TC02792

Appeal number TC/2011/08997

VALUE ADDED TAX – partial exemption – whether attribution of input tax under regulation 101 of the VAT Regulations 1995 can take account of a taxable use of goods in a period more remote than the end of the prescribed accounting period in question which is brought about by a change in the law making what were formerly exempt supplies taxable supplies – held it cannot – appeal dismissed

FIRST-TIER TRIBUNAL
TAX CHAMBER

PALATIAL LEISURE LIMITED **Appellant**

- and -

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

TRIBUNAL: JUDGE JOHN WALTERS QC
MRS HELEN MYERSCOUGH ACA CTA

Sitting in public in Norwich on 10 January 2013

Patrick Duffy, Managing Director, for the Appellant

Cheryl Payne-Dwyer, Presenting Officer, HMRC, for the Respondents

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DECISION

1. The appellant, Palatial Leisure Limited ("Palatial") appealed by a Notice of Appeal dated 21 October 2011 against decisions of the Respondents ("HMRC") on three points. Only one of these points remained unresolved at the time of the hearing of the appeal and the hearing proceeded on the basis that only that one outstanding point needed to be determined by the Tribunal.

2. The outstanding point arose in the following way. Palatial made a claim on 24 November 2005 to HMRC for repayment of output VAT wrongly charged on the income from its gaming machines. This claim was made following the decision of the Court of Justice of the European Union ("the ECJ") in the joined cases of *Finanzamt Gladbeck v Linneweber* and *Finanzamt Herne-West v Akritidis* (C-453/02 and C-462/02) [2008] STC 1059, which was handed down on17 February 2005. In *Linneweber*, the ECJ had held that in exercising their powers under article 13B(f) of the 6th VAT Directive to determine the conditions and limitations subject to which the operation of games of chance and gaming machines were to be exempted from VAT, the member states could not validly make that exemption dependent on the identity of the operator of such games and machines and, further, that article 13B(f) had direct effect in the sense that it would be relied on by an operator of games of chance or gaming machines before national courts to prevent the application of rules of national law which were inconsistent with that provision.

3. In short, following *Linneweber*, Palatial, who, since 1996, had operated gaming machines and had always accounted for VAT in full on the net takings in accordance with UK national law (the exclusion from the exemption provided by Group 4, Schedule 9, VAT Act 1994 ("VATA") for betting, gaming and lotteries, of "the provision of a gaming machine" by Note (1)(d) of that Group), claimed repayment of VAT paid in the previous 3 years, from and after 1 October 2002, on the ground that the supplies concerned should have been treated as exempt from VAT.

4. With effect from 6 December 2005 (some 12 days after Palatial's claim was made), the UK national law was changed, by section 16, Finance Act 2006, which amended the definition of gaming machines in section 23 VATA, with the consequence that supplies consequent on the use of all gaming machines ("gaming machine supplies") were within the exclusion from the exemption provided by Group 4, Schedule 9, VATA, which cured the defect in the UK national law identified by the *Linneweber* decision.

5. Palatial has been at all material times a partially exempt trader. Palatial's income from prize bingo was exempt from VAT before 6 December 2005. HMRC accepted Palatial's claim on the basis that its gaming machine supplies should have been treated as exempt from VAT between 1 October 2002 and 5 December

2005 (inclusive). HMRC has made repayments of VAT on this basis amounting to more than £692,000.

6. However, for the purposes of the claim, HMRC required Palatial to re-examine its partial exemption calculations in order to estimate any input VAT claimed in that period which ought not to have been claimed on the basis that Palatial's gaming machine supplies had been exempt and not taxable.

7. In other words, on repaying output VAT following their acceptance that gaming machine supplies, which were originally treated as taxable, ought to have been exempt, HMRC required Palatial to make a counteracting adjustment to their repayment claim, to recognise that input VAT deducted on the basis that the supplies were taxable would not be deductible on the basis that they were exempt.

8. In the estimate of input VAT claimed which ought not to have been claimed a dispute arose between Palatial and HMRC which is the remaining unresolved subject of this appeal.

9. That dispute concerns the correct treatment of VAT on the supply *to* Palatial of gaming machines between 1 October 2002 and 31 March 2005 (inclusive). The position in respect of the period 1 April 2005 to 5 December 2005 (inclusive) is not in dispute. This is because that period falls in the "tax year" (as defined in regulation 99(1) of the VAT regulations 1995 ("the Regulations")) in which the change of law occurred. The significance of this is that HMRC accept that use of the gaming machines on and after 6 December 2005 giving rise to taxable gaming machine supplies can be taken into account in making the adjustment of attribution of input tax for the tax year (which we understand corresponds to the 'longer period' to be applied to Palatial – see: regulation 99(4) of the Regulations) called for by regulation 107 of the Regulations. The parties agree that in the tax year spanning 6 December 2005, any VAT on the supply of gaming machines to Palatial is 'residual input tax' liable to apportionment between taxable and exempt supplies pursuant to regulation 101(1)(d) of the Regulations.

10. But the position in respect of the period between 1 October 2002 and 31 March 2005 (inclusive) is in dispute, because HMRC contend that VAT on supplies of gaming machines to Palatial in that period must all be attributed under regulation 101 of the Regulations to exempt supplies (on the basis that Palatial's gaming machine supplies in that period were properly exempt). Palatial, on the other hand, contends that VAT on supplies to it of gaming machines in that period ought also to be 'residual tax' on the basis that those machines were intended to be used both for making exempt supplies (before 6 December 2005) and also for making taxable supplies (after 5 December 2005). It is common ground between the parties that the gaming machines concerned have an average life of about 7 years from new and so all gaming machines purchased by Palatial between 2002 and 2005 (inclusive) - which were new when purchased by Palatial – were in fact used both before 6 December 2005 (for making exempt supplies) and after 5 December 2005 (for making taxable supplies).

11. The relevant facts, summarised above, were not in dispute. Mr Duffy gave evidence of them informally before us and Ms Payne-Dwyer did not choose to cross-examine him. We find facts accordingly. We note that we received a Witness Statement from Officer Philippa Kent who dealt with the matter for HMRC, but she was not cross-examined either.

12. The issue for our determination is one of law. It concerns the correct application to the facts of this case of regulation 101(2)(d) of the Regulations, which deals with the attribution of input tax to taxable supplies made by a partially exempt trader.

13. We set out the relevant provisions of regulation 101(1) and (2) of the Regulations as they applied at the relevant time (1 October 2002 to 31 March 2005):

> '**101**
>
> (1) Subject to regulation 102 [use of other methods, which we understand is not applicable in this case] the amount of input tax which a taxable person shall be entitled to deduct provisionally [that is, subject to any adjustment required by regulation 107 in respect of a 'longer period'] shall be that amount which is attributable to taxable supplies in accordance with this regulation.
>
> (2) In respect of each prescribed accounting period-
>
> (a) goods imported or acquired by and ... goods or services supplied to, the taxable person 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, and
>
> (d) there shall be attributed to taxable supplies such proportion of the input tax on such of those goods or services as are used or to be used by him in making both taxable and exempt supplies as bears the same ration 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.'

14. The parties take issue over the effect of the words 'such of those goods or services as are used or to be used by him in making both taxable and exempt supplies' in regulation 101(2)(d), which, it will be seen, mirror the formulations in regulation 101 (2)(b) and (c).

15. Mr Duffy, for Palatial, submitted that the words 'or to be used' in regulation 101(2)(d) entitle Palatial to attribute input VAT referable to the use of purchased gaming machines after the change of law effective on 6 December 2005, because such use was (as a result of the changed law) use by Palatial in making taxable supplies. He points out that regulation 101(2)(d) does not limit the use referred to

to use within the prescribed accounting period in which the input VAT was incurred.

16. Addressing the possibility that HMRC's point was that input tax should be re-attributed on the basis that gaming machine supplies had been exempt from VAT at all times (before 6 December 2005) and so that input VAT on the purchase of gaming machines would never (before 6 December 20095) have been deductible, Mr Duffy said that such was a 'superficially plausible position' but it was wrong because it ignored three points.

17. The first point was that the re-attribution is called for because of HMRC's failure to exempt gaming machine supplies. Mr Duffy claimed that in such circumstances Palatial "should be entitled to benefit from the more complete picture offered by hindsight and which we can use to look back with complete confidence and know that the machines in question were indisputably used to make exempt ***and*** taxable supplies".

18. Mr Duffy's second point was that if HMRC had properly treated gaming machine supplies as exempt before 6 December 2005 but then the law had been changed to make them taxable from and after 6 December 2005, it is likely that the change would have been announced well in advance. If it had been, and Palatial had purchased a gaming machine after the announcement but before the change, it could still have said with confidence that the input VAT incurred on the purchase would relate to use of the gaming machine in making both taxable and exempt supplies.

19. Mr Duffy's third point was that in the context of the need for partial exemption calculations to be fair and reasonable, it is clearly unfair that Palatial should get no recovery at all of input VAT incurred on goods (gaming machines) "which no one disputes were used in part to make taxable supplies".

20. Ms Payne-Dwyer submitted that for the purposes of applying regulation 101(2) of the Regulations it was correct to take account of the use and/or intended use of the goods or services concerned as at the time the input VAT was incurred. This submission was supported by article 167 of the Principal VAT Directive ("PVD"), formerly article 17(1) of the 6th VAT Directive which states in terms that 'a right of deduction [of input VAT] shall arise at the time the deductible tax becomes chargeable'.

21. In consequence, Ms Payne-Dwyer submitted, the exercise of the right of deduction (and the attribution of input tax for the purposes of regulation 101(2)) must be based on the circumstances (including the correct application of VAT) prevailing at that time – that is, when the gaming machines in question were purchased by Palatial.

22. An adjustment to the initial attribution of input tax can only, in Ms Payne-Dwyer's submission, be made pursuant to articles 184 to 191 of the PVD, which have been implemented in the UK by regulations 108-110 and 112-116 of the

regulations, which do not apply in this case to Palatial's prescribed accounting periods before 1 April 2005.

23. Ms Payne-Dwyer interprets the expression 'used or to be used' in regulation 101(2) as referring to immediate use (if there was immediate use on the supply being made to the taxable person concerned) or intended use (if there was no such immediate use). On that basis, since there was immediate use of the gaming machines concerned, the attribution must be made on the basis that they were used by Palatial for making exempt supplies.

24. Further, she submits, that as at any time before 1 April 2005, if it was relevant to enquire what Palatial's intended use of acquired gaming machines was, it was use for making exempt supplies since, as at any such time, gaming machine supplies were properly treated as exempt.

25. Ms Payne-Dwyer submitted that the change in tax liability with effect from 6 December 2005 did not change the intended or actual use of the gaming machines except in the case of the longer period adjustment for Palatial's tax year spanning 6 December 2005, where HMRC recognise that in that year the use of Palatial's gaming machines was to make both exempt and taxable supplies, and that this falls to be taken into account for the purposes of the longer period adjustment called for by regulation 107 of the Regulations. They point out, however, that that adjustment is not a correction of an error in the initial attribution, but the second stage (after the initial provisional attribution) in determining Palatial's normal VAT liability for the longer period.

26. We accept Mr Payne-Dwyer's submissions and reject those of Mr Duffy.

27. Gaming machines are not (it was agreed between the parties) capital goods for the purposes of article 187 of the PVD. That being the position, the only adjustment of the initial deduction which is permitted is to give effect more accurately the deduction to which the taxable person was originally entitled (article 184 of the PVD). In the UK that adjustment is provided for by regulation 107 of the Regulations – the longer period adjustment. This is (as stated above) the adjustment which entitled Palatial to take into account the effect of the change of the law in its longer period spanning 6 December 20102.

28. As the ECJ stated in its judgment is *Proceedings brought by Uudenkaupungin kaupinki* [2008] STC 2329 at [24]:

> 'The deduction of input taxes is linked to the collection of output taxes. 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.'

29. There is no need for an express limitation in the wording of regulation 101(2) that an intended use for relevant purposes must be implemented within the prescribed accounting period in which the input VAT is deductible. The question which is formulated by the regulation is "what, in that period, is the use or intended us of the goods or services concerned?" HMRC are, in our view, correct

when they say that the gaming machines in question were put to immediate use in making exempt supplies and that is sufficient to answer the questions posed by regulation 101(2) of the Regulations.

30. The answer to Mr Duffy's first point (paragraph 17 above) is that there is no place for hindsight in ascertaining whether goods or services are used or to be used for making taxable or exempt supplies outside the longer period adjustment – except in the case of capital goods. In the interests of legal certainty the ascertainment of the purposes for which goods or services are used or are intended to be used must be made at the time the input VAT becomes chargeable. This is subject to the longer period adjustment pursuant to regulation 107 of the Regulations but it is not open to Palatial to have regard in relation to input VAT incurred before 1 April 2005 to the change of tax treatment effective on 6 December 2005.

31. HMRC's failure to exempt gaming machine supplies before the decision of the ECJ in *Linneweber* cannot affect Palatial's entitlement to input VAT deduction. HMRC were in any case at all times administering the law as they *bona fide* understood it to be.

32. Mr Duffy's second point (paragraph 18 above) is a variant on his first point. In the application of the relevant rules, it is not significant that one can (as in this case) look at a period longer than that for which a longer period adjustment applies and say that, as a matter of fact, a gaming machine will be used to make both exempt and taxable supplies. The use or intended use which is relevant is only such use as can be determined within the periods laid down in the Regulations – that is, initially in the prescribed accounting period in which the input VAT is incurred, and then in the longer period for which an adjustment can be made under regulation 107 of the Regulations.

33. Mr Duffy's third point, on fairness (see paragraph 19 above) is understandable but misconceived. The deduction system as laid down by the PVD and the regulations must be applied according to its terms. It is fair, in the sense that although Palatial cannot claim as residual input VAT the VAT incurred on its gaming machines in the period between 1 October 2002 and 31 March 2005 (inclusive), in relation to the change with effect from 5 December 2005 when the tax status of gaming machine supplies was changed from exempt to taxable, if that change had been from taxable to exempt, then Palatial would have been entitled to treat all the relevant input tax as wholly deductible under regulation 101(2)(b) of the Regulations, notwithstanding that, as a matter of fact, the machines would have been used for making exempt supplies after the change in the law.

34. For these reasons, we dismiss the appeal.

35. We were told by Mr Duffy that the tax at stake in this appeal was not significant in amount but that Palatial wanted the point to be decided as a matter of principle. Both sides requested that our decision should be a decision in principle. Accordingly we leave the parties to agree the amount of deductible

input VAT in accordance with our decision, while giving liberty to apply to the Tribunal for a further determination in case of any further dispute which they are not able to settle amongst themselves.

Right to apply for permission to appeal

35. This document contains full findings of fact and reasons for our decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Rules. 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.

JOHN WALTERS QC

TRIBUNAL JUDGE

RELEASE DATE: 22 July 2013