**EXTRA DIVISION, INNER HOUSE, COURT OF SESSION**

**[2017] CSIH 77**
XA55/16

Lord Menzies
Lord Brodie
Lord Drummond Young

OPINION OF THE COURT

delivered by LORD DRUMMOND YOUNG

in the appeal to the Court of Session

by

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS

Appellant

against

a decision of the Upper Tribunal dated 21 January 2016

in an appeal by

FRANK A SMART & SON LIMITED

Respondent

**Appellant: Young QC, Anderson; Office of the Advocate General**
**Respondent: Small; HBJ Gateley**

8 December 2017

[1] The respondent taxpayer is a company that carries on a farming business in Aberdeenshire. The taxpayer has claimed repayment of value added tax amounting to £1,054,852.28 which was paid on its purchase of 34,477 units of Single Farm Payment Entitlement ("SFPE"). Those units are issued by the Scottish Government in accordance

with the European Union Single Farm Payment ("SFP") scheme, a scheme which makes provision for the payment of agricultural subsidies throughout the European Union. The SFPE units purchased by the taxpayer entitled it, on fulfilling specified conditions, to obtain benefits under the SFP scheme. The units are tradeable. The critical question in the appeal is whether the SFP units were services used or to be used for the purposes of the taxpayer's taxable business supplies, so as to entitle it to repayment of the value added tax charged on them. The taxpayer made a claim to such repayment, but this was refused by HMRC. The taxpayer appealed to the First-tier Tribunal, where its claim to repayment was successful. HMRC appealed to the Upper Tribunal, but the appeal was refused. HMRC has now appealed to this court against the decision of the Upper Tribunal.

**Facts**

[2] The First-tier Tribunal made detailed findings in fact at paragraph 38 of its decision. It was noted both by the First-tier Tribunal and on appeal by the Upper Tribunal that those findings were not generally controversial. They were as follows:

> (a) The taxpayer company is wholly owned by Mr Frank Smart, who is its sole director. He and his wife are the whole partners of "Mr and Mrs Frank Smart, trading as Tolmauds Farm", which owns the farmland there. The farm extends to about 200 hectares and is leased by the taxpayer for £30,000 per annum.
>
> (b) The taxpayer receives Single Farm Payments (SFPs). These are agricultural subsidies paid by the Scottish Government. At the inception of the scheme in 2005 UK farmers received initial units of entitlement without consideration. These were tradeable and a market in them developed. To claim the SFP in respect of one unit the farmer must have one hectare of eligible land at his disposal on 15 May of the

particular year. To satisfy this, the requirements of ensuring plant and animal health and maintaining Good Agricultural and Environmental Condition (GAEC) must be met. This latter condition does not require the claimant personally or anyone else to cultivate the land or stock it with animals.

(c) In addition to leasing Tolmauds Farm the taxpayer leased a further 35,150 hectares under seasonal lets. Typically the relative leases were qualified by a post-lease agreement in terms of which the landlord could stock the land or cultivate it himself provided that the ground was kept in GAEC. The rent payable in respect of such seasonal lettings was generally about £1 per acre but could go up to £10 per acre.

(d) At Tolmauds Farm the taxpayer produces beef cattle for slaughter and store purposes. It also produces certain crops. It did not cultivate or stock the ground held on seasonal leases. The taxpayer ensured that it held more hectares than units to ensure that it received its full entitlements to SFP.

(e) Over a period the taxpayer paid about £7.7m in respect of traded SFPE units. In addition to its original allocation of 194.98 units, it purchased a further 34,477 units. This was funded by loan finance from the Clydesdale Bank with whom it had its only bank accounts. These units yielded a payment of £1.7m in the year to 30 September 2011 and of £2.4m in the year to 30 September 2012. VAT was charged to the taxpayer in respect of the units purchased. After about March 2012 the taxpayer did not purchase units bearing "input" VAT. The operation of the SFP Scheme has been extended from 2012 to 2014.

(f) The taxpayer's intention in purchasing units was to apply the income arising in settling its overdraft and developing its business operations. At present and for most

of the material period the farm has been worked by Mr Frank Smart and Roderick, one of his four sons. Both are engaged full-time on the farm. Another son, Stuart, now employed as a land agent, assisted on the farm for a period. There are no other employees. During the material period stock numbers have not been increased, at least significantly. From about 2011 the taxpayer has been considering establishing a wind farm. The necessary preliminary investigations have involved obtaining technical information and costings. Local community responses, including finding a "community partner", have been investigated. A planning application and enquiries have been conducted with professional assistance. Over £119,000 has been spent to date in relation to these matters. The capital costs of such a development would be substantial.

(g) The construction of further farm buildings, including cattle-courts and a Dutch barn, is contemplated. Recently site preparation works have been undertaken with a view to erecting one additional cattle-court. The necessary planning applications have been made.

(h) The possible purchase of neighbouring farms, expected to be on the market for sale shortly, is also being contemplated.

(i) The SFP payments have been accumulated in the taxpayer company and are held as cash in the taxpayer's bank account with the Clydesdale Bank. (This is the taxpayer's only bank account apart from a Euro account in which the payments were deposited initially and then later transferred. This has certain potential currency exchange advantages.) The SFPs received and the amounts of other subsidies are set out in two productions, FS15 and G5. The taxpayer's overdraft has been repaid but

no part of the SFP payments has been withdrawn for any personal use or benefit by Mr Smart.

(j) The taxpayer seeks repayment of VAT paid on SFP units during the period from October 2008 to June 2012. HMRC have refused to make payment. That decision is the subject of the appeals to the First-tier and Upper Tribunals and to the court.

[3] Certain further matters were not in dispute between the parties; these are narrated at paragraph 8 of the decision of the Upper Tribunal. It is agreed in the first place that the taxpayer is a taxable person which carries on an economic activity, in the form of its farming business, and that it has plans to diversify into the production of electricity by means of a wind farm. Secondly, none of the taxpayer's business activities or proposed business activities constitutes or would constitute an exempt supply. Thirdly, the purchase by the taxpayer of SFPE units was a supply of services. Fourthly, the receipt by the company of SFPs was not an economic activity and did not constitute the making of supplies. For the purposes of the European Union legislation governing VAT the expression "economic activity" means an activity governed by the scheme of VAT. Economic activities include both taxable transactions and exempt transactions. These four factors are in our opinion important elements in the proper analysis of the transactions undertaken by the taxpayer in relation to SFP units.

**Decisions of the First-tier and Upper Tribunals**

[4] The First-tier Tribunal allowed the taxpayer's appeal against HMRC's refusal of its claim to repayment of VAT. It held that the taxpayer's intention as to the application of payments received on the purchased units of SFPE was critical to their conclusion. Mr Frank Smart gave evidence that those payments were used to develop the farming business, a view

that was consistent with the farm accounts and other documentation relating to exploratory work for a wind farm development and excavations and site preparation work for a new cattle court, as the first of several new farm buildings. That evidence, it was held, supported the necessary direct and immediate link between inputs and future taxable supplies. The acquisition of SFPE units was a funding exercise related to business overheads. On the basis of two decisions of the European Court of Justice, *Abbey National PLC* v *Commissioners for Customs and Excise*, (Case C-408/98), [2001] STC 297, and *Kretztechnik AG* v *Finanzamt Linz*, (Case C-465/03) [2005] STC 1118, the First-tier Tribunal held that it was irrelevant that the use of capital could not be linked to any specific output transactions but rather was attributed to the company's economic activity as a whole. The whole of the supplies made by the taxpayer were taxable; none was exempt. The financing obtained through the purchase of the SFPE units would be used to fund the farming enterprise; the purchase of the SFPE units was not a separate enterprise, and none of the receipts was abstracted for any unrelated or personal purpose.

[5] The Upper Tribunal upheld the decision of the First-tier Tribunal. After referring to *Abbey National*, *Kretztechnik* and a third case, *Commissioners for Customs and Excise* v *Midland Bank PLC*, (Case C-98/98) [2000] ECR 1-4198, [2000] STC 501, the judge held that the key element of those cases was that an operation that did not fall within the scope of the relevant VAT Directive was found to have been carried out for the benefit of its economic activity in general. That fell to be contrasted with other cases, notably *Securenta Goettinger Immobalienanlagen und Vermoegensmanagement AG* v *Finanzamt Goettingen*, (Case C-437/06), [2008] STC 3473, where the costs in respect of which input tax was incurred were attributable to both economic activities and non-economic activities carried out simultaneously. On the facts found by the First-tier Tribunal, the judge held that the

expenditure in the present case was clearly carried out for the benefit of the taxpayer's economic activity in general. The First-tier Tribunal had found that the financing opportunity afforded by purchasing the SFPE units did not form a distinct business activity but was a wholly integrated feature of the farming enterprise. That finding was fully justified by the evidence. The right to deduct input tax arose immediately upon the incurring of the charge to that tax, and might be exercised in respect of goods and services intended to be used in connection with taxable transactions. Thus, contrary to the submissions for HMRC, the First-tier Tribunal was fully entitled to proceed on the basis of evidence of the taxable person's future intention as demonstrating that the acquisition of entitlement to SFPs was not an end in itself but formed part of the company's economic activity in general.

**The Issue between the Parties**

[6] The critical question in dispute between the parties is whether the input tax paid by the taxpayer on the purchase of SFPEs can be deducted or reclaimed on the ground that the SFPE units were services used or to be used for the purposes of the taxpayer's taxable business supplies. More precisely, the taxpayer has claimed repayment of VAT paid in acquiring SFPEs. That claim has been refused by HMRC. The taxpayer appealed against that refusal, and its appeal has been upheld both by the First-tier Tribunal and by the Upper Tribunal. HMRC has now appealed against the decision of the Upper Tribunal. Its argument is that the taxpayer, in addition to its farming business, is also engaged in an extensive business of trading in SFPE units. This business is not an economic activity for VAT purposes. HMRC contends that the inputs incurred on the acquisition of SFPE units have a direct and immediate link with the taxpayer's trade in SFPE units, not the farming

business, and that because trading SFPE units was not an economic activity the input tax was not deductible. As an alternative, HMRC contends that if the inputs are general costs of the taxpayer's taxable business, the right to deduct is limited to the extent that the VAT inputs are attributable to that business, which constitutes the taxpayer's economic activity.

[7] The argument for the taxpayer is that the purchase of the SFPE units was for the purpose of raising capital to meet the requirements of its farming business and future development of the business through the construction and operation of a wind farm. The farming business is an economic activity for VAT purposes, and the operation of a wind farm would likewise be an economic activity. Raising capital in this way, it is said, amounted to a general overhead of the taxpayer's business, linked to its total economic activity and forming a component part of the price of the taxpayer's products, at least in the future. Consequently it is contended that the input tax paid on the acquisition of the SFPE units was deductible as a general overhead. The taxpayer accepts that, if the funds raised through the use of SFPE units are not utilized for the purposes of its economic activities, in the form of the farming business and a possible future wind farm, the right to deduct input tax will be nullified. That would apply equally if the funds raised were used for private purposes.

[8] In considering these contentions, we first set out the relevant European Union and United Kingdom legislation that governs the deductibility of input tax for VAT purposes. We then consider the case law of the European Court of Justice that deals with the deductibility of input tax, with a view to establishing the basic principles that emerge from the legislation. Thereafter we consider how those principles apply to the facts of the present case. Finally, we comment on certain other cases that were cited by counsel in the course of their arguments. These are significant mainly as examples of how the basic principles have

been applied in different factual situations, and their interest is rather by way of analogy than as an independent source of principle.

**Legislation**

*Principal VAT Directive*

[9] The relevant European Union legislation is contained in Council Directive 2006/112 (the Principal VAT Directive). Article 1(2) of that Directive states the fundamental nature of VAT; it provides as follows:

> "The principle of the common system of VAT entails the application to goods and services of a general tax on consumption exactly proportional to the price of the goods and services, however many transactions take place in the production and distribution process before the stage at which the tax is charged.
>
> 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.
>
> The common system of VAT shall be applied up to and including the retail trade stage".

Thus the underlying structure of VAT is that it is a tax on the turnover of a taxable person under deduction of VAT charged on the cost components of the taxable person's economic activity. Article 2(1) of the Directive states:

> "The following transactions shall be subject to VAT:
>
> (a) the supply of goods for consideration within the territory of a member state by a taxable person acting as such;
>
> (b) the supply of services for consideration within the territory of a Member State by a taxable person acting as such…".

Article 9 provides:

> "(1) 'Taxable person' shall mean any person who, independently, carries out in any place any economic activity whatever the purpose of that activity.

> (2) Any activity of producers, traders or persons supplying services… shall be regarded as an economic activity. The exploitation of tangible or intangible property for the purpose of obtaining income therefrom on a continuing basis shall in particular be regarded as an economic activity…".

Article 14(1) defines "supply of goods" as the transfer of the right to dispose of tangible property as owner, and Article 24(1) defines the supply of services as any transaction which does not constitute a supply of goods.

[10] Article 62 provides as follows:

> "For the purposes of this Directive:
>
> (1) 'chargeable event' shall mean the occurrence by virtue of which the legal conditions necessary for VAT to become chargeable are fulfilled;
>
> (2) VAT shall become 'chargeable' when the tax authority becomes entitled under the law, at a given moment, to claim the tax from the person liable to pay, even though the time of payment may be deferred".

Article 63 provides that the chargeable event shall occur and VAT shall become chargeable when the goods or services are supplied. Article 167 of the regulation entitles taxpayers to deduct tax at the time when the deductible tax becomes chargeable. Article 168 provides:

> "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… to deduct the following from the VAT which he is liable to pay:
>
> (a) the VAT due or paid… in respect of supplies to him of goods or services, carried out or to be carried out by another taxable person…".

Article 173 provides that, in the case of goods or services used by a taxable person both for transactions in respect of which VAT is deductible pursuant to Article 168 and in respect of which VAT is not deductible only such proportion of the VAT as is attributable to the former transactions shall be deductible.

*Value Added Tax Act 1994*

[11] Within the United Kingdom, the relevant domestic legislation that implements the foregoing provisions of the Principal VAT Directive is found in the Value Added Tax Act 1994. Section 1(1) of that Act charges VAT on the supply of goods and services in the United Kingdom. Section 4 provides as follows:

> "(1) VAT shall be charged on any supply of goods or services made in the United Kingdom, where it is a taxable supply made by a taxable person in the course or furtherance of any business carried on by him.
>
> (2) A taxable supply is a supply of goods or services in the United Kingdom other than an exempt supply".

Section 24 provides as follows:

> "(1) Subject to the following provisions of this section, 'input tax', in relation to a taxable person, means the following tax, that is to say –
>
> (a) VAT on the supply to him of any goods or services;…
>
> being… goods or services used or to be used for the purpose of any business carried on or to be carried on by him.
>
> (2)… 'output tax', in relation to a taxable person, means VAT on supplies which he makes…
>
> (5) Where goods or services supplied to a taxable person…are used or to be used partly for the purposes of a business carried on or to be carried on by him and partly for other purposes, VAT on supplies… shall be apportioned so that only so much as is referable to his business purposes is coded as his input tax…".

Section 25(2) provides

> "[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".

Section 26 provides:

> "(1) The amount of input tax on which a taxable person is entitled to credit at the end of any period shall be so much of the input tax for that period (that is input tax on supplies, acquisitions and importations in the period) as is allowable by or under regulations as being attributable to supplies within subsection (2) below.

> (2) The supplies within this subsection are the following supplies made or to be made by the taxable person in the course or furtherance of his business –
>
> (a) taxable supplies…".

**Case Law of the European Court of Justice**

[12] The foregoing provisions of the Principal VAT Directive and similar provisions in that Directive's predecessors have been commented on by the European Court of Justice in a substantial number of cases. The Upper Tribunal referred to three important early decisions in which the basic principles of law applicable to the deductibility of input tax were laid down: *Commissioners of Customs and Excise* v *Midland Bank PLC* (Case C-98/98) [2000] STC 501, *Abbey National PLC* v *Customs and Excise Commissioners* (Case C-408/98) [2001] STC 297, and *Kretztechnik AG* v *Finanzamt Linz* (Case C-465/03) [2005] STC 1118. The third of these cases, *Kretztechnik*, involved the deductibility of expenses incurred in raising capital, and the Court of Justice's statement of legal principles in that case is in our view pertinent to the present case. In *Kretztechnik* the taxpayer had raised capital through a share issue. The issue of shares did not constitute a supply of services, but it was held that the cost of supplies acquired in connection with the raising of the capital formed part of the general overheads of the taxpayer and were therefore component parts of the price of its products. On that basis, the supplies had a direct and immediate link with the whole economic activity of the taxpayer, and VAT on those supplies was deductible. The relevant principles were stated by the Court of Justice as follows (at paragraphs 34 et seq):

> "34. 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 VAT consequently ensures complete neutrality of taxation of all economic activities, whatever their purpose or results, provided that they are themselves subject in principle to VAT….

> 35. It is clear from the last-mention condition that, for VAT to be deductible, the input transactions must have a direct and immediate link with the output transactions giving rise to a right of deduction. Thus, the right to deduct VAT charged on the acquisition of input goods or services presupposes that the expenditure incurred in acquiring them was a component of the cost of the output transactions that gave rise to the right to deduct….
>
> 36. In this case, in view of the fact that, first, a share issue is an operation not falling within the scope of the [Directive] and, second, that operation was carried out by Kretztechnik in order to increase its capital for the benefit of its economic activity in general, it must be considered that the costs of the supplies acquired by that company in connection with the operation concerned form part of its overheads and are therefore, as such, component parts of the price of its products. Those supplies have a direct and immediate link with the whole economic activity of the taxable person….
>
> 37. It follows that… Kretztechnik is entitled to deduct all the VAT charged on the expenses incurred by that company for the various supplies which it acquired in the context of the share issue carried out by it, provided, however, that all the transactions carried out by that company in the context of its economic activity constitute taxed transactions. A taxable person who effects both transactions in respect of which VAT is deductible and transactions of which it is not may… deduct only that proportion of the VAT which is attributable to the former transactions".

[13] The approach laid down by the Court of Justice in *Midland Bank*, *Abbey National* and *Kretztechnik* has been followed repeatedly. The relevant principles are stated in, for example, *Skatteverket* v *AB SKF* (Case C-29/08), [2010] STC 419, where the Court stated (at paragraphs 55-58):

> "55. First, it should be recalled that the right of deduction… is an integral part of the VAT scheme and in principle may not be limited. The right to deduct is exercisable immediately in respect of all the taxes charged on input transactions….
>
> 56. The deduction system is intended 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 VAT consequently ensures neutrality of taxation of all economic activities, whatever their purpose or results, provided that they are themselves subject in principle to VAT….
>
> 57. According to settled case law, the existence of a direct and immediate link between a particular input transaction and a particular output transaction or transactions giving rise to entitlement to deduct is, in principle, necessary before the taxable person is entitled to deduct input VAT and in order to determine the extent of such entitlement….

> 58. It is, however, also accepted that a taxable person 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 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. Such costs do have a direct and immediate link with the taxable person's economic activity as a whole…".

[14] A number of other cases on this topic were cited by counsel. As already noted, we discuss the more significant of these at a later stage in this opinion. They are essentially examples of the application of the general principles discussed in cases such as *Abbey National* and *SKF*, and as such their relevance is by way of analogy rather than establishing the principles of law that must be applied. We should, however, note at this stage the most recent discussion of the law in this area by the Court of Justice.

[15] This is found in *Direktor na Direktsia 'Obzhalvane i danachno-osiguritelna prakrika* v *Iberdrola Immobiliaria Real Estate Investments*, (Case C-132/16), an opinion issued on 14 September 2017. In their submissions both parties referred at length to the opinion of the Advocate General in the same case, issued on 6 April 2017. While the present case was at avizandum, the opinion of the Court of Justice was issued, and it became clear that it differed in material respects from the opinion of the Advocate General. For that reason we invited the parties to prepare short written submissions on the matter, which they did, and which we have found to be helpful. The case concerned the reconstruction of a waste-water pump station serving a holiday village in Bulgaria. The taxpayer was a developer which purchased land in the village to construct buildings containing approximately 300 apartments for seasonal use. It entered into a contract with the municipality for the reconstruction of the pump station, and commissioned those works from a third party. Expert opinion indicated that, without the reconstruction, the necessary connection for the

taxpayer's development would be impossible owing to the inadequacy of the existing sewerage system. The taxpayer treated the cost of reconstruction as expenditure for *inter alia* the acquisition of tangible fixed assets. It reclaimed the input tax. The Court of Justice held that a taxable person had the right under Article 168 to deduct input tax in respect of the supply of services comprising the construction or improvement of a property owned by a third party when the third party enjoyed the resulting services free of charge and the services were usable by the taxable person and by the third party in the context of their economic activity. That was subject to conditions: the services should not exceed what was necessary to allow the taxpayer to carry out the taxable transactions, and the cost of the services must be included in the price of those transactions.

[16] The Advocate General emphasized the requirement that the input in respect of which VAT is reclaimed should go into a taxable output rather than an exempt or non-taxable output. That link could not be established on the basis of a vague causal link, but only by reference to the application of the input to particular outputs (paragraph 31). In some cases relief from VAT had to be calculated on the basis of economic activity as a whole. If, however, there was a direct link between the input and a particular output, using that output was the more precise method for determining the entitlement to deduct input tax. That more precise method must take precedence over a general consideration of total turnover (paragraph 36). Where there existed a direct and immediate link between the input and an output transaction which, in the absence of economic activity, did not fall within the scope of VAT, there was no entitlement to deduct input tax (paragraph 37). That was relevant to the case under consideration, because the development and letting of property was not within the scope of VAT. We should add that the Advocate General's emphasis on the importance of any link between the input and any particular output transaction, and the

characterization of the input by reference to that output transaction rather than general economic activities, does not appear to us to be prefigured in any of the earlier decisions of the Court of Justice.

[17] The Court of Justice did not adopt the approach suggested by the Advocate General, and stated the applicable legal principles in a manner consistent with earlier decisions. The issue before the Court was identified as whether Article 168(a) of the Principal VAT Directive must be interpreted as meaning that a taxable person has the right to deduct input tax in respect of the supply of services consisting of the construction or improvement of a property owned by a third party when the third party enjoys the results of those services free of charge and the services are used both by the taxable person and the third party in the context of their economic activity (paragraph 24). The Court then provided a helpful statement of the existing law in this area (paragraphs 26 et seq):

> "26 The deduction system is intended 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 VAT consequently ensures neutrality of taxation of all economic activities, whatever their purpose or results, provided that they are themselves subject in principle to VAT…
>
> 28 In accordance with settled case-law, the existence of a direct and immediate link between a particular input transaction and a particular output transaction or transactions giving rise to the right to deduct is necessary, in principle, before the taxable person is entitled to deduct input VAT and in order to determine the extent of such entitlement. The right to deduct VAT charged on the acquisition of input goods or services presupposes that the expenditure incurred in acquiring them was a component of the cost of the output transactions that gave rise to the right to deduct.…
>
> 29 A taxable person also has a right to deduct even when 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 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. Such costs do have a direct and immediate link with the taxable person's economic activity as a whole….

> 30 On the other hand, where goods or services acquired by a taxable person are used for purposes of transactions that are exempt or do not fall within the scope of VAT, no output tax can be collected or input tax deducted….
>
> 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…".

The authority primarily cited for the foregoing propositions was *SKF*, C-29/08, *supra*. As we have noted, that statement of the law is wholly consistent with earlier cases, and is significantly different, especially in its emphasis, from the Advocate General's opinion.

[18] On the facts of *Iberdrola*, the Court noted that without the reconstruction of the pump station it would have been impossible to complete the project that the taxable person had in mind and thus to carry out the taxable person's economic activity. That was likely to demonstrate the existence of a direct and immediate link between the reconstruction of the pump station and the taxed output transactions of the taxable person. This was not affected by the fact that the municipality also benefited from the service, because the input reconstruction service was a component of the cost of a taxed output transaction by the taxable person (paragraphs 33-36). Nevertheless, to the extent that the cost of reconstructing the pump station exceeded the requirements of the taxable person's economic activities, the existence of the essential direct and immediate link between the service and the taxed output transaction would be partially broken (paragraphs 38-39). That would restrict the ability to recover output VAT.

**Summary**

[19] From the foregoing authorities, it is possible in our opinion to identify five basic principles that govern the recoverability of input tax. First, at a general level, the deduction of input tax is intended to relieve a trading entity entirely of the VAT that is payable in the course of all of its economic activities; this ensures overall neutrality of taxation in respect of all activities that are subject to VAT. Secondly, if VAT paid on an input transaction is to be deductible, there must be a direct and immediate link between that input transaction and the output transactions that give rise to a right of deduction. This is necessary because, if deduction of the input tax is to be permitted, the expenditure on the relevant inputs must be a component in the cost of the output transactions that are charged with the output VAT from which the input VAT is to be deducted. Thirdly, such a link will be broken if the goods or services obtained through the input transaction are used by the taxpayer for the purposes of an exempt transaction or a transaction that does not fall within the scope of VAT, including activities that are not economic activities in the sense in which that expression is used in dealing with VAT.

[20] Fourthly, the direct and immediate link will not be broken if the goods or services in question form part of the general overheads on the taxpayer's business, in such a way that they form component parts of the price of the taxpayer's product. This represents common sense. When goods or services are supplied to a customer, the costs incurred by the supplier in providing the relevant goods or services will include not only the cost of purchasing or manufacturing the goods or providing the services but also general overheads. To take a simple example, if the supplier manufactures goods, the cost of providing the goods will include not merely the cost of raw materials but also the cost of plant and equipment. This is a general proposition that has been recognized throughout the case law of the Court of

Justice. Fifthly, if the goods or services in question are used partly as general overheads of the taxpayer's business and partly for the purposes of exempt or zero-rated transactions, the input tax must be apportioned between those two uses. The reasons for this are obvious and straightforward.

[21] Financial transactions, such as those required to provide finance for the expansion of the business, will normally be exempt from VAT; an example is found in the issue of shares that formed the subject matter in *Kretztechnik*. In the United Kingdom most financial transactions are exempt from VAT by virtue of Schedule 9 to the Value Added Tax Act 1994. Nevertheless, as *Kretztechnik* demonstrates, while the actual raising of finance by means of a share issue is an exempt transaction, the cost of the services required to achieve the share issue is chargeable to VAT. The share issue will normally be for the general purposes of the business, and the cost of those services accordingly forms part of the overheads of the business, and as such is a component part of the price of the product of the business. In that way, "Those supplies have a direct and immediate link with the whole economic activity of the taxable person": *Kretztechnik*, at paragraph 36. That entitles the taxable person to deduct VAT charged on the costs of raising capital, to the extent that the transactions carried out by the company are economic activities that are subject to VAT. This is common sense; the fundamental reason for permitting the deduction of input tax is to relieve the taxable person of the VAT that it has incurred in the course of its economic activities. That amount is not lost to the tax authorities, because VAT is payable on the taxable person's product. The purpose of permitting deduction is to ensure overall neutrality of taxation, and this would be lost if the VAT on any inputs that are subject to VAT cannot be deducted. The critical questions are accordingly whether VAT has been paid on an input to the business and

whether that input can be considered a component in the ultimate price of the taxable person's products.

[22] As we have remarked, financial transactions are generally exempt from VAT, but to the extent that a taxable person incurs input VAT in connection with a financial transaction designed to provide finance for his business and its expansion, we can see no reason in principle why it should not be deductible. The general statements of principle in cases such as *Abbey National*, *Kretztechnik*, *SKF* and *Iberdrola* set out the conditions for the deduction of input VAT, if they are satisfied deduction should be allowed. The use of the SFPEs as a source of finance is not common, which is hardly surprising as they are a specialized source of income available to the agricultural community. Nevertheless, it is possible to conceive of other methods of raising finance that would give rise to input VAT, not merely on the expenses of a transaction, as in *Kretztechnik*, but on the cost of the financial product itself; examples include the use of commodity-based repo transactions and commodity-based derivatives. In all such cases, the critical question is whether the tests laid down in the case law of the Court of Justice have been satisfied.

**Application of Legal Principles to the Facts of the Case**

[23] We have already set out the findings of fact made by the First-tier Tribunal. These disclosed that the taxpayer is a company that carries on a substantial farming business. For some time it has had plans for diversification through the construction of a wind farm; this would involve considerable preliminary work (some of which has already been carried out) and significant capital costs. The taxpayer also has plans for expansion of its farming business; these include the possible construction of further farm buildings, including a cattle court and a Dutch barn, and the possible acquisition of neighbouring farms. All of the

taxpayer's business activities are economic activities, in the VAT sense; none of their supplies is an exempt supply. Thus there is no factor subsequent to the acquisition of the SFPEs that might break the chain of supply: see First-tier Tribunal at paragraph 41.

[24] When the SFPEs were acquired, the taxpayer paid VAT in full, as the acquisition was not an exempt supply. The SFP payments themselves have been accumulated within the taxpayer, and are held as cash in its account with the Clydesdale Bank. As would be expected, proper records have been kept of the amounts received; these were set out in productions. As a matter of elementary company law, the entitlement to the funds so deposited with the Clydesdale Bank is part of the assets of the taxpayer, and the directors' fiduciary duties require that those assets should be used for the purposes of the taxpayer rather than its directors or shareholders in any personal capacity. No doubt the taxpayer might declare a dividend or might embark on voluntary winding up, but in either of those events what happened to the funds would be perfectly clear, and HMRC would be entitled to impose a charge to VAT on the funds that were not used for the purposes of the taxpayer's business; we discuss this possibility subsequently under reference to the VAT (Supply of Services) Order 1993.

[25] In the foregoing circumstances, we are of opinion that the acquisition of the SFPEs was undertaken by the taxpayer to finance the development and diversification of its business. As such, the SFPEs are properly considered an input to the taxpayer's business, and their cost formed part of the general overheads of the business. If the payments are used to fund expansion and diversification, the cost of obtaining those payments will form a component part of the price of the taxpayer's product. The test for the deduction of input tax laid down in *Abbey National* and reaffirmed in subsequent cases up to and including

*Iberdrola* has accordingly been satisfied. For this reason we are of opinion that both the Upper Tribunal and the First-tier Tribunal reached the correct conclusion.

[26] The primary argument for HMRC focused on the existence or otherwise of a direct and immediate link between the relevant input transaction and the taxpayer's outputs. Either a direct and immediate link must exist between a particular input transaction and a particular output transaction, or it must be possible to attribute the input tax to the taxable person's economic activities as a whole by virtue of their being part of the general overheads of the business. In assessing the existence of a direct and immediate link, the objective character of the transaction must be considered. For this purpose it is not permissible, it was said, to have regard to the intentions of the taxpayer; instead an objectively assessed direct and immediate connection was required. In the present case, HMRC's argument is that on an objective analysis the purchase of the SFPEs was directly and immediately linked to the receipt of the SFP income, but that was outwith the VAT scheme. The existence of that link, taken together with the proposition that the ultimate intention of the taxpayer was irrelevant, meant that there could not be any direct and immediate link to the general overheads of the taxpayer's business.

[27] In our opinion this argument is misconceived. The receipt of the SFP payments is merely a consequence of the acquisition of the SFPEs. It cannot in our view be considered a separate business activity distinct from the taxpayer's general business. The SFPEs are rather a form of investment, made by the taxpayer for the purposes of its business, and from which income is derived. There is no business activity beyond providing additional finance for the taxpayer's existing farming business, the future development of that business and possible future diversification by the taxpayer into a wind farm. HMRC relies on the fact that the SFPs could not have been claimed if the taxpayer did not perform any taxable

transactions within the scope of VAT. That is correct as far as it goes, but the taxpayer did in fact perform taxable transactions on a regular basis, with the result that this possibility is hypothetical.

[28] HMRC further contends that the intention of the taxpayer as to how the SFPs would be used for the benefit of the business is irrelevant. We have difficulty in understanding how intention could be irrelevant; the intention of the directors of a company is an objective fact, and it appears to us to be a factor that may properly be taken into account. If it is manifested in corporate documents, as occurred in the present case, ascertaining the state of mind should not be difficult. In this connection, as the judge of the Upper Tribunal points out at paragraph 20 of his opinion, section 24 of the Value Added Tax Act 1994 refers to goods and services "used or to be used" for the purposes of the taxable person's business. That clearly points to what may happen in future, and in that context the intention of the taxable person, or the directing mind of the taxable person, must be relevant. In any event, it is important to have regard to two further matters: the funds received by way of SFPs were paid into the company's bank account, and the directors' fiduciary duties required that those funds should be applied for the purposes of the company's business. This seems to us to be central to the analysis of the case. Finally, the findings of the First-tier Tribunal are clearly contrary to the argument for HMRC. As the judge of the Upper Tribunal indicates (paragraph 20) the First-tier Tribunal held (paragraph 42) on the basis of its primary findings in fact that the financing opportunity obtained through purchasing the SFPE units did not form a distinct business activity but was rather a wholly integrated feature of the farming enterprise. Like the judge of the Upper Tribunal, we consider that the findings of primary fact fully justify such a conclusion. For these reasons we reject HMRC's argument.

[29] Finally, we should note the secondary argument put forward by HMRC. This was, in summary, that to the extent that the funds acquired by the taxpayer from SFP payments were not used for the general purposes of their business, the input tax that had been reclaimed in respect of those funds would have to be repaid to HMRC. This proposition was not disputed by the taxpayer; its counsel indicated that the taxpayer fully accepted that its right to deduct input tax on the cost of units of SFPE would be nullified if and to the extent that the funds raised were spent for private or other non-business purposes. In our opinion that concession was properly made. At the point when any funds were used for non-business purposes, which would include the payment of a dividend or any other return to the directors or shareholders of the taxpayer, a charge to VAT would arise under regulation 3 of the VAT (Supply of Services) Order 1993 (SI 1993/1507). On that basis there would be no risk to the Exchequer that VAT might be lost through the use of funds for private purposes.

**Other Cases**

[30] We were referred by counsel to a number of other decided cases. As we have indicated, we do not think that these add in any material way to the fundamental principles that govern this area of law. Nevertheless, we should indicate, fairly succinctly, our opinion as to the relevance of the more pertinent of those decisions to the present case. Certain cases, for example *BLP Group PLC* v *Customs and Excise Commissioners*, (Case C-4/94) [1995] STC 424, *Church of England Children's Society* v *Revenue and Customs Commissioners*, [2005] STC 1644; [2005] EWHC 1692 (Ch) 17, *University of Southampton* v *Revenue and Customs Commissioners*, [2006] STC 1389; [2006] EWHC 528 (Ch) 19, and *HMRC* v *Cambridge University*, [2015] STC 2353; [2015] UKUT 0305 TCC 20, depend on the application of the

legal principles that are stated somewhat more fully in *Abbey National*, *Kretztechnik*, *SKF* and most recently in *Iberdrola*. These cases are of significance as applications of the statements of principle in *Abbey National* and *Kretztechnik*. As such, they are in our opinion entirely consistent with our decision in the present case. Indeed it hardly needs stressing that in this area of law each case must turn on its own particular facts, but the general principles that have been clearly laid down by the Court of Justice must be properly applied.

[31] In *Securenta Goettinger Immobalienanlagen und Vermoegensmanagement AG* v *Finanzamt Goettingen*, *supra*, the taxable person's activities comprised acquiring, managing and selling real estate, securities, financial holdings and investments of all types. Under German tax law, transactions in securities and transactions concerning interests in companies or other associations were exempt from VAT, and consequently some of the taxable person's commercial activities were subject to output VAT and others were outside the VAT system. When the taxable person raised funds it incurred input VAT on the incidental costs of doing so, in a manner similar to the fund-raising exercise considered in *Kretztechnik*. The funds so raised were, however, for the benefit of the whole of the taxable person's activities, both those that were subject to VAT and those that were not. The Court of Justice held, following *Abbey National* and *Kretztechnik*, that input VAT paid on the costs of raising funds was recoverable only to the extent that the funds so raised were used for taxable economic activities, and not for the taxpayer company's other activities which fell outside the VAT system. To the extent that the funds raised were used for non-economic activities, input VAT was not deductible. *Securenta Goettinger* is in our opinion readily distinguishable from the present case in that the taxable person there carried on two distinct types of output activity, one taxable and the other outside the scope of VAT. That is distinct from the

present case, and indeed *Kretztechnik*, where the whole of the output economic activities of the taxpayer are subject to VAT.

[32] In *Vereniging Noordelijke Land en Tuinbouw Organisatie (VNLTO)* v *Staatssecretaris van Financien*, (Case C-515/07) [2009] STC 935, the taxpayer company promoted the interests of the agricultural sector in the Netherlands. It performed promotional activities at a general level, which did not constitute an economic activity for VAT purposes, and also provided individual services for members and non-members for which it charged a fee. The Court of Justice held that where goods or services acquired by a taxable person are used for transactions that are exempt or do not fall within the scope of VAT, no output tax can be collected and input tax cannot be deducted: paragraph 28. This is fully in accordance with the discussions of principle that we have already set out. The same general point is made in two further cases that were cited, "*Sveda" UAB* v *Valstybinė mokesčių inspekcija prie Lietuvos Respublikos finansų ministerijos*, (CaseC-126/14) [2016] STC 447, where the general principles are discussed at paragraphs 31-34, and *Odvolací finanční ředitelství* v *Český rozhlas*, (Case C-11/15) (2016), a case where a large part of the taxpayer's activity (as a public broadcaster) was outside the scope of VAT, and the statutory charge paid by the owners of radio receivers that benefited the taxable person did not constitute a supply of services effected for consideration. In our opinion these cases do not add to the general discussions of principle that we have cited previously. On the facts, these cases are readily distinguishable from the present case.

[33] In *Odvolací finanční ředitelství* v *Baštová*, (Case C-432/15) (2016) the operator of a racing stable provided services both for horses belonging to others and for her own horses. The Court of Justice applied the well established principles that we have discussed previously (paragraphs 43-44). In that case, on the facts, activities involving the breeding

and training of particular horses required a direct and immediate link between the costs incurred and the particular output transaction involving that horse; consequently input VAT was not recoverable in respect of the operator's own horses. That is entirely consistent with our decision in the present case. Finally, we should note the recent decision of the Upper Tribunal in *Vehicle Control Services Ltd* v *Revenue and Customs Commissioners*, [2016] UKUT 316 (TCC); [2017] STC 11, where it was held that where purchased goods or services were used by a taxable person both for transactions in respect of which VAT is deductible (taxable supplies) and for transactions in respect of which VAT is not deductible (transactions which do not constitute economic activity or taxable supplies, or where supplies are exempt), VAT can only be deducted in so far as it is attributable to taxable supplies. That is potentially applicable to the present case. If in future the sums recovered by the taxpayer as SFP payments are not in fact used for the purposes of its taxable business (farming, a wind farm and the like), input tax will be recoverable, in the manner that we have already described.

**Conclusion**

[34] For the foregoing reasons we conclude that the decisions made by both the First-tier Tribunal and the Upper Tribunal were correct. We will accordingly refuse the appeal.