence of an objective economic link between input and output transactions is therefore crucial to the question whether the costs are incorporated into the price of a service as understood in case-law. A merely causal link is clearly not sufficient. However, if an input transaction objectively serves the purpose of the performance of certain or all output transactions of a taxable person, there is a direct and immediate link between the two as understood in case-law. This is because in such a case the input transaction constitutes, from an economic perspective, a cost component in the provision of the respective output transaction. As the wording of Article 168 of the VAT Directive already indicates, that therefore depends on the objective purpose of the use of an input transaction.
>
> 46. In the present case the national court found that the creation of the recreational path serves to attract visitors who may then be supplied with goods and services for consideration. Consequently, the creation of the recreational path belongs, from an economic perspective, to the cost components of these transactions.
>
> 47. It follows that there is in principle a direct and immediate link, as understood in case-law, between the acquisition or manufacture of the capital goods of the recreational path and the chargeable services offered to visitors."

54. Thus it is clear that the non-inclusion of the input costs of the initial transaction in the price charged for the downstream transactions will not prevent the inputs being treated as cost components of that supply and therefore from satisfying the used for test under Article 168, provided the link is not merely a causal link. The only issue was whether, objectively viewed, a direct economic link existed between the input costs and the taxable supplies which Sveda intended to make at the facility. The Advocate General then considered whether there was a "break in the chain" which would preclude the deduction as would have been the case had the use of the facility by the public involved the making of an exempt supply. At [48]-[53] the Advocate General said:

> "48. The fact that the recreational path is made available to visitors free of charge does not exclude the right of deduction.
>
> 49. Although this is the primary use of the capital goods of the recreational path, such use may break the direct and immediate link with secondary use for taxed output transactions in two cases only.
>
> 50. The first case is if the primary use is for supplies provided for a consideration but exempt from VAT. Here the input transactions belong to the cost components of exempt output transactions and are thus incorporated into their price. However, Article 168 et seq. of the VAT Directive provides, in principle, no right of deduction for these transactions. According to case-law, it is irrelevant in such a situation that the input transactions serve an additional 'ultimate' aim that also entails taxed output transactions.

> 51. In the case at hand, however, the primary use is not for exempt chargeable transactions, but for use free of charge.
>
> 52. The second case in which a direct and immediate link would be broken between the input transactions and the provision of chargeable services to visitors is if the primary use of the recreational path for use by visitors free of charge represented a non-economic activity of Sveda. This is because in the case-law there is no right of deduction for a taxable person's expenditure in so far as it is linked to the exercise of non-economic activities.
>
> 53. However, this is not the case here, according to the findings of the national court. The mere fact that a service is provided free of charge does not form the basis — contrary to the Commission's view — for a non-economic activity of a taxable person. In this respect the United Kingdom rightly referred at the hearing to the example of a shopping centre that provides customers with free parking."

55. Accordingly, at [67] the Advocate General proposed the following answer to the question referred:

> "Article 168 [PVD] must be interpreted to the effect that a taxable person has the right to deduct input VAT paid in producing or acquiring capital goods, which (i) are directly intended for use by members of the public free of charge, but which (ii) are used as a means of attracting visitors to a place where the taxable person, in carrying out his economic activities, plans to supply goods and/or services."

56. The CJEU in its judgment answered the question in slightly different terms to what was proposed by the Advocate General, as we explain at [58] below.

57. The Court observed at [32] that the direct and immediate link between the input expenditure incurred and the economic activity subsequently carried out by the taxable person is severed where the goods or services required are used for the purposes of transactions which are exempt or outside the scope of VAT. At [33], it said that the expenditure in creating the path could be linked to the economic activity planned by Sveda, so that the expenditure did not relate to activities that were outside the scope of VAT. It then said at [34] and [35]:

> "34. Therefore, immediate use of capital goods free of charge does not, in circumstances such as those in the main proceedings, affect the existence of the direct and immediate link between input and output transactions or with the taxable person's economic activities as a whole and, consequently, that use has no effect on whether a right to deduct VAT exists.
>
> 35. Thus, there does appear to be a direct and immediate link between the expenditure incurred by Sveda and its planned economic activity as a whole, which is, however, a matter for the referring court to determine."

58. It gave its answer to the question referred at [37] as follows:

> " Having regard to all the foregoing considerations, the answer to the question asked is that Article 168 of the VAT Directive must be interpreted as granting, in

circumstances such as those in the main proceedings, a taxable person the right to deduct the input VAT paid for the acquisition or production of capital goods, for the purposes of a planned economic activity related to rural and recreational tourism, which are (i) directly intended for use by the public free of charge, and may (ii) enable taxed transactions to be carried out, provided that a direct and immediate link is established between the expenses associated with the input transactions and an output transaction or transactions giving rise to the right to deduct or with the taxable person's economic activity as a whole, which is a matter for the referring court to determine on the basis of objective evidence."

59. Mr Mantle relies in this case for his submission that in the same way that the recreational path in *Sveda* was used as a means of attracting customers to partake of Sveda's taxable supplies, in this case the Production Costs can be regarded as having been used in part as a means of attracting customers to partake of the Catering Supplies. We return to that submission later, but observe from [37] of the judgment of the court emphasised, in the way that the Advocate General's conclusion at [67] of her opinion did not, that even if the initial transaction "enabled" taxed transactions to be carried out, it was still necessary to establish a direct and immediate link between the expenses associated with the initial transaction and the downstream transactions.

60. The second case relied on by Mr Mantle is *HMRC v Associated Newspapers Ltd ("ANL")* [2017] STC 843. We need not say much about the facts and matters arising in that case, other than to say that one of the questions to be determined was whether input tax was deductible in respect of vouchers purchased from high street retailers for distribution to the customers of the taxpayer's newspaper publishing business as part of a scheme to promote the sale of the taxpayer's newspapers.

61. It is clear that Patten LJ, who gave the only reasoned judgment, proceeded on the basis that the question as to whether the acquisition of the vouchers had a direct and immediate link to the supplies of newspapers was to be determined on the basis that the vouchers were linked to the business as a whole as an overhead rather than as being linked to a particular output supply: see [37] to [41] where the discussion is focused on the circumstances in which particular inputs can be linked to the taxpayer's economic activity. The main focus of the discussion was on the position where there was a direct and immediate link with the taxpayer's overall economic activity as opposed to exempt supplies.

62. It was in that context that Patten LJ, reviewed *Sveda* when considering the question as to whether the cost of purchasing the vouchers was attributable to the taxpayer's sales of newspapers. He then said this at [47] and [48]:

"47. It seems to me that the CJEU has clearly moved away in these recent decisions from any disregard of the ultimate economic purpose of the relevant expenditure in considering whether it should be treated as linked to the taxpayer's wider economic activities. This is not a question of subjective intent but requires an objective analysis in terms of the taxpayer's identifiable economic activities of why the input supplies were acquired. Although there must, I think, be some evidence that the cost of the input supplies was passed on as part of the cost of the supplies which the taxable person subsequently makes, the absorption of those costs as part of the expenditure of running the business is not to be

ignored merely because they also facilitated the making of supplies which in themselves were either exempt or outside the scope of the PVD.

48. So in the present case the cost to ANL of acquiring the vouchers can be treated in purely causal terms as attributable to the onward supply of the vouchers. Without the purchase of the vouchers their free distribution could not have taken place. However, in economic terms, the cost of purchasing the vouchers was also part of ANL's overall expenditure in the production and sale of its newspapers which the vouchers were intended to promote. The fact that the vouchers were provided free to buyers of the newspapers merely serves to confirm that they were cost components of the business rather than the onward supply of the vouchers."

63. It is therefore clear from this passage that Patten LJ was considering whether the vouchers were cost components of the taxable supplies of newspapers on the basis of the necessary link to the taxpayer's business as a whole as an overhead of that business rather than their being linked to any particular downstream transactions. Therefore, in indicating at [47], having reviewed *Sveda*, that there had been a movement away from recent decisions, he was referring to the change of approach in how exempt supplies or supplies outside the scope of VAT were to be taken into account when considering the link to the taxpayer's wider economic activities.

64. Patten LJ referred to *Mayflower* at [55] as follows:

"In the *Mayflower Theatre Trust* case Carnwath LJ seems to have been concerned to remain true to the reasoning in *BLP* as he understood it by not extending the test of what constitutes a direct and immediate link: see the references at [33] of the judgment to a slippery slope. But, in the light of the judgment in *Sveda*, a different approach seems now to be required. The fact that services in the form of the vouchers were acquired in order to make non-taxable output supplies of the same items to ANL's customers is not determinative if the cost of those supplies is in fact a component of ANL's taxable business: see *Sveda* at [34]."

65. In our view, in this passage, consistent with what he said at [47], Patten LJ was recognising that the jurisprudence which started with *BLP*, and which was followed by Carnwath LJ in *Mayflower*, had developed to the extent that there was now wider scope for overhead costs to be deductible as cost components of the business as a whole.

66. However, where the link is to the taxpayer's wider economic activities, in applying the direct link test account must be taken only of the transactions which are objectively linked to a person's taxable activity. That appears from the Court of Appeal's decision in *HMRC v University of Cambridge* [2018] STC 848 ("*University of Cambridge*"). Patten LJ set out his analysis of the position following *ANL* and *Sveda*, and in the light of the CJEU's subsequent judgment in Case C-1324/16 *Iberdrola* at [42] to [45] as follows:

"42. As I indicated in [47] of my judgment in *Associated Newspapers*, the Court seems to have rejected the view expressed by Advocate General Jacobs that a

non-taxable transaction can be ignored in determining the output supply to which the expenditure is directly linked for the purposes of Article 168. We therefore accept the submission of the Commissioners that a finding of a direct link to such a supply will render the input tax irrecoverable just as in the case of an exempt output supply. But the decision also, we think, confirms that in appropriate cases expenditure which is factually attributable to a more immediate (non-taxable) activity such as the creation of the free discovery path facility can for VAT purposes be treated as linked to the economic activity which will follow. It appears from the judgment in *Sveda* that this falls to be determined not by reference to what might be said to be the purpose of the expenditure because that approach was rejected in *BLP* and that question is in any case capable of more than one answer depending on how wide a view of the consequences of the transaction one takes. On one view the construction of the path in *Sveda* was the purpose behind the expenditure. Nor is it resolved simply by establishing a causal connection. Instead the question seems to be whether one can link the expenditure to the ultimate economic activity by treating it as a cost component of a specific taxable supply or as an overhead of the business, i.e. are the costs incorporated in the cost of the taxpayer's economic activities to use the test suggested by the Advocate General.

43. To complete the review of the CJEU authorities, we come to Case 132/16 *Iberdrola Inmobiliaria Real Estate Investments EOOD* EU:C:2017:683, [2017] All ER (D) 114 (Sep). It concerned the reconstruction by the taxpayer company for a local authority of a sewage pumping station as what amounted to a condition of being able to obtain planning permission for a development of some 30 apartments within the vicinity. On completion of the work to the pumping station Iberdrola was permitted to connect the apartments to the station. Expert evidence was given to the referring court that without the reconstruction of the pumping station it would not have been possible to connect the development to the station because the existing sewer and drainage system were inadequate. Iberdrola sought to deduct the input tax on the cost of the works to the pumping station as a cost component of the taxable supplies which it made as part of its subsequent housebuilding activity. This was resisted by the tax authority on the basis that the relevant input costs were related to the construction works to the pumping station which were provided free of charge to the municipality even though they also served to unlock the development of the apartments.

44. The CJEU adopted the same reasoning as in *Sveda*, holding that input tax was irrecoverable if directly linked to either an exempt or a non-taxable transaction and that in applying the direct link test national courts should consider and take account only of the transactions which are objectively linked to a person's taxable activity:

> "31. It is apparent from the case-law of the Court that, in the context of the direct-link test that is to be applied by the tax authorities and national courts, they should consider all the circumstances surrounding the transactions concerned and take account only of the transactions which are objectively linked to the taxable person's taxable activity. The existence of such a link must thus be assessed in the light of the objective content of the transaction in question (see, to that effect, judgment of 22 October 2015, *Sveda*, C-126/14, EU:C:2015:712, paragraph 29).

32. In the appraisal of the question as to whether, in circumstances such as those at issue in the main proceedings, Iberdrola has the right to deduct input VAT for the reconstruction of the waste-water pump station, it is therefore necessary to determine whether there is a direct and immediate link between, on the one hand, that reconstruction service and, on the other hand, a taxed output transaction by Iberdrola or that undertaking's economic activity.

33. It is clear from the order for reference that, without the reconstruction of that pump station, it would have been impossible to connect the buildings which Iberdrola planned to build to that pump station, with the result that that reconstruction was essential for completing that project and that, consequently, in the absence of such reconstruction, Iberdrola would not have been able to carry out its economic activity.

34. Those circumstances are likely to demonstrate the existence of a direct and immediate link between the reconstruction service in respect of the pump station belonging to the municipality of Tsarevo and a taxed output transaction by Iberdrola, since it appears that the service was supplied in order to allow the latter to carry out the construction project at issue in the main proceedings.

35. The fact that the municipality of Tsarevo also benefits from that service cannot justify the right to deduct corresponding to that service being denied to Iberdrola if the existence of such a direct and immediate link is established, which is a matter for the referring court to determine."

45. It can be seen from these paragraphs that a particular complication in *Iberdrola* was that the local municipality rather than the taxpayer or its customers benefited from the works to the pumping station in that it was owned and operated by the municipality for waste water disposal. This persuaded the Advocate General to distinguish the facts from *Sveda* and to conclude that the provision of the services free of charge to a third party meant that the input tax was irrecoverable. The Court, however, rejected this by applying a but-for test of causation to the works themselves and ruling that the benefits received from the works by the municipality did not prevent the costs associated with the works being attributable to the housing development which the reconstruction of the pumping station facilitated."

67. We observe that in *Iberdrola* the finding was that the costs incurred in relation to the pumping station did have a direct and immediate link to the taxpayer's taxable activities.

68. *University of Cambridge* was the subject of a reference to the CJEU by the Court of Appeal. The CJEU issued its judgment on 3 July 2019 (Case C-316/18 [2019] STC 1523). As the CJEU records at [9], the university is a not-for-profit educational institution whose principal activity is the provision of educational services, which are VAT exempt, but which also makes taxable supplies including commercial research,

the sale of publications, etc. The university's activities are financed in part by charitable donations and endowments, which it places in a fund and invests. The university had claimed a right to deduct input VAT relating to fees which it had paid to third party managers of the fund on the basis that the income generated by the fund had been used to finance the whole range of its activities.

69. The CJEU summarised the relevant principles to be applied, as most recently stated in *Iberdrola,* at [25] to [27] as follows:

> "25. In accordance with settled case-law, in order for a taxable person to have a right to deduct input VAT, there must be a direct and immediate link between a particular input transaction and a particular output transaction or transactions giving rise to the right to deduct. The right to deduct VAT charged on the acquisition of an input asset or service presupposes that the expenditure incurred in acquiring that asset or service was a component of the cost of the output transactions that gave rise to the right to deduct…
>
> 26.However, a taxable person also has a right to deduct even where there is no direct and immediate link between a particular input transaction and an output transaction or transactions giving rise to the right to deduct, where the costs of the goods or services in question are part of his general costs and are, as such, components of the price of the goods or services which he supplies, as such costs do have a direct and immediate link with the taxable person's economic activity as a whole…
>
> 27. It follows from the above that, in either case, whether there is such a direct and immediate link will depend on whether the cost of the input goods or services is incorporated either in the cost of particular output transactions or in the cost of goods or services supplied by the taxable person as part of his economic activities."

70. The CJEU decided that the input tax claimed by the university in this case was not deductible. Its reasoning was set out at [31] and [32] as follows:

> "31. It is true that the fact that costs are incurred in the acquisition of a service in the context of a non-economic activity does not, in itself, preclude those costs giving rise to a right to deduct in the context of the taxable person's economic activity, if they are incorporated into the price of particular output transactions or into the price of goods and services provided by the taxable person in the context of that economic activity …
>
> 32. However, in the present case, it is apparent from the documents before the Court that, first, costs relating to the management of donations and endowments invested in the fund concerned are not incorporated into the price of a particular output transaction. Second, as it is apparent from the documents before the Court that (i) the University of Cambridge is a not-for-profit educational establishment and (ii) the costs at issue are incurred in order to generate resources that are used to finance all of that university's output transactions, thus allowing the price of the goods and services provided by the latter to be reduced, those costs cannot be considered to be components of those prices and, consequently, do not form part of that university's overheads. In any event, as there is no direct and immediate link in the present case either between those costs and a particular output

> transaction or between those costs and the activities of the University of Cambridge as a whole, the VAT relating to those costs is not deductible."

71. Thus again, the requirement that the costs of the initial transaction be incorporated into the price of particular output transactions or into the price of goods and services provided by the taxable person in the context of his taxable activity is made clear.

72. The latest case where the relevant principles have been considered is *Frank A Smart*. The relevant facts were that the taxpayer, which carried out a farming business, received agricultural subsidies from the Scottish Government, known as the Single Farm Payment ("SFP"). Those SFPs derived from units of entitlement to single farm payments allocated to the United Kingdom by the European Union ("SFPEs") and which were allocated to farmers without consideration. SFPEs were tradeable. In addition to receiving SFPs, the taxpayer took advantage of the market in SFPEs to accumulate a fund for the development of its business. The taxpayer paid VAT on the SFPEs which it purchased and sought to deduct that VAT as input tax. HMRC refused to allow these deductions. They contended that the taxpayer acquired the SFPEs to generate the receipt of SFPs, which was a form of investment income outside the scope of VAT and that the receipt of the SFP was a non-economic activity. Accordingly, HMRC contended that there was no direct and immediate link between the acquisition of the SFPEs and a taxable output transaction by the taxpayer, nor was VAT deductible on the basis that the SFPEs were a general overhead of the taxpayer's business.

73. The FTT found that when it purchased the SFPs, the taxpayer intended to apply the income which it received from the SFPs to pay off its overdraft and develop its business operations. The FTT concluded that the acquisition of the SFPEs was a funding exercise which related to the taxpayer's business overheads in its farming enterprise. It found that the taxpayer had raised finance for its future economic activities as a whole. There was a direct and immediate link between the expenditure and the taxpayer's future taxable supplies, the FTT having found that the purchase of the SFPs did not form a separate business activity of the taxpayer but was "a wholly integrated feature of the farming enterprise" and not a separate enterprise. These holdings were upheld by the Upper Tribunal and the Inner House of the Court of Session. HMRC then appealed to the Supreme Court.

74. As we have said, Lord Hodge carried out a detailed analysis of the jurisprudence of the CJEU in the relevant cases. He then set out the propositions that he had derived from his analysis which were relevant to the appeal at [65]. Although they do not cover all the ground that we need to consider in determining the present appeal it is helpful to set out Lord Hodge's summary as follows (omitting his citation of authorities):

> "(i) As VAT is a tax on the value added by the taxable person, the VAT system relieves the taxable person of the burden of VAT payable or paid in the course of that person's economic activity and thus avoids double taxation. This is the principle of deduction set out in article 1(2) and operated in article 168 of the PVD…

(ii) There must be a direct and immediate link between the goods and services which the taxable person has acquired (in other words the particular input transaction) and the taxable supplies which that person makes (in other words its particular output transaction or transactions). This link gives rise to the right to deduct. The needed link exists if the acquired goods and services are part of the cost components of that person's taxable transactions which utilise those goods and services…

(iii) Alternatively, there must be a direct and immediate link between those acquired goods and services and the whole of the taxable person's economic activity because their cost forms part of that business's overheads and thus a component part of the price of its products…

(iv) Where the taxable person acquires professional services for an initial fund-raising transaction which is outside the scope of VAT, that use of the services does not prevent it from deducting the VAT payable on those services as input tax and retaining that deduction if its purpose in fund-raising, objectively ascertained, was to fund its economic activity and it later uses the funds raised to develop its business of providing taxable supplies…

(v) Where the cost of the acquired services, including services relating to fund-raising, are a cost component of downstream activities of the taxable person which are either exempt transactions or transactions outside the scope of VAT, the VAT paid on such services is not deductible as input tax…Where the taxable person carries on taxable transactions, exempt transactions and transactions outside the scope of VAT, the VAT paid on the services it has acquired has to be apportioned under article 173 of the PVD.

(vi) The right to deduct VAT as input tax arises immediately when the deductible tax becomes chargeable... As a result, there may be a time lapse between the deduction of the input tax and the use of the acquired goods or services in an output transaction, as occurred in *Sveda*. Further, if the taxable person acquired the goods and services for its economic activity but, as a result of circumstances beyond its control, it is unable to use them in the context of taxable transactions, the taxable person retains its entitlement to deduct…

(vii) The purpose of the taxable person in carrying out the fund-raising is a question of fact which the court determines by having regard to objective evidence. The CJEU states that the existence of a link between the fund-raising transaction and the person's taxable activity is to be assessed in the light of the objective content of the transaction…The ultimate question is whether the taxable person is acting as such for the purposes of an economic activity. This is a question of fact which must be assessed in the light of all the circumstances of the case, including the nature of the asset concerned and the period between its acquisition and its use for the purposes of the taxable person's economic activity…"

75. Applying these principles to the facts, Lord Hodge observed at [67] that on the FTT's findings of fact, the purchase of the SFP's was part of an exercise raising funds for the taxpayer's economic activities. He then held at [68] that the FTT was entitled to conclude that when the taxpayer incurred the cost of the purchase of the SFPEs it was acting as a taxable person because it was acquiring assets in support of its current

and planned economic activities, namely farming and a windfarm. The taxpayer was therefore entitled to an immediate right of deduction of the VAT paid on the purchase of the SFPEs and was entitled to retain that deduction so long as it uses the SFPEs which are received as cost components of its economic activities. The taxpayer did not carry out downstream non-economic activities or exempt transactions and therefore no question of apportionment arose.

76. It would appear from the language that Lord Hodge used, that he regarded this as an overheads case because of his reference to the SFPEs having been acquired in support of the whole of the taxpayer's economic activities, rather than on the basis that the acquisitions were linked to specific transactions: see the contrast between his proposition (ii) and (iii) set out at [72] above.

77. For completeness, we should mention one further decision, simply because it was relied on to a material extent by the FTT. That is the FTT's decision in *North Of England Zoological Society v HMRC* [2015] SFTD 841 ("*Chester Zoo*"). The issue before the Tribunal in *Chester Zoo* was whether there was a direct and immediate link between the animal related costs (i.e. the costs of keeping and maintaining animals at the Zoo and in respect of improving and building new animal habitats) and catering and retail supplies. In that case, the FTT found that the attractions and facilities at the Zoo, including catering and retail facilities, all had animal themes and, to a greater or lesser extent, "everything is driven by the animals." The FTT accepted that there was a closer link between the animal related costs and the exempt supply of admission to the Zoo and that the animal related costs were not directly reflected in the prices charged for the catering and retail offerings. However, it concluded, "standing back to look at the overall picture … that in the particular circumstances of the Society's economic activities the animal related costs have a direct and immediate link to the catering and retail supplies. We are satisfied that economically the animal related costs are a cost component of the catering and retail supplies."

78. It seems to us that this was a case decided on its own facts. The FTT applied the principles derived from the CJEU's jurisprudence as it stood at that time, which was after *Mayflower* but before *Sveda* and the cases that followed it. The case is therefore an illustration of the application of those principles to the specific facts of that case. The case does not contain any statement of general principle which we should apply in preference to the principles we derive from the authorities we have considered earlier. Accordingly, we are not unduly influenced by this decision, even though there are some similarities between the facts of that case and the present case.

79. Therefore, to the extent to which we identify an error of law in the FTT's reasoning and we determine to remake the Decision, in our view we can determine the appeal by applying the propositions set out by Lord Hodge in *Frank A Smart*.

80. This is subject to one point of clarification. That is whether the "different approach" referred to by Patten LJ in *ANL* in any way affects the test to be applied in circumstances, such as the present case, where it is common ground that the Production Costs are not in the nature of overheads because they have a direct and immediate link with particular outputs.

81. Lord Hodge did not deal with that point in *Frank A Smart*. He did not need to because, as we have said, *Frank A Smart* was an "overheads" case. His proposition (ii) and his proposition (iii) were clearly expressed as being alternative bases for deduction. Either there was a direct and immediate link between a particular input transaction and a particular output transaction or transactions, which would be established if the acquired goods and services are part of the cost components of taxable transactions which utilise those goods or services, or there is a direct and immediate link between the particular input transaction and the whole of the taxable person's economic activity because the cost of the input transaction forms part of the business's overheads and is thus a component part of the price of the taxable outputs it supplies.

82. In our view, there is nothing in *Sveda* which suggests that either the Advocate General or the CJEU were seeking to blur the distinction between two alternative bases on which a direct or immediate link could be established. In *Sveda,* the reasoning of the CJEU gave more support to an analysis to the effect that the cost of the recreational path was regarded as an overhead of the business rather than being attributable to any particular output transaction or transactions. That would appear to be Lord Hodge's view of the case: see his observation at [50] of *Frank A Smart* referred to at [49] above that *Sveda* was about establishing whether there was a direct and immediate link between an initial transaction and the taxable person's general economic activity and downstream transactions.

83. Furthermore, as we have said at [65] above, where Patten LJ referred to a "different approach" since *Sveda*, he was not saying that there had been any change of approach as to how the "direct and immediate link" test was to be applied in the context of the case, such as this one, where it is accepted that question is whether the initial transaction has a direct and immediate link to specific downstream transactions. In that context, the approach taken by Carnwath LJ in *Mayflower* seems to us still to be correct.

The Decision

84. The FTT undertook a detailed review of the authorities at [17] to [42] of the Decision. It is important to note at this stage that the Decision pre-dated both the CJEU's judgment in *University of Cambridge* and the Supreme Court's judgment in *Frank A Smart*.

85. Having summarised the submissions of the parties at [75] and [76], the FTT made some general observations at [77] derived from the authorities that it had reviewed. We set out the text of that paragraph of the Decision in full as follows:

> "(1) Like the animals in *Chester Zoo*, everything in the present case "is driven" by the ROH's operatic and ballet productions with such productions being the "central draw", "main event" or the "core" of its commercial proposition.
>
> (2) It is not disputed that the profits from the Disputed Supplies enable the ROH to produce its highly acclaimed productions.

(3) Were it not for its artistic reputation the ROH would not be able to generate as much income from its commercial activities as it does.

(4) Therefore, as is clear on the evidence, there is a commercial and/or 'but for' link between the Production Costs and the Disputed Supplies.

(5) It also clear that such a link is not sufficient (see *Mayflower* at [9] and *Cambridge University* at [42]).

(6) The issue is the extent of that link - Why, on an objective analysis in terms of the ROH's identifiable activities, were the Productions Costs incurred and whether there is evidence that the Production Costs were a cost component of and/or have a direct and immediate link with the Disputed Supplies (see *ANL* at [47] and *VWFS* at [41]).

(7) The test is not identifying the most direct and immediate link but whether there is a sufficiently direct and immediate link with a taxable economic activity (see *Mayflower* at [9]).

(8) Although a transaction which is exempt from VAT will break the chain of attribution that will "only come into play" where two transactions are links in the same chain (ie one being a cost component of the other) there will not be a chain to break if the transactions are, like the programmes and production costs in *Mayflower*, not linked but separate transactions.

(9) It is necessary to consider all the circumstances surrounding the transactions concerned and take account only of the transactions which are objectively linked to the ROH's taxable activity. The existence of such a link must be assessed in the light of objective content of the transaction in question (see *Sveda* at [31] cited by Patten LJ in *Cambridge University* at [44]).

(10) Finally, as Lord Reed said in *WHA Limited* which Lord Neuberger cited in *Airtours*, decisions about the application of the VAT system are highly dependent on the factual situations involved and a small modification of the facts can render the legal solution in one case inapplicable to another thus limiting the assistance that can be derived from any factual similarities between this case and the authorities to which I was referred, particularly *Chester Zoo*."

86. The FTT then turned to the question as to whether the Catering Supplies had a sufficient direct and immediate link with the Production Costs. Having said at [81] that "like programmes in Mayflower, which were also purchased by ticketholders, the catering in the bars and restaurants of the Opera House are separate supplies rather than links in the same chain", the FTT held that there was a sufficient direct and immediate link. Its reasoning was set out at [82] to [85] as follows:

"82. I agree with [Counsel for ROH] that the comments of Carnwath LJ in relation to the "indirect and not immediate" link sales of confectionary and drink to the activities of a particular location at [40] in *Mayflower* even though the purpose of the performance was "in part" to allow the Trust to make taxable supplies of refreshments (see para 20, above), should be read in the light of the decision of the CJEU in *Sveda* and the remarks of Patten LJ in *ANL* at [55] (see para 36, above) where he considered a different approach to be required.

> 83. That approach, as is apparent from *ANL* and *Cambridge University*, is to objectively consider whether there is a "necessary economic link between the initial expenditure and the economic activities which follow". Adopting such an approach I have come to the conclusion that there is such a link between the Production Costs and taxable catering supplies in this case.
>
> 84. As with the animals in *Chester Zoo*, in this case, as I have already mentioned, it is the opera or ballet that is central to everything the ROH does. It is these performances that bring the restaurants and bars of the Opera House their clientele. Such a connection between the productions and catering supplies is, in my judgment, more than a "but for" link. Taking an economically realistic view the performances at the Opera House, and therefore the Production Costs, are essential for the ROH to make its catering supplies. It therefore follows that the purpose of the Production Costs, objectively ascertained, is not solely for the productions of opera and ballet at the Opera House but also to enable the ROH to maintain its catering income.
>
> 85. As such I am satisfied that the Production Costs do have a direct and immediate [*word missing*] with the catering supplies of the ROH in the bars and restaurants of the Opera House. Given, given [*sic*] the "different approach" which is now required, and notwithstanding the comments of Carnwath LJ in *Mayflower*, I am able to derive some support for such a conclusion in the observation of Patten LJ at [54] of *ANL* that the purpose of the performance in *Mayflower* was in part to enable the Trust in that case was [*sic*] "to make taxable supplies of refreshments"."

87. At [92] the FTT dealt with the ice cream sales as follows:

> "[Counsel for HMRC] relies on the dicta of Carnwath LJ in *Mayflower* cited above in support of HMRC's argument that there is not a direct and immediate link between the Production Costs and ice cream sales. However, given the different approach now required following *Sveda* and *ANL*, to which I have referred above, I consider that, as with catering, the Opera House productions, with their associated costs, are essential for the sale of ice creams. Accordingly, I consider the Production Costs do have a direct and immediate link to the sale of ice creams."

Grounds of Appeal and issues to be determined

88. HMRC were granted permission to appeal on the grounds that the FTT arguably made the following errors of law by:

> (1) finding that the Catering Supplies were "separate supplies" such that any link between the Production Costs and the Catering Supplies was not broken by the exempt nature of the ballet and opera supplies;
>
> (2) failing to give adequate reasons for such a finding; and
>
> (3) failing to apply the "cost component" test.

89. As is apparent from our discussion of the authorities, the "cost component" test is not a separate test to the well-established test of attribution, namely whether there is a "direct and immediate link", in this case between the Production Costs and the

Catering Supplies. Whether an item is a “cost component” of a supply is one way of establishing a “direct and immediate link”.

90. Furthermore, as appears from our discussion of the authorities, a finding that the ballet and opera supplies were “separate supplies” to the Catering Supplies would not be not determinative of the issue because the authorities show that an item of expenditure can be a cost component of both of two separate supplies, with the cost being attributed on a proportionate basis to the two supplies, but only if there is a “direct and immediate link” to both supplies.

91. We have therefore been able to determine this appeal simply by applying the principles to be derived from the authorities as to what constitutes a “direct and immediate link” on the facts of this case and we have therefore not found it necessary to deal with each of the three grounds of appeal separately.

The parties’ submissions

92. HMRC have two fundamental criticisms of the FTT’s reasoning as follows:

(1) The FTT’s approach was objectively to consider whether there was a “necessary economic link between the initial expenditure and the economic activities which follow” and then determined that there was a “necessary economic link” in the sense that the Production Costs were “essential” for ROH to make the Catering Supplies, it “following” from this that the Production Costs were incurred, in part, to make Catering Supplies. Mr Donmall submitted that this approach was incorrect in law and the test that the FTT should have applied was whether the cost of acquiring the input concerned was a component of the cost of the output transaction, that is the cost component test. In essence, the FTT had merely applied a “but for” test.

(2) The FTT found at [84] that it was the opera and ballet performances that brought the restaurants and bars of the Opera House their clientele and were therefore essential for the ROH to make its catering supplies, from which it followed that the purpose of the Production Costs, objectively ascertained, was not solely for the productions of opera and ballet at the Opera House but also to enable the ROH to maintain its catering income. Mr Donmall submitted that the correct analysis was that the Production Costs have a direct and immediate link to the exempt supply of admission to ballet and opera performances, and those attending those performances then consumed catering supplies. The asserted link to the supplies of catering to those attending the ballet and opera performances was, he submits, therefore exclusively via these exempt supplies, and therefore the Catering Supplies were in the same chain of supply as the Production Costs. Consequently, as the CJEU jurisprudence demonstrates, any link between input expenditure incurred for an exempt transaction, and “downstream” economic activity subsequently carried out was severed by the exempt nature of the initial exempt transaction. Mr Donmall submits that the FTT was therefore wrong to have found at [81] that the Catering Supplies were separate supplies rather than links in the same chain.

93. Mr Mantle submits that the FTT directed itself properly at [77] as to the legal principles of the direct and immediate link test. In particular, it correctly directed itself that a "but for link", and/or just a commercial link, between the Production Costs and the relevant outputs was not sufficient for a "direct and immediate link". He submits there was no error of law on the face of the Decision and accordingly the Upper Tribunal is not entitled to interfere with the FTT's evaluation of the facts. In particular, the FTT found that a visit to the Opera House was a fully integrated visitor experience and that the high-quality productions attracted customers to the Catering Supplies. Mr Mantle submits that it was clear from *Sveda* that the costs of attracting customers to use a facility can be a cost component of the taxable supplies that the facility is attracting customers to purchase. Accordingly, Mr Mantle submits, a finding of a "fully integrated visitor experience" allowed the FTT to evaluate and decide, as it did at [84] that there was an economic link that was more than a "but for" link between the Production Costs and the Catering Supplies.

94. Mr Mantle submits that *Sveda* demonstrates, as Patten LJ recognised at [55] of *ANL*, that the ultimate economic purpose of the relevant expenditure was not to be disregarded when considering whether there was a direct and immediate link. Mr Mantle submits that viewed objectively, on an economically realistic view, in all the circumstances, the Production Costs were incurred and used, in part, by ROH to attract customers to its restaurants and bars and consume the taxable supplies of catering offered in the Opera House. He submits that just because there was a closer link to the exempt supplies of tickets to productions, that did not mean that there was no direct and immediate link to the Catering Supplies as well. Mr Mantle submits that the authorities do not support some fundamental bifurcation in the direct and immediate link/cost components test, whether "specific attribution" is being considered, looking to particular outputs, or "overhead attribution", looking to the taxpayer's economic activities as a whole.

Discussion

95. We start by considering whether the FTT correctly directed itself as to the legal test to be applied. This was dealt with by the FTT at [77] of the Decision which we have set out at [27] above. At [77] (1) to (3) the FTT set out a number of its key findings of fact from which it concluded at [77] (4) that there was a commercial and/or "but for" link between the Production Costs and the Catering Supplies. That finding was clearly open to the FTT on the basis of its findings of fact. It then correctly directed itself at [77] (5) that a "but for" link was not sufficient to establish a direct and immediate link.

96. The FTT's exposition of the direct and immediate link test was set out briefly at [77] (6). The FTT did not elaborate that a direct and immediate link could be established either through specific attribution to particular outputs, or through there being a direct and immediate link between the acquired goods and services and the whole of the taxable person's economic activity because the costs form part of the taxpayer's overheads. No doubt that was because there was no argument before the FTT, in the same way as there was no argument before us, to the effect that there was a direct and immediate link between the Production Costs and ROH's economic

activity as a whole. We therefore do not regard [77](6) as in itself disclosing any error of law although it was potentially misleading to refer to [47] in *ANL* which was not dealing with specific attribution.

97. However, in our view the approach that the FTT took in applying the "direct and immediate link" test at [82] to [85] was incorrect and amounted to an error of law for the following reasons. At [82], the FTT suggests that Carnwath LJ's observations at [40] of Mayflower, as set out at [45] above, to the effect that the link of ticket sales at the theatre to the sales of confectionary and drink to ticketholders at the theatre, was "indirect and not immediate" would no longer hold good in the light of *Sveda* and the remarks of Patten LJ at [55] of ANL. We do not agree. As we have explained, we have not detected any change of approach on the part of the CJEU in relation to specific attribution cases. The latest formulation of the test is that set out by the CJEU in *University of Cambridge*, as set out at [69] above, and followed by the Supreme Court in *Frank A Smart.* As we have said, that formulation continues to give two alternative bases on which a right to deduct applies, but it is only where the costs of the goods and services are part of the general costs (i.e. overheads) that a right to deduct on the basis of a direct and immediate link with the taxpayer's economic activity as a whole arises. In our view, the FTT erred in its approach by relying on *ANL* and *Sveda* and by holding at [83] that those cases were authority for the proposition that all that was necessary to establish a "direct and immediate link" in this case, a specific attribution case, was to consider whether there was a "necessary economic link" between the Production Costs "and the economic activities which follow".

98. In our view, the FTT's reasoning at [84] takes it no further than establishing a "but for" link between the Production Costs and the Catering Supplies. The FTT is clearly correct in its conclusion in the second sentence of [84] that the opera and ballet performances bring the restaurants and bars of the Opera House their clientele. That clearly establishes a "but for" link. However, in the fourth sentence of [84] the FTT seem to do no more than elevate that link into a "direct and immediate" link on the basis that the Production Costs are "essential" for the ROH to make its catering supplies. In the context in which the word "essential" is used, in our view it does no more than emphasise the commercial link between the productions of opera and ballet and the bars and restaurants and demonstrate that the Catering Supplies could not take place without those productions.

99. Mr Mantle submitted that the direct and immediate link was established because the Production Costs were incurred in order to attract customers to two different supplies therefore the FTT was entitled to find, as it did in the last sentence of [84] and the first sentence of [85], that objectively ascertained, it was not the sole purpose of the Production Costs to enable the opera and ballet performances to take place, but also to enable the ROH to make the Catering Supplies.

100. We reject that submission. The fact that the Production Costs "enabled" the ROH to make the Catering Supplies by attracting customers who bought tickets to the opera or the ballet partake of the Catering Supplies is not sufficient to establish a direct and immediate link. In our view Mr Mantle's reliance on what was said in

Sveda by the Advocate General at [67] of her opinion about the right to deduct input VAT paid in respect of expenditure used to attract customers to purchase taxable supplies is misplaced.

101. As we have said, the CJEU at [37] of *Sveda*, as set out at [58] above, made it clear that whether particular expenditure "enabled" taxed transactions to be carried out was dependent upon a direct and immediate link being established between the expenses associated with the input transactions and specific output transactions. On the facts of *Sveda* that appeared to be the case (although it was a matter to be left to the national court to determine) because there was a direct link between visitors using the recreational path in order to access the place where the taxable supplies took place. In our view, the FTT here has failed to explain how the "direct and immediate" link has been established beyond explaining how the Production Costs enabled the Catering Supplies to take place. Accordingly, it reached its conclusion at [85] that the Production Costs did have a direct and immediate link with the Catering Supplies without applying the test correctly and that was a further error of law on its part. It made the same error at [92] in relation to the ice cream sales.

Conclusion

102. Section 12 of the Tribunals, Courts and Enforcement Act 2007 provides that if the Upper Tribunal finds that the making of the relevant decision involved the making of an error on a point of law it "may (but need not) set aside" the decision, and that, if it does set it aside, it must either remit the case to the FTT with directions for reconsideration, or remake the decision.

103. We have identified that the FTT made errors of law in its approach to the application of the "direct and immediate link" test. In our view, those errors were material and we should therefore exercise our discretion to set aside the Decision.

104. We consider that it is not necessary to remit the matter to the FTT and we can remake the Decision by applying the correct test to the facts found by the FTT.

105. In our view, as this is a specific attribution case, we should consider whether the Production Costs have a direct and immediate link to the Catering Supplies by applying the test most recently articulated by the CJEU at [25] of *University of Cambridge*, as set out at [69] above. In doing so, we also bear in mind the confirmation of the CJEU at [37] of *Sveda* to the effect that the test is more than a "but for" test.

106. We conclude, on the facts found by the FTT, the link between the Production Costs and the Catering Supplies was no more than an indirect link. We accept, as was the case in *Mayflower*, that there were two separate supplies, which operated in parallel, to which the Production Costs were linked. We therefore do not accept Mr Donmall's alternative submission that the Production Costs and the Catering Supplies were in the same chain of supply.

107. However, in our view the Production Costs were only cost components of the exempt supply of tickets to the performances staged by the ROH and were not cost

components of the Catering Supplies. As Mr Donmall submitted, the costume is used for a ballet performance and a guest opera singer sings at the Opera. The Production Costs are, undeniably, specifically attributable to the ballet and opera performances and are physically used to put on the ballet and opera productions. Consistent with what was held by Carnwath LJ in *Mayflower*, the Production Costs are also used in order to produce the programmes for the performances; the performances not only enable the programmes to be produced, but they have a direct and immediate link in that the material from the performances is directly reflected in the content of the programmes.

108. However, the same cannot be said of the Catering Supplies. The Production Costs are not used in order to make supplies of champagne at the bars of the ROH. There is an indirect link to the supplies of champagne in that without the performances the champagne would not be served but that is an indirect link. In no sense could it be said that the Production Costs are part of the costs of supplying the champagne and thus a direct and immediate link is precluded. Whilst accepting that the making of the exempt supplies in this case is promotional of the Catering Supplies and assists in giving the visitor to the ROH "a fully integrated visitor experience", that is not sufficient in itself to enable conclusion to be reached that the Production Costs are a cost component of the Catering Supplies.

109. This case shows that the requirement of a direct and immediate link between the two supplies is an important qualification which must be satisfied if the input tax is to be deducted. It was always clear that a but for test of causation was not sufficient in itself to satisfy the direct and immediate requirement. It is not enough to express the but for test in economic terms and then contend that the link must be considered to be direct and immediate. A requirement that the link be direct and immediate will produce the result in some cases that an indirect link or a non-immediate link will not meet the requirement. The present is such a case. We do not consider that the conclusion in this case is in any way a departure from economic reality.

110. Accordingly, HMRC were correct to deny ROH's claim to recover VAT input tax associated with the Production Costs.

Disposition

111. The appeal is allowed.

MR JUSTICE MORGAN **JUDGE TIMOTHY HERRINGTON**

UPPER TRIBUNAL JUDGES

RELEASE DATE: 22 April 2020