VAT focus

VAT deductibility for fund-raising: clarity at last

Speed read

The Supreme Court in *Frank A Smart Ltd & Son* distilled the existing CJEU case law to provide clarity on VAT deductibility for those undertaking fund-raising activities. Helpfully, it appears that the receipt of outside the scope of VAT income for a business is not fatal to VAT deductibility, provided it can be demonstrated that the costs incurred in relation to the outside the scope income forms part of either the overheads of the business or ongoing taxable transactions. Despite this helpful analysis of the case law, there is little doubt that the judgment itself will be analysed by the courts in the future as to exactly how it should be applied to a wide variety of cases on input tax recovery.

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VAT deductibility in the context of non-economic activities is having its moment in the spotlight. First was the Court of Justice of the EU (CJEU) decision's in *University of Cambridge* (Case C-316/18), concluding that VAT incurred on services relating to the investment of donations and endowments (an outside the scope of VAT activity) is not deductible, unless there is an objective link between the outside the scope activity and the taxpayer's wider taxable activities. The university failed to obtain the right to recover the VAT incurred on services obtained to manage its investment fund as it could not be proven that the cost of these services formed a component of the university's prices charged for its taxable activities. Hot on the heels of this judgment, the Supreme Court has provided a timely decision on the VAT deductibility on costs relating to an outside the scope activity, in this case the acquisition of units giving rise to the right to obtain farming subsidies.

The facts

As always with VAT cases, the facts are critical to the legal analysis and need to be considered carefully. FASL is a Scottish farming company that obtained units of entitlements to EU farming subsidies, known as single farm payments (SFPs). SFPs were available to those with eligible land who met the requirements of ensuring plant and animal health and maintaining the eligible land in what was known as 'good agricultural and environmental condition'. Units in entitlements to SFPs were initially allocated to farmers, when the scheme began in 2005. The units in the entitlements to SFPs were tradable and a market subsequently emerged. FASL began purchasing the units in SFP entitlements as a method of funding their wholly taxable business activities. FASL used the funds derived from the SFPs to pay off its overdraft and develop further business operations, including farm buildings, the purchase of other farms and scoping to create a wind farm. FASL incurred VAT on the purchase of the SFP entitlements and sought to recover the VAT as input tax on the basis that the SFP funds were used to further FASL's taxable business activities. It was agreed the sale on the market of units of entitlement to SFPs were taxable supplies. The question throughout the litigation was whether the receipt of the SFPs prevented FASL from deducting the VAT which it had paid on the purchase of the units.

The journey from the First-tier Tribunal in Scotland to the Supreme Court has been one sided, with the FTT upholding FASL's appeal and the Upper Tribunal and Court of Session dismissing HMRC's subsequent appeals. The question for the Supreme Court was whether FASL was entitled to deduct the VAT incurred in purchasing the entitlements to the SFPs as input tax which it claimed it used in making taxable supplies or whether, as HMRC argued, the input tax on the purchase of the units had a direct and immediate link to the receipt of the outside the scope SPFs.

The arguments

Broadly, HMRC's challenge in the Supreme Court contained three core submissions. First was that income derived from the SFPs was investment income and outside the scope of VAT. There was therefore no direct and immediate link between the input tax charged on the SFP entitlements and any taxable activities undertaken by FASL. The only direct and immediate link is between the input tax on the SFP entitlements and the receipt of the SFPs, which is an outside the scope transaction.

Second, HMRC argued that the Court of Session incorrectly concluded that VAT incurred on the SPF entitlements was deductible as input tax as an overhead of FASL's business.

Third, HMRC submitted all three of the lower courts' reliance on the evidence of FASL's director's intention to use the payments (obtained via the acquisition of the entitlement units to SFPs) to fund FASL's business was an irrelevant consideration.

HMRC's submissions relied upon *BLP Group Plc v Customs & Excise Commrs* (Case C-4/94) to support that VAT incurred on costs directly and immediately related to an exempt supply is not recoverable, regardless of whether the funds obtained were used for downstream taxable activities. HMRC submitted there was no reason why the analysis in *BLP* relating to exempt supplies should not apply to supplies outside the scope of VAT. HMRC argued if the Supreme Court was in any doubt about this contention, then it should refer to the CJEU.

FASL's response to HMRC's appeal, as summarised by the Supreme Court, was based on the principle of neutrality, and continued (at para 23):

> 'the VAT system gives fully taxable traders, in other words people, such as FASL, who only make taxable supplies, a right to recover all input tax incurred in raising finance for

their business so long as (i) the finance which they raise is spent on funding the business which goes on to make further taxable supplies and (ii) the financing exercise itself remains outside the scope of VAT because it does not involve the taxable person in making any taxable or exempt supplies. FASL does not dispute that if it were in the future to use part of the funds, which it has obtained through the receipt of SFPs and kept in its bank account, on downstream activities which were outside the scope of VAT, that use would restrict the input tax to which it had been entitled and might give rise to an obligation to repay a proportionate part of any deduction which it had made or any repayment of VAT which it had received from HMRC. Disagreeing with HMRC, FASL submits that the case law of the CJEU is clear and supports its position.'

The Supreme Court agreed that FASL is entitled to recover the VAT incurred in obtaining the SPF entitlements as input tax. In support of this conclusion, Lord Hodge (giving the only judgment of the court and with whom the other judges all agreed) provided a detailed distillation of CJEU case law, the interpretation of which was disputed by HMRC.

In determining the correct approach to be taken, the Supreme Court's CJEU case law review reached the broad conclusion at para 56 that there could be a 'direct and immediate link between an input [i.e. FASL's acquisition of the SPF entitlements] and either (i) particular output transactions or (ii) the taxable person's economic activity as a whole. This link would exist if the cost of the input was in the first case a cost component of the particular transactions and in the second case if it was a cost component of the price of goods and services which it supplies'.

The court's review

The court has analysed, carefully, what the CJEU has said in the long line of leading cases of *BLP*, *Midland Bank* (Case C-98/98), *Abbey National* (Case C-408/98), *Kretztechnik* (Case C-465/03), *Investrand BV* (Case C-435/05), *Securenta* (C-437/06), *SKF* (Case C-29/08), *Iberdrola* (Case C-132/16) and *Cambridge* (Case C-316/18).

Lord Hodge placed particular weight on the opinion of Advocate General Jacobs in *Abbey National* (the case concerning input tax recovery in the context of a TOGC) where he contrasted the approach of the CJEU in *BLP* (input tax used to effect an exempt sale of shares). As Lord Hodge put it (at para 31): 'what mattered was whether the taxed supply was a cost component of a taxable output, and not whether the most closely-linked transaction was itself taxable.' He went on to say it was inherent in an exempt transaction that it fatally broke the chain between a supply and the taxable person's taxable activities, such that input tax used to make that supply was irrecoverable.

However, where no supply of goods or services (taxable or exempt) takes place in a transaction outside the scope of VAT, the chain was not broken. One was required to look beyond the immediate transaction to see whether the supply giving rise to input tax deduction, formed a cost component of some other taxable transaction, including in the form of general overheads. The advocate for FASL contended that the CJEU has since gone on in later case law to adopt the reasoning of AG Jacobs. This was the approach of the CJEU in *Kretztechnik* where it was possible to ignore the outside the scope of VAT share issue, in order to recover the VAT on the costs incurred in making that share issue, as Kretztechnik was a fully taxable person.

Lord Hodge gives some helpful guidance as to how this is squared with situations such as in *SKF*, where the CJEU considered again the ability to recover VAT in the context of an exempt share sale by a parent of a wholly-owned subsidiary. Lord Hodge observed that the CJEU held that the referring court should look at the facts and determine whether the costs incurred were likely to be incorporated in the price of the shares sold or whether they were among only the cost components of transactions within the scope of the taxable person's economic activities. Lord Hodge, importantly for his overall analysis, notes at [46], that the CJEU itself observed the main difference between an exempt share sale and a share sale that was outside the scope of VAT was whether the taxable company was or was not involved in the management of the companies whose shares were being sold. He went on to say, that the CJEU must have accepted the distinction made by AG Jacobs in *Abbey National* and *Kretztechnik*, but recognised the need to modify the result for the purposes of an exempt initial transaction.

In addition, Lord Hodge noted the CJEU's determination in *SKF* that where a taxable person acquires goods or services and uses them for the 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. In relation to this factor, he said in the context of a fund-raising transaction, the CJEU must have been referring to the downstream transactions of which the input tax costs form a cost component, and not the initial fund-raising transaction itself, unless the costs of the inputs was a component of the price of the shares in the initial transaction. Ultimately, Lord Hodge concluded that it was 'clear' that in *SKF* the CJEU has not extended the reasoning of *BLP* to apply to outside the scope fund-raising transactions.

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He held that in order to avoid discriminatory treatment of taxable persons, it has extended the reasoning in the cases about outside the scope share disposals to share disposals which are VAT exempt, requiring an examination as to whether the costs associated with the input services are incorporated in the price of the shares sold in the initial transaction or in the price of the taxable person's products in downstream transactions. If the latter are taxable transactions the input tax is recoverable. Accordingly, a factual analysis will be important to determine this question in cases of this type.

In a helpful summary, Lord Hodge, distilled the following from his CJEU case law review:

- The principle of neutrality under article 168 of Principal VAT Directive requires a taxable person to be relieved of the burden of VAT payable or paid in the course of that person's economic activity.
- There must be a direct and immediate link between the incoming goods and services acquired by the taxable person and the outgoing taxable supplies made by that person. The link exists if the cost of the goods and services acquired form part of the cost component of the taxable supplies.
- Alternatively, there can be a direct and immediate link between the incoming goods and services and the whole of the taxable person's taxable supplies if the cost incurred forms part of the overheads of the business.
- In fund-raising activities that are either exempt (such as a share sale) or outside the scope of VAT (such as receipt of

a subsidy), VAT may be recovered on professional services relating to the fundraising if the purpose of the fundraising is to fund future taxable supplies. Testing this purpose is a question of fact requiring objective evidence.

There is a rich seam of analysis of the CJEU case law in this judgment that will no doubt be analysed by the courts in the years to come. However, what is striking is that although Lord Hodge has not said the reasoning in *BLP* has been extended in *SKF*, in his summary of the case law, he focuses on para 68 of the judgment in the latter, stating:

> 'It follows that, if the consultancy costs relating to disposals of shareholdings are considered to form part of the taxable person's general costs in cases where the disposal itself is outside the scope of VAT, the same tax treatment must be allowed if the disposal is classified as an exempted transaction.'

What is critical to the deduction of the input tax, in the latter scenario, is whether the input tax costs are incorporated in the price of an exempt share sale. If so, input tax on the associated costs are blocked, but if not, it appears that there is scope, nevertheless, if an objective analysis of the facts supports it, for the input tax to be recoverable if there are downstream taxable activities.

Reference to CJEU

The Supreme Court rejected HMRC's request for a reference to the CJEU on the basis that the FTT made findings of fact that entitled it to conclude that FASL, when it acquired units of entitlement to SFPs, was acting as a taxable person because of its aim of accumulating sums to develop its taxable business through capital expenditure on assets which it would use to generate taxable outputs. Lord Hodge held, at para 67, that he did not 'detect in the jurisprudence of the CJEU any basis for distinguishing expenditure incurred in a fund-raising exercise which takes the form of a sale of shares from a fund-raising exercise that involves the receipt of a subsidy over several years.' He held that the payment of the subsidies were not separate transactions from the acquisition of the entitlement to the subsidies, which is capable of breaking the link between the purchase of the units and the use of the net proceeds of the subsidies in FASL's taxable activities.

Conclusions

Thanks to the Supreme Court's careful distillation of CJEU jurisprudence, there is now some clarity on VAT deductibility for those undertaking fund-raising activities. Helpfully, it appears that the receipt of outside the scope of VAT income for a business is not fatal to VAT deductibility, provided it can be demonstrated that the costs incurred in relation to the outside the scope income forms part of either the overheads of the business or to an ongoing taxable transaction. This case also seems to put paid to HMRC's valiant efforts to argue that outside the scope of VAT transactions almost automatically create the same chain breaking event as an exempt supply of shares. They do not. As we said earlier, the input tax status depends upon a careful consideration of the objective factors. Despite this helpful analysis of the case law, there is no doubt that the judgment will itself be analysed by the courts in the future as to exactly how it should be applied to a wide variety of cases on input tax recovery. ■

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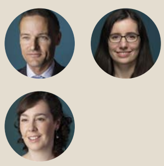

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