TC02266

Appeal number: TC/2009/15300

VAT – INPUT TAX – partial exemption – whether standard method and special method produce fair and reasonable attribution of input tax – held yes - whether special method proposed by Appellant produces fairer and more reasonable result than standard method – held yes – appeal allowed

FIRST-TIER TRIBUNAL
TAX CHAMBER

LOK'NSTORE GROUP PLC

Appellant

- and -

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

TRIBUNAL: JUDGE GREG SINFIELD
NIGEL COLLARD

Sitting in public at 45 Bedford Square, London on 2 and 3 July 2012

Andrew Hitchmough and Thomas Chacko, counsel, instructed by Baker Tilly

Sarabjit Singh, counsel, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents

DECISION

Introduction

1. This appeal concerns the method that must be used by the Appellant, Lok'nStore Group Plc ("LnS"), to determine the amount of VAT on supplies to it that it is entitled to deduct from VAT which it is liable to pay to the Respondents ("HMRC").

2. A taxable person is entitled to deduct VAT incurred on supplies of goods and services that are used or to be used for the purposes of making taxable supplies (ie supplies on which VAT is charged) or which otherwise give a right to deduct. VAT incurred on goods and services that are used for the purposes of exempt supplies cannot be deducted. Where a taxable person makes both taxable and exempt supplies (ie is partly exempt), VAT incurred on supplies of goods and services is only deductible in so far as those goods and services are used for the purposes of the taxable supplies. In such cases, an apportionment must be made. The default method of apportionment is called, in the UK, the standard method and is described more fully below. The standard method must be used by all partly exempt taxable persons unless HMRC have agreed or directed the use of a different method, called a partial exemption special method ("PESM").

3. LnS is a taxable person. LnS supplies taxable self-storage services and, to a lesser extent, other goods and services. It also makes exempt supplies of insurance. LnS considered that the standard method did not provide a fair and reasonable attribution of VAT incurred on overhead costs to its taxable supplies. LnS proposed four PESMs to HMRC which, in LnS's view, achieved a fairer and more reasonable attribution. In a letter dated 10 June 2009, HMRC:

> (1) rejected the four PESMs proposed by LnS; and
>
> (2) confirmed an assessment issued to LnS on 6 March 2008 for £140,899 VAT relating to periods 04/05 to 04/07 which HMRC considered was not recoverable in those periods on the application of the standard method.

4. LnS asked for the decisions to be reviewed. In a letter dated 21 August 2009, HMRC upheld the earlier decisions. LnS appeals against that review decision.

5. At the hearing, LnS stated that the Tribunal was only now asked to consider one of the four proposed PESMs: the mix of floor space and values method originally submitted by LnS on 19 June 2008 and amended by letter dated 15 December. It is described in more detail below. HMRC maintained that the standard method is the appropriate method for LnS to apportion VAT on its overheads.

6. The issues in this appeal are whether the standard method and LnS's proposed PESM produce a fair and reasonable attribution and, if both do so, whether LnS's proposed PESM is fairer and more reasonable than the standard method.

Facts

7. Witness statements were produced by Mr Raymond Davies on behalf of LnS and Mr Alexander Sherwood on behalf of HMRC. The witness statements were admitted as evidence in chief. Both witnesses gave oral evidence and were cross-examined. The parties also produced bundles of documents. On the basis of the witness evidence and documents, we find the material facts to be as follows.

8. LnS operates 21 self-storage facilities or stores in the south-east of England from which it provides self-storage services to the general public and to businesses. The stores have been purpose-built by LnS. They are, typically, large buildings with rather plain exteriors distinguished by panels painted in the company colour of bright orange. They have a ground floor and, usually, two or more other floors of storage space, divided into steel windowless rooms with wire mesh ceilings. On the ground floor of each store is a reception area where staff deal with existing and potential customers. All stores have CCTV monitoring and a secure perimeter. This appeal is concerned with the deduction of VAT on the overhead costs associated with the construction, maintenance and operation of LnS's stores.

9. LnS grants customers licences to store goods in the stores, usually in lockable steel containers but sometimes in open covered containers and (for very large items) on pallets in storage areas. Some of the stores have outside storage. Customers either provide their own padlock to secure the units or they can buy a padlock and key from the store. With rare exceptions, LnS does not keep keys to the customers' units. The units range in size from 25 to 10,000 square feet. LnS staff advise potential customers how much space they are likely to need and there is also information on this on LnS's website. LnS charges different amounts per square foot in different stores and ground floor space is often charged at a higher rate. It was common ground that the provision of storage by LnS is a supply of services chargeable to VAT at the standard rate.

10. LnS also hires vans to its storage customers. The van hire operates at a loss and is used to encourage people to rent storage space. The vans are hired out at £10 per day for those moving in, and £40 per day for customers who have already moved in. It is common ground that the van hire is chargeable to VAT at the standard rate. LnS also sells products related to storage, such as bubble-wrap, tape and boxes. These products are sold to anyone who walks into the store, not just those renting storage space. Any walk-in customers are asked about their storage needs and encouraged to lease storage space where appropriate. These supplies of storage-related products are also standard rated for VAT.

11. LnS provides some of its customers with insurance for their goods while they are stored with LnS. It was common ground that the supplies of insurance are exempt. LnS takes out a block insurance policy with Brit Insurance Ltd for a fixed premium payment, which entitles LnS to offer a single insurance cover product, up to a pre-set cover limit, to storage customers. Insurance is only provided to customers and only covers the goods (not the container or space) while they are in storage and not while they are in transit or elsewhere.

12. Insurance is currently supplied at a fixed price of £1 per week per £1,000 of goods insured, with a minimum of £2,000 worth of insurance. Prior to November 2008, the price was 75p per week per £1,000 of goods. The price increase was driven by market forces rather than by any other factor. LnS set the price of its insurance by reference to the amounts charged by its competitors for similar insurance.

13. Customers taking out insurance are required to declare the maximum value of goods they are storing. There is a fixed excess of £100 and the terms of the insurance policy are not negotiable. It is a requirement of the Self-Storage Association, of which LnS is a member, that all customers must insure their goods. Customers cannot move their goods into storage at an LnS store until they either show that they already have suitable insurance or buy it through LnS.

14. Insurance is discussed with customers when they discuss their storage requirements and before any documents are signed. It is possible that insurance may be discussed when a customer is being shown round the storage units but we find that this was not what usually happened and, in any event, insurance agreements were always concluded in the reception areas.

15. Not all customers purchase insurance from LnS. In the Annual Report and Accounts for the year ended 31 July 2011, the chief executive's review stated that, during the year, over 86% of new customers took LnS's insurance. The review also stated that ancillary sales accounted for 9.9% of storage revenues in the year and were increasingly focused on insurance which increases overall margin. In each of the last seven years, insurance turnover was between 4.1% and 6.8% of LnS's total turnover. The insurance sales contribute significant profit to LnS but the business would still be profitable and sustainable without it.

16. LnS's management accounts and financial statements do not allocate costs to insurance or other ancillary sales.

Legislation

17. Article 168 of Directive 2006/112/EEC ("the VAT Directive") provides that a taxable person is entitled to deduct VAT due or paid in respect of supplies of goods or services to him from the VAT which he is liable to pay in so far as the goods and services are used for the purposes of the taxed transactions of the taxable person. There is no right to deduct VAT due or paid in respect of supplies of goods or services which are used by the taxable person for the purposes of exempt transactions.

18. Where goods or services are used by a taxable person both for transactions in respect of which VAT is deductible (eg taxable transactions) and for transactions in respect of which VAT is not deductible (eg exempt transactions), Article 173(1) of the VAT Directive provides that only such proportion of the VAT as is attributable to the former transactions is deductible. The deductible proportion is determined in accordance with Articles 174 and 175 which provide a default turnover-based calculation. Article 173(2) allows Member States to adopt other measures to determine the deductible proportion. Article 173(2)(c) allows Member States to

authorise or require a taxable person to make the deduction on the basis of the use made of all or part of the goods and services. The UK PESM regime described below is based upon Article 173(2)(c).

19. The UK has implemented the provisions of the VAT Directive in the Value Added Tax Act 1994 ("the VATA") and regulations made under it. Section 24 of the VATA defines "input tax" as VAT on the supply of any goods or services to a taxable person which are used or to be used for the purpose of any business carried on or to be carried on by the taxable person. Section 25(2) provides that a taxable person is entitled to deduct input tax allowable under section 26 from output tax due from the person at the end of each prescribed accounting period. Section 26 states that the amount of input tax for which a taxable person is entitled to credit is such input tax as is allowable by or under regulations as attributable to taxable supplies. Section 26(3) provides that where a taxable person makes both taxable and exempt supplies, HMRC shall make regulations for securing a fair and reasonable attribution of input tax to taxable supplies.

20. The relevant regulations are Regulations 101 and 102 of the Value Added Tax Regulations 1995 ("the VAT Regulations"). Regulation 101(2) sets out the default standard method of apportionment:

> "…in respect of each prescribed accounting period—
>
> (a) goods imported or acquired by and goods or services supplied to, the taxable person in the period shall be identified,
>
> (b) there shall be attributed to taxable supplies the whole of the input tax on such of those goods or services as are used or to be used by him exclusively in making taxable supplies,
>
> (c) no part of the input tax on such of those goods or services as are used or to be used by him exclusively in making exempt supplies, or in carrying on any activity other than the making of taxable supplies, shall be attributed to taxable supplies,
>
> (d) … 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,
>
> …".

21. Regulation 101(10) of the VAT Regulations defines "residual input tax" as input tax incurred by a taxable person on goods or services which are used or to be used by him in making both taxable and exempt supplies.

22. The standard method for apportioning residual input tax in Regulation 101(2)(d) of the VAT Regulations reflects the turnover-based calculation in Article 174 of the VAT Directive. The proportion of residual input tax deductible is determined by dividing the value of the taxable supplies made by a business in each VAT period by the value of the aggregate of both the taxable and exempt supplies made by it in that

same period, and expressing the result as a percentage. As pointed out by Warren J in *St Helen's School Northwood Ltd v HMRC* [2006] EWHC 3306 (Ch), [2007] STC 633 at [16] the standard method can be viewed as a proxy for an apportionment according to use.

23. Regulation 102 of the VAT Regulations provides, so far as is material, that

> "(1) … the Commissioners may approve or direct the use by a taxable person of a method other than that specified in regulation 101.
>
> …
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> (3) A taxable person using a method as approved or directed to be used by the Commissioners under paragraph (1) above shall continue to use that method unless the Commissioners approve or direct the termination of its use.
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> …
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> (5) Any approval given or direction made under this regulation shall only have effect if it is in writing in the form of a document which identifies itself as being such an approval or direction.
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> …
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> (9) With effect from 1st April 2007 the Commissioners shall not approve the use of a method under this regulation unless the taxable person has made a declaration to the effect that to the best of his knowledge and belief the method fairly and reasonably represents the extent to which the goods or services are used or to be used by him in making taxable supplies.
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> …
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> (10) The declaration referred to in regulation (9) above shall –
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> (a) be in writing,
>
> (b) be signed by the taxable person or by a person authorised to sign it on his behalf, and
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> (c) include a statement that the person signing it has taken reasonable steps to ensure that he is in possession of all relevant information."

24. Regulation 102(1) of the VAT Regulations enables HMRC to approve or direct the use by a taxable person of a PESM which, as Etherton LJ observed in *HMRC v London Clubs Management Limited* [2011] EWCA Civ 1323, [2012] STC 388 at [29] is directed [by Section 26(3) of the VATA] to achieving a fair and reasonable attribution when the standard method does not do so, or at least a fairer and more reasonable attribution than the standard method.

LnS's proposed PESM

25. The PESM proposed by LnS replaces the standard method's turnover-based calculation with a method that uses floor space as the proxy for the use of VAT-

bearing costs together with a turnover element for those parts of the stores used for taxable and exempt supplies (ie the reception areas). The PESM was set out in detail in a letter of 15 December 2008 to HMRC.

26. Under the proposed floor space and values PESM, input tax is directly attributed to taxable and exempt supplies as far as possible and deducted or not accordingly. Input tax that is not directly attributable to either taxable or exempt supplies is attributed to taxable supplies in the proportion which "taxable floor space" in LnS's stores bears to "total floor space". "Taxable floor space" for this purpose means areas of the stores used for making taxable supplies of storage space to customers. The PESM states that the only areas that are used for making both taxable and exempt supplies are the reception areas. The floor space of the reception area is further reduced to reflect the area used exclusively for making taxable supplies. The remaining mixed use floor space of the reception area is apportioned between taxable and exempt use in accordance with the ratio of the value of LnS's taxable supplies to the value of all its supplies.

27. On this basis, LnS calculated that only 0.02% of its income was attributable to insurance sold through the reception areas. The result of the PESM is that LnS would be entitled to deduct 99.98% of VAT incurred on the construction, maintenance and operation of the stores.

Authorities

28. The issue of what constitutes a fair and reasonable method of attribution of input tax has been considered by the courts on many occasions. We were referred to several authorities by counsel. The general principles to be applied when considering deduction of input tax where a person makes both taxable and exempt supplies were set out by Carnwath LJ in *Mayflower Theatre Trust Limited v HMRC* [2007] EWCA Civ 116, [2007] STC 880 on page 885 at [9] as follows:

> "i) Input tax is directly attributable to a given output if it has a "direct and immediate link" with that output (referred to as "the *BLP* test" [*BLP Group Plc v HM Customs and Excise* [1995] STC 424]).
>
> ii) That test has been formulated in different ways over the years, for example: whether the input is a "cost component" of the output; or whether the input is "essential" to the particular output. Such formulations are the same in substance as the "direct and immediate link" test.
>
> iii) The application of the *BLP* test is a matter of objective analysis as to how particular inputs are used and is not dependent upon establishing what is the ultimate aim pursued by the taxable person. It requires more than mere commercial links between transactions, or a "but for" approach.
>
> iv) The test is not one of identifying what is the transaction with which the input has the most direct and immediate link, but whether there is a sufficiently direct and immediate link with a taxable economic activity.

> v) The test is one of mixed fact and law, and is therefore amenable to review in the higher courts, albeit the test is fact sensitive."

29. In *Mayflower Theatre Trust*, a theatre, which was a charitable trust, made exempt supplies of the admission to performances but treated VAT on payments to production companies for staging the performances as residual input tax. The Court of Appeal held that the production services were not solely attributable to supplies of admission but also had a direct and immediate link to the theatre's taxable supplies of programme sales. The theatre was entitled to treat the input tax as residual.

30. We were also referred to *HM Customs and Excise v Southern Primary Housing Association Limited* [2003] EWCA Civ 1662, [2004] STC 209. In that case, the issue was whether input tax incurred on land purchased by the taxpayer was directly and immediately linked to an exempt sale of the land, or to an overall transaction consisting of the sale of the land and the taxable supply of construction of residential dwellings. In *Southern Primary*, Jacob LJ accepted that the tribunal had been wrong to ask whether the input enabled the taxpayer to make a supply in determining attribution. Jacob LJ observed at [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."

31. Mr Andrew Hitchmough, who appeared with Mr Thomas Chacko for LnS, submitted that there was a direct read across from *Southern Primary* to LnS. Mr Sarabjit Singh, who appeared for HMRC, submitted that the case cannot be read across because it was about direct attribution to specific outputs whereas LnS's appeal concerned overheads which could not be attributed to particular outputs. It is correct that *Southern Primary* did not concern overheads but, as *Skatteverket v AB SKF* Case C-29/08 [2010] STC 419 (discussed further below) shows, the "direct and immediate link" and "cost component" tests are also relevant when considering overheads. We accept Mr Hitchmough's submission that "but for" is not the test for attribution of VAT on overheads. It follows from *Southern Primary* that the fact that LnS would not have made supplies of insurance if it did not have facilities to store the insured goods is not the correct test.

32. Mr Hitchmough also relied on similarities between LnS's situation and that of the appellant in *Camden Motors (Holdings) Limited v HMRC* [2008] UKVAT V20674. In that case, a car dealer introduced customers to finance houses in return for commission which was an exempt activity. The issue was how much input tax incurred on the refurbishment of the car showroom could the car dealer recover. The car dealer applied the standard method which resulted in 100% deduction of VAT. HMRC objected and said that the car dealer should apply the standard method override. The tribunal found, at [74] and [75], that the sale of cars was the economic

driver of the business and a far higher proportion of its costs were used in respect of car sales than sales of finance because a greater infrastructure was needed to sell and service cars than to sell financial products. We agree with the approach taken by the Tribunal in *Camden Motors.*

33. Both parties sought to rely on the decision of Warren J in *St Helen's School* as setting out the principles to be applied in determining the apportionment of residual input tax. The school in that case granted a licence of a new sports complex to a subsidiary ("SHEL") in order to facilitate commercial (i.e. taxable) use of the new complex outside school hours in term time and during the holidays. The school retained the right to use the complex for its own, exempt, purposes during school hours in term time. The school argued that it should be able to recover input tax on construction of the complex by reference to the physical use made of the new complex by SHEL, SHEL's use of the complex being compared to that of the school itself by a time-based apportionment. Warren J rejected that argument, on the grounds that it did not accord with the "economic use" of the new complex. At [76]-[79], he concluded:

> "76. In that context, it is instructive, I consider, to look at the position had the School not granted the licence at all and had [it] not allowed any out-of-hours use. In those circumstances, there would have been no taxable supply at all. In consequence, none of the input tax would fall to be attributed to taxable supplies as a result of Regulations 101(2)(b) and (c), Regulation 101(2)(d) not applying. However, the sports complex is <u>used</u> for the purposes of the School's (exempt) business. It is so used not because there is a supply to parents of the physical use (by their daughters) of the sports complex to their children, but because the availability of the complex is part of the package of benefits which is acquired by parents for the fees they pay and which constitutes the exempt supply by the School. The use made by the School, for VAT purposes, of the sports complex is its use in providing that package of services, a single supply. There is, of course, no need to identify a proxy for use when there is only an exempt supply since questions of allocation under Regulation 101(2)(d) do not then arise. Nonetheless, one can see that the "use" referred in Regulation 101 (as elsewhere) is not physical use but some special VAT use. It is, I think, the same as what Miss Simor terms "economic use".
>
> 77. On the facts of the present case, it seems to me that the overwhelming economic use of the sports complex by the School is in relation to the provision of educational services. In that context, I agree with Miss Simor that the source of funds and the purpose of constructing the sports complex are relevant considerations. To regard those factors as relevant is not, in my judgment, to fall into the error, as Mr Thomas would say it is, of categorising the nature of a supply by reference to the purpose or motive in making it. There is no doubt that in the present case, the supplies are distinct and readily identifiable, that is to say the taxable supply of the licence to SHEL and the exempt supply of education. Nor,

> in my judgment, is there any question, in taking those factors into account of treating a taxable supply as an exempt supply or vice versa. The question is what "use" is being made of the inputs in producing the outputs. It seems to me that the purpose of the School, objectively ascertained, in constructing the sports complex is a highly relevant factor in attributing cost components between the relevant outputs and is an entirely different issue from identifying the nature of the output by reference to purpose or motive (which is inadmissible), the issue addressed by Patten J in *Yarburgh Children's Trust*.
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> 78. On the evidence, it is clear that, objectively assessed, the principal purpose of the School in building the sports complex was the furtherance of its educational activities and was carried out in connection with its business of making exempt supplies of education. That conclusion is clear from the way the matter was put in the first draft of the business plan and the approach of the School to the generation of funds by out-of-school use which was designed to meet the running costs of the complex and, if possible, something over and above that. Further, the capital cost of the complex was met out of funds which were either charitable funds or derived from a fund-raising exercise and which were clearly dedicated to the educational purposes of the School. The generation of income by out-of-school use was essentially a secondary consideration, albeit that the benefit thereby produced was an aspect of the whole project from the beginning.
>
> 79. Moreover, it is also clear, I consider, that the income generated by the licence to SHEL was never intended or expected to meet a share of the capital cost proportionate to the physical use of the sports complex by SHEL. The relevance of this is that it is supportive of the view that the principal, objective, purpose of the expenditure on the sports complex was in furtherance of the School's main function of providing education to its pupils and that the license to SHEL was secondary, simply putting to productive use that which has been acquired for a different main purpose. In terms of VAT, the provision of an exempt supply of education was the principal use of the sports complex and the taxable supply of the licence to SHEL was a secondary use."

34. *St Helen's School* was approved by the Court of Appeal in *London Clubs Management* which concerned the appropriate apportionment of input tax in the case of a casino with a catering operation. A very similar situation had been considered by the VAT and Duties Tribunal in *Aspinall's Club Limited v HM Customs and Excise* (2002) (VAT Decision 17797). In that case, a gaming club maintained extensive (standard rated) dining facilities for gamblers making use of its exempt gaming facilities. The club sought to apply a PESM based on floor area that attributed large amounts of its property-related expenditure to taxable catering activity. The tribunal dismissed the club's appeal, holding that exempt gaming was clearly the foundation of the business. The catering was not operated at a profit and its costs were incurred to support the exempt gaming activity. The Tribunal held that a floor area based

method, which would have allowed deduction of 55% of input tax on overheads, did not achieve a reasonable attribution of input tax.

35. In *London Clubs Management*, the taxpayer operated a number of casinos with restaurants and bars. The taxpayer proposed a PESM based on floor space which HMRC refused. The Tribunal held that, although it was not profitable at the time, the catering was not merely provided to facilitate exempt gambling but was an activity in its own right. The Tribunal concluded that the floor space method was more fair and reasonable than the existing method and allowed the appeal. The Court of Appeal held that, in view of the Tribunal's finding of fact that the catering was a business in its own right carried on with a view to making a profit, the Tribunal's decision could not be disturbed. In the Court of Appeal, Etherton LJ, having analysed *Aspinall's*, said this at [41]-[42]:

> "That case and the reasoning of the Tribunal, with which I agree, is illustrative of three points of principle. First, it shows the importance in these cases of close attention to the facts in order to understand the economic or commercial reality underlying the use of the relevant VAT inputs. Secondly, identification of the source or potential source of profit in a business may be an important feature of a business throwing light on whether or not the standard method or a PESM is a more fair, reasonable and accurate method of attribution. It all depends on the facts of each case: cf. *Banbury Visionplus Ltd v Revenue and Customs Commissioners* [2006] STC 1568 at [68]. Thirdly, depending again on the precise factual situation under consideration, the approach of the Tribunal in *Aspinall's Club* (see para 49) may well be appropriate in a case where the taxable supplies are not, in themselves, a source of profit:
>
> > "Those costs are funded by the gaming. That in itself does not make them cost components of those exempt supplies. But in this case it is additional proof, if any is needed, that gaming is the foundation of the business and it is the furtherance of that gaming which causes and is seen as justifying commercially the decisions to incur the expenditure."
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> As both *St Helen's School* and *Aspinall's Club* show, and as was emphasised in *Dial-a-Phone v Customs and Excise Commissioners* [2004] STC 987 at [72] by Parker LJ (with whom the other members of the Court agreed), analysis of attribution for the purposes of Article 2 of the First Directive, Article 17 of the Sixth Directive and Regulation 101 is highly fact sensitive."

36. It is clear from the passage cited above that the task for the Tribunal is to determine the use of the supplies on which the VAT is incurred by reference to economic or commercial reality. We bear in mind that the profit which is derived from an activity may be relevant in determining whether a method produces a fair and reasonable attribution but that is not necessarily the case. As Etherton LJ observed in

London Clubs Management at [84], "profit may be an important factor, but it is not necessarily so, and in some cases it may be entirely irrelevant".

Submissions

37. Mr Hitchmough submitted that the standard method does not work in the case of LnS because it assumes that exactly the same amount of residual input tax is used in order to generate £1 of exempt income as to generate £1 of taxable income. LnS contended that the proposed PESM reflects the true nature of its business (selling storage space) and the economic use of its overheads. Mr Hitchmough emphasised that the sale of storage space, not insurance, is the "driver" of LnS's business, as education was in *St Helen's School*, car sales were in *Camden Motors* and gambling was in *Aspinall's*, and the proposed PESM reflects this. The fact that LnS is only able to sell insurance because it supplies space to store the goods in its stores does not, of itself, mean that overheads are being used for the purpose of selling insurance.

38. Mr Singh submitted that LnS was in error in assuming that physical space was an accurate reflection of how the overheads were used to make taxable supplies. The proposed PESM was flawed because it allocates all storage space exclusively to a taxable use, whereas the reality is that the storage space is attributable to both taxable and exempt supplies, as the storage space is used to generate both taxable supplies of storage and exempt supplies of insurance. It was similar to the error made by the school in *St Helen's School.* Mr Singh said that it was important not to be distracted by physical use of the stores. HMRC's view was that the premises were used for the purposes of the business as a whole, which included making exempt supplies of insurance. LnS was wrong to say that all the floor space apart from the reception area was used only to make taxable supplies and that insurance sales take place physically in reception. HMRC's case is that the storage space is also used to generate exempt income which is important part of LnS's business and a significant contribution to its profit. The sale of storage and insurance are negotiated at the same time. The two are inextricably intertwined. Physical use of space is not an appropriate proxy as it does not reflect economic use. An important feature of LnS's business is the sale of insurance as indicated by the increased focus on sales. The increase in turnover and contribution to profit show that it is a driver of LnS's business. The lack of allocation of costs in the management accounts of the business indicate that the overheads are used for the purposes of the business as a whole. The standard method is fair and reasonable because it changes with the levels of turnover for exempt and taxable supplies which is appropriate when overheads are used to make all supplies.

Discussion

39. Input tax is recoverable by a business to the extent that supplies on which it has incurred VAT are used to make taxable supplies (section 26 VAT Act 1994). Where a supply is used by a business for mixed (ie taxable and exempt) purposes, some form of apportionment is necessary. The purpose of a method is to provide a fair and reasonable apportionment of the supplies on which VAT has been incurred according to use by reference to a proxy. As Etherton LJ observed in *London Clubs Management*, at [33],

> "The onus is on the taxpayer to show that the proposed PESM is more fair and reasonable, that is to say, more accurate ..."

40. The task for this Tribunal is to determine whether the standard method and the proposed PESM produce a fair and reasonable attribution of the supplies on which LnS has incurred VAT to taxable supplies by LnS. That requires us to form a view on whether the methods are accurate proxies for apportionment according to use. If we conclude that both do so, then we must determine whether LnS has established that its proposed PESM is fairer and more reasonable, ie a more accurate proxy, than the standard method.

41. The starting point is use. This appeal concerns the deduction of VAT on the overhead costs associated with the construction, maintenance and operation of LnS's stores. We must determine the extent to which the goods and services supplied to LnS in connection with the construction, maintenance and operation of its stores are used for transactions in respect of which VAT is deductible ie taxable supplies.

42. The meaning of "use" and the way it should be measured for VAT purposes was discussed by Warren J in *St Helen's School*. Warren J observed, at [75] that "physical use of the complex is not necessarily a fair and reasonable proxy … [and] … the phrase 'economic use' is a helpful approach to establishing what the search is for."

43. The term "economic use" is consistent with the analysis of the CJEU in the *SKF* case. SKF was the parent company of an industrial group which made taxable supplies. SKF proposed to sell shares in two of its subsidiaries in order to raise funds to finance other activities of the group. The *SKF* case concerned the deductibility of VAT incurred on services relating to the sale of shares. The issue was not simply whether the services were attributable to the sale of shares but also whether they were attributable to SKF's business generally ie were overheads. At [57]-[58], the CJEU said:

> "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 ... 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 …
>
> 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 …"

44. There is no dispute in this case that the VAT incurred on construction, maintenance and operation of LnS's stores are part of its general costs ie are overheads. In the passage above, the CJEU makes clear that the "direct and immediate link" and "cost component" tests are also relevant when considering overheads. At [60], the CJEU set out how to apply the tests:

> "It follows that whether there is a right to deduct is determined by the nature of the output transactions to which the input transactions are assigned. Accordingly, there is a right to deduct when the input transaction subject to VAT has a direct and immediate link with one or more output transactions giving rise to the right to deduct. If that is not the case, it is necessary to examine whether the costs incurred to acquire the input goods or services are part of the general costs linked to the taxable person's overall economic activity. In either case, whether there is a direct and immediate link will depend on whether the cost of the input 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."

45. At [62], the CJEU showed the national court how it should approach the issue:

> "In order to establish whether there is such a direct and immediate link, it is necessary to ascertain whether the costs incurred are likely to be incorporated in the prices of the shares which SKF intends to sell or whether they are only among the cost components of SKF's products."

46. Applying the CJEU's guidance in *SKF*, in determining what the goods and services supplied to LnS in connection with the construction, maintenance and operation of its stores are used for, it is necessary to ascertain whether and, if so to what extent, the costs of such supplies are likely to be incorporated in the prices of LnS's supplies to its customers. In our view, the actual or likely impact of the costs of overheads on the prices of LnS's supplies not only establishes whether there is a direct and immediate link with those supplies but is also a useful measure of the extent of the economic use of the overheads.

47. First, we consider whether and the extent to which the overhead costs are incorporated in the price of the insurance. The evidence showed that LnS set the price of its insurance by reference to the amounts charged by its competitors for insurance rather than in response to any costs (not even the cost of the block policy). We find that the costs of constructing, maintaining and operating the stores did not materially affect and were not incorporated in the price of the insurance. We consider that there is some link between overheads costs and the sale of insurance simply because the insurance is sold in the reception areas of the stores and the overheads relate, in some part, to those areas. We could not determine the impact of such costs on the price of the insurance from the evidence before us but, for the reasons given above, we consider that the impact of the cost of general overheads on the price of insurance must be very small. Accordingly, we conclude that LnS uses the goods and services

supplied to it in connection with the construction, maintenance and operation of its stores in relation to the exempt supplies of insurance only to a very small extent.

48. The link between overhead costs associated with the construction, maintenance and operation of LnS's stores and the taxable supplies of storage is easier to discern. In our view, if LnS opens a new store or enlarges or refurbishes a store then the overhead costs will increase. Not all customers purchase insurance from LnS and it follows that, if LnS is to recover them, the costs of the new or improved space are likely to be incorporated in the prices of the storage. We consider that costs of constructing, maintaining and operating the store are linked to the price of the supplies of storage because expenditure on new stores and valuation of development projects is assessed in the LnS annual reports in terms of projected space rental levels and levels of occupancy and not by reference to projected sales of insurance. In our view, if the overhead costs increased then that would be likely to lead to an increase in the charges per square foot for storage.

49. Our conclusion is that LnS uses the goods and services supplied to it in connection with the construction, maintenance and operation of its stores almost exclusively for the purpose of making supplies of storage. This conclusion does not determine the appeal. Next we consider whether the methods provide a fair and reasonable determination of the amount of the VAT that is attributable to LnS's taxable supplies and whether one method is fairer and more reasonable than the other.

50. As Etherton LJ stated in *London Clubs Management* at [34]:

> "A fair and reasonable attribution to a taxable supply must, for the purposes of art 17(2) and (5) of the Sixth Directive and reg 101(2)(d) of the Regulations, reflect the use of a relevant asset in making that supply. In assessing that use, and its extent, consideration is not limited to physical use. The assessment must be of the real economic use of the asset, that is to say having regard to economic reality, in the light of the observable terms and features of the taxpayer's business"

51. The standard method, found in regulation 101(2)(d) of the VAT Regulations, involves dividing the value of taxable supplies by the value of all supplies to arrive at a percentage figure, which is treated as the percentage of residual input tax that is attributable to taxable supplies. The application of the standard method in this case would result in 94% to 96% of LnS's residual input tax being attributed to taxable supplies. The proposed PESM produces a level of taxable use of 99.98%.

52. HMRC contend that the level of taxable income to total income is generally a good measure of the economic use of goods and services. The greater the level of taxable income, the greater the economic use of the overhead costs in making taxable supplies. Equally, the greater the level of exempt income, the greater the use of the overhead costs in making exempt supplies. In our view, that proposition only holds good where the relationship between the overhead costs and the income from the taxable and exempt supplies is, broadly, the same. If the costs of goods and services used to make exempt supplies are far greater than the costs of the goods and service used to make taxable supplies then the use of a turnover method would lead to an over

recovery of VAT on those costs. In such a case, the economic reality is that the use of goods and services is weighted towards the exempt supplies which cost more to make and consume more of the VAT-bearing overheads.

53. Further, we do not consider that the contribution to LnS's profitability made by insurance sales and the, understandable, focus on increasing the volume of such a profitable line of business are relevant in determining the extent to which supplies relating to the construction, maintenance and operation of its stores are used by LnS to make supplies of insurance. The fact that a supply generates a large turnover or profit does not, by itself, indicate that the activity uses a high level of overheads.

54. In LnS's case, we have found that the goods and services on which the residual VAT is incurred are used almost exclusively for the purpose of making taxable supplies of storage which is the main focus of its business. We consider that a fair and reasonable attribution of the residual input tax would show that the overheads were almost exclusively attributable to taxable supplies of storage. Although both methods attribute the majority of the overheads to taxable supplies and both might be considered to be fair and reasonable, the PESM proposed by LnS better reflects the economic use of the overheads by LnS and is, accordingly, a more accurate proxy than the standard method.

Decision

55. For the reasons given above, our decision is that the PESM proposed by LnS produces an attribution which is fairer and more reasonable than the attribution that would result from the standard method and, therefore, the appeal is allowed.

Rights of appeal

56. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with the Tribunal's decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this Decision Notice.

GREG SINFIELD
TRIBUNAL JUDGE

RELEASE DATE: 14 September 2012