Neutral Citation Number: [2021] EWCA Civ 910

Case No: A3/2020/1347

IN THE COURT OF APPEAL (CIVIL DIVISION)
ON APPEAL FROM THE UPPER TRIBUNAL
(TAX AND CHANCERY CHAMBER)
(Mr Justice Morgan and Judge Timothy Herrington)
[2020] UKUT 0132 (TCC)

Royal Courts of Justice
Strand, London, WC2A 2LL

Date: 17/06/2021

Before:

LORD JUSTICE DAVID RICHARDS
LADY ROSE OF COLMWORTH
and
LORD JUSTICE DINGEMANS

- -

Between:

ROYAL OPERA HOUSE COVENT GARDEN FOUNDATION	**Appellant**
- and -	
THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS	**Respondents**

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- -

Peter Mantle (instructed by **Edwin Coe LLP**) for the **Appellant**
Matthew Donmall (instructed by **the General Counsel and Solicitor to HM Revenue and Customs**) for the **Respondents**

Hearing dates: 9 and 10 February 2021

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Approved Judgment

Lord Justice David Richards:

Introduction

1. This appeal concerns the claim of the appellant, Royal Opera House Covent Garden Foundation (the ROH), to deduct the value added tax (VAT) paid by it on supplies comprising Production Costs, a term which I explain below, from the VAT chargeable on its catering supplies. The claim relates to VAT totalling £532,069 paid by the ROH between 1 June 2011 and 31 August 2012.

2. The respondents (HMRC) refused the ROH's claim. The First-tier Tribunal (Tax Chamber) (FTT) allowed the ROH's appeal, by a decision dated 24 May 2019: see [2019] UKFTT 0329 (TC). HMRC's appeal was allowed by the Upper Tribunal (the UT), by a decision dated 22 April 2020: see [2020] UKUT 0132 (TCC). The ROH appeals to this court with permission granted by the UT.

The facts

3. The primary facts were found by the FTT. Those facts were not for the most part in dispute and there has been no challenge to the FTT's findings. In a case such as the present, it is important to pay close regard to those findings. As the authorities make clear, small variations in facts can make a decisive difference to the outcome in any particular case. In *WHA Ltd v HMRC* [2013] UKSC 24, [2013] STC 943, Lord Reed said at [26], "decisions about the application of the VAT system are highly dependent on the factual situations involved. A small modification of the facts can render the legal solution in one case inapplicable to another".

4. The FTT set out its findings relevant to this appeal in its Decision at [44] to [56] and [64].

5. The ROH stages ballet and opera performances in its main auditorium, which has 2,204 seats. Its productions are "highly acclaimed" and they are the "central draw" or the "core" of its commercial proposition.

6. There are extensive catering facilities, particularly as a result of extensive modernisation following the acquisition of the adjacent Floral Hall in the 1990s, providing a new dining area, a balcony restaurant and a champagne bar. In addition, there is the Amphitheatre Restaurant and Bar at the top level of the theatre, the Crush Room for dining and the Conservatory Bar at the Grand Tier level for drinks and bar snacks and a bar adjacent to the studio theatre at a lower level. The overall dining capacity is for 256-365 people. The theatre opens its doors 90 minutes before evening performances and some matinees, allowing access to the restaurants and bars before the performance. Tables are booked in advance and, after booking a ticket, customers are sent an email detailing the various catering options. Once booked, a table is made available for the entire evening until the end of the last interval (there are normally two intervals of about 25 minutes each) and most customers spread their dining over the period before the start of the performance and during the intervals. The proximity of the bar and restaurants and bars to the auditorium enables the audience to have convenient access to their seats which results in most staying within the building during intervals rather than leaving to buy drinks and snacks from nearby establishments.

7. The unchallenged evidence described a visit to the Royal Opera House as "a fully integrated visitor experience". Unlike a West End theatre, "where there might be a cramped bar or just ice creams available, the facilities of the Opera House were a key element for anyone attending a performance".

8. The ROH, as a charity, does not expect to make a profit, and the income from catering and retail sales, in addition to box office receipts and funding from Arts Council England, is required to support its artistic output. The FTT quoted the evidence of the ROH's Director of Finance:

> "The investment in our artistic output, including our direct production costs enables us to generate the necessary income from all sources – including box office and catering/retail. If our productions were not perceived to be of the highest artistic quality by the public, we would not be able to generate the revenues to support our business."

9. In his submissions, Mr Mantle for the ROH described a virtuous circle, whereby the high quality of the artistic output drove demand for the catering offered by the ROH, which in turn increased the income available for spending on the artistic output. The FTT accepted this analysis.

10. The Production Costs relevant to this appeal are those related to each production and do not include the costs of the ROH permanent staff or its fixed overhead costs. They are described by the FTT at [49]:

> "These include the fees for guest performers and conductors, creative teams, music costs (for music still in copyright), the cost of sets, props, costumes, transportation, extras and actors. As such, these can vary from one production to another depending on, for example, the number of performers, the size of chorus (if any) and whether it is a new production requiring an initial outlay in relation to the set, costumes and props or a revival, for which only repairs, alterations and adjustments to existing sets etc. are needed."

Relevant principles of VAT law

11. The basic relevant principles of VAT law are well-settled and not in dispute. They derive from the EU legislation applicable to VAT, which in the present case is Council Directive 2006/112/EC, often called the Principal VAT Directive (the PVD), as interpreted by the Court of Justice of the European Union (CJEU) and by our domestic courts. Effect is given to the PVD by national legislation. As the dispute in the present case relates to VAT paid in 2011-12, the applicable law is unaffected by the UK's exit from the European Union.

12. The principles of VAT law can appear more obscure than they need, partly because some of the most important terms are unfamiliar to all but the specialists. The terms which I will use are as follows. I will use "taxable person" to describe a person, in this case the ROH, liable to account to HMRC for VAT. The VAT system applies to the "economic activity" carried out, independently, by a taxable person: art 9 of the PVD.

In the many cases where the taxable person is a commercial concern, this will mean their businesses, but it has a wider ambit, extending to all economic activities involving the supply of goods and services for consideration, whether or not for profit.

13. Supplies may be made by a taxable person that do not form part of its economic activity, for example if they are made for no consideration. Such supplies fall outside the scope of VAT. Supplies made by a taxable person may form part of the taxable person's economic activity but are, under applicable law, "exempt" from VAT, in which case no VAT is chargeable on such supplies. There is a limited category of supplies forming part of a taxable person's economic activity, not directly relevant to the present case, which are "zero-rated". The difference between exempt and zero-rated transactions lies in the taxable person's right to claim back input tax paid on supplies to it which are linked to zero-rated transactions and the absence of such right in the case of exempt transactions.

14. A supply made by a taxable person is an output transaction or supply and a supply made to a taxable person is an input transaction or supply and the VAT charged on those supplies are respectively output and input tax.

15. The net amount for which a taxable person is accountable is calculated by deducting the input tax on supplies made to the taxable person from the output tax on supplies made by it, but only where taxable input supplies are attributable to taxable output supplies. This arises under art 1.2 of the PVD which includes the provision that:

> "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 costs components*." (emphasis added)

16. The taxable person's right to deduct input tax is conferred by article 168:

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

17. The reference to "costs components" in article 1 might suggest that the cost of the goods or services supplied to the taxable person must be reflected in the price charged for the relevant output supplies made by the taxable person. That is not, however, the case. As article 168 makes clear, it is the fact that the goods or services supplied to the taxable person are used "for the purposes of" the taxed supplies made by the taxable person that gives rise to the right of deduction. The taxable person's purpose is to be objectively ascertained from the facts and circumstances of the transactions, not by investigating the subjective intentions of the taxable person.

18. "Cost components" and objectively determined "purposes" are very general terms whose meaning may not be clear when applied to actual supplies. By its decisions, the CJEU has established that for an input supply to be made "for the purposes of" an output supply, there must be "a direct and immediate link" between them, as confirmed by the reference to "cost components" in art 1.2 of the PVD: see *BLP Group PLC v Customs and Excise Commissioners* (Case C-4/94) [1996] 1 WLR 174 (*BLP*) at [19]-[21]. On the basis of the CJEU's judgment in *University of Cambridge v HMRC* (Case C-316/18) [2019] 4 WLR 126, Lord Hodge said in *Frank A Smart & Son Ltd v HMRC* [2019] UKSC 39, [2019] 1 WLR 4849 (*Frank A Smart*) at [65(ii)] that a direct and immediate link exists "if the acquired goods and services are part of the cost components of that person's taxable transactions which utilise those goods and services".

19. It has further been accepted that where the direct and immediate link is not with a particular supply by the trader but with the whole of its economic activity, (in other words, it is an overhead cost), the input tax on the supply to the taxable person is deductible from the output tax on the taxable supplies made by it in the course of its economic activity.

20. It is common ground in the present case that the Production Costs are not overhead costs.

21. In cases where all the supplies made by a taxable person in the course of its economic activity are taxable, which will often be the case, the need to identify the supplies by the trader with which the supplies to the trader have a direct and immediate link will not arise. Its input tax will usually be deductible from its output tax without further enquiry.

22. The need to make this connection does, however, arise in the case of those taxable persons who are making both taxable supplies and supplies which are either exempt or fall outside the scope of VAT. If the direct and immediate link is exclusively with the taxable supply on the one hand or with the exempt supply or the supply falling outside VAT on the other hand, the input tax will be respectively fully deductible or not deductible at all. Where the link is with both types of supply, articles 173-175 of the PVD provide for an apportionment of the input tax.

The parties' cases

23. In the present case, the ROH's supplies of tickets for performances are exempt but its supplies of catering services are subject to VAT. HMRC contend that the only direct and immediate link of the Production Costs is with the sale of tickets, so that the input tax on the Production Costs is not deductible from the output tax on its catering supplies. The ROH contends that there is a direct and immediate link with both ticket sales and the supply of catering services, so that an apportionment is required. No apportionment has yet been determined.

24. The ROH does not deny that there is an obvious direct and immediate link between the Production Costs of any particular production and the sale of tickets to see performances of that production. But, the authorities establish that the required direct and immediate link of an input supply is not restricted to the output supply with which

it has the closest link. The requirement is only that there is a direct and immediate link.

25. The ROH argues that the Production Costs functioned, in part, to attract customers to consume and pay for its catering supplies at the Royal Opera House. That was part of its purpose in incurring those costs, viewed objectively and in an economically realistic way. They formed part of the costs of the "integrated visitor experience" offered by the ROH to its customers. The catering offered by the ROH is part of that experience and the staging of high-quality productions promotes the catering, which in turn provides financial support for the productions. This, it submits, is sufficient to create a direct and immediate link between the Production Costs and the catering supplies made by it.

26. The ROH submits that the necessary economic link between the Production Costs and the catering supplies exists because the expenditure on productions not only attracts customers to buy tickets but also attracts customers for catering supplies. The ROH accepts that this is not precisely analogous to, for example, an advertising campaign for both ticket sales and catering, but it relies on decisions of the CJEU and this court to establish that expenditure for the purpose of attracting customers for a taxable supply is sufficient to create a direct and immediate link between the expenditure and the supply.

27. HMRC submit that no sufficient direct and immediate link exists between the Production Costs and the catering supplies. The FTT found that it is the high-quality performances of opera and ballet that brings the restaurants and bars their clientele but, HMRC submits, that promotional link is insufficient to constitute the requisite direct and immediate link, as the UT held. HMRC argue there is no basis in the authorities for holding that, where an exempt supply helps to promote a taxable supply, there is a direct and immediate link between the inputs for the exempt supply and the taxable supply. The direct and immediate link of the Production Costs is with the exempt sale of tickets to attend performances of the productions, not with the catering supplies that are promoted by those productions and by the sale of tickets to attend performances of them.

The FTT's decision

28. The FTT accepted the ROH's case. It accepted that the supplies of tickets for performances and the catering supplies to customers were separate supplies, rather than links in the same chain of supplies, and on that point the UT agreed. The relevant question was whether each had a sufficient direct and immediate link with the Production Costs. As it was not in doubt that there was a such a link with the sale of tickets, the real question was whether there was a direct and immediate link with the catering supplies.

29. The FTT considered that the correct approach, following the CJEU's decision in '*Sveda' UAB v Valstybiné mokesčių inspekcija prie Lietuvos Respublikos finansų ministerijos* (Case C-126/14) [2016] STC 447 (*Sveda*) and this court's decisions in *HMRC v Associated Newspapers Ltd* [2017] EWCA Civ 54, [2017] STC 843 (*ANL)* and *HMRC v University of Cambridge* [2018] EWCA Civ 568, [2018] STC 848 (*Cambridge*), was to ask whether there is a "necessary economic link between the initial expenditure and the economic activities which follow" (quoted from this

court's judgment in *Cambridge*). Adopting that approach, the FTT concluded that there was such a link between the Production Costs and the catering supplies. It explained:

> "84.…it is the opera or ballet that is central to everything the ROH does. It is these performances that bring the restaurants and bars of the Opera House their clientele. Such a connection between the productions and catering supplies is, in my judgment, more than a "but for" link. Taking an economically realistic view the performances at the Opera House, and therefore the Production Costs, are essential for the ROH to make its catering supplies. It therefore follows that the purpose of the Production Costs, objectively ascertained, is not solely for the productions of opera and ballet at the Opera House but also to enable the ROH to maintain its catering income.
>
> 85. As such I am satisfied that the Production Costs do have a direct and immediate [link] with the catering supplies of the ROH in the bars and restaurants of the Opera House. Given the "different approach" which is now required, and notwithstanding the comments of Carnwath LJ in *Mayflower*, I am able to derive some support for such a conclusion in the observation of Patten LJ at [54] of ANL that the purpose of the performance in *Mayflower* was in part to enable the Trust in that case was "to make taxable supplies of refreshments"."

The UT's decision

30. The UT held that the FTT had made an error of law in its approach to the direct and immediate link test. Insofar as there had been any change in approach, following *Sveda*, it related to overhead costs. The UT did not consider that there had been any change in approach to the attribution of input costs to specific output supplies. It said at [97]:

> "it is only where the costs of the goods and services are part of the general costs (i.e. overheads) that a right to deduct on the basis of a direct and immediate link with the taxable person's economic activity as a whole arises. In our view, the FTT erred in its approach by relying on *ANL* and *Sveda* and by holding at [83] that those cases were authority for the proposition that all that was necessary to establish a "direct and immediate link" in this case, a specific attribution case, was to consider whether there was a "necessary economic link" between the Production Costs "and the economic activities which follow"."

31. The UT considered that the FTT's reasoning took it no further than a "but for" link which, as the parties agree, is insufficient. It was not enough, as the FTT seemed to think, that the Production Costs were essential to enable the ROH to make its catering supplies. That did no more than emphasise the commercial link between the opera and ballet productions and the catering supplies and demonstrate that those supplies could not take place without the productions.

32. At [100], the UT rejected the ROH's submission that a direct and immediate link was established because the Production Costs were incurred to attract customers to the two different supplies of tickets for performances and of catering: "The fact that the Production Costs "enabled" the ROH to make the Catering Supplies by attracting customers who bought tickets to the opera or ballet [to] partake of the Catering Supplies is not sufficient to establish a direct and immediate link."

33. The UT set aside the FTT's decision and exercised its power to re-make the decision. They accepted that "there were two separate supplies, which operated in parallel, to which the Production Costs were linked" and rejected HMRC's submission that they were in the same chain of supply and therefore any link with the catering supplies was severed by the exempt supply of the tickets. However it accepted at [106] that the link between the Production Costs and the catering supplies was no more than indirect, which they explained in the following paragraphs:

> "107. However, in our view the Production Costs were only cost components of the exempt supply of tickets to the performances staged by the ROH and were not cost components of the Catering Supplies. As Mr Donmall submitted, the costume is used for a ballet performance and a guest opera singer sings at the Opera. The Production Costs are, undeniably, specifically attributable to the ballet and opera performances and are physically used to put on the ballet and opera productions. Consistent with what was held by Carnwath LJ in *Mayflower*, the Production Costs are also used in order to produce the programmes for the performances; the performances not only enable the programmes to be produced, but they have a direct and immediate link in that the material from the performances is directly reflected in the content of the programmes.
>
> 108. However, the same cannot be said of the Catering Supplies. The Production Costs are not used in order to make supplies of champagne at the bars of the ROH. There is an indirect link to the supplies of champagne in that without the performances the champagne would not be served but that is an indirect link. In no sense could it be said that the Production Costs are part of the costs of supplying the champagne and thus a direct and immediate link is precluded. Whilst accepting that the making of the exempt supplies in this case is promotional of the Catering Supplies and assists in giving the visitor to the ROH "a fully integrated visitor experience", that is not sufficient in itself to enable [the] conclusion to be reached that the Production Costs are a cost component of the Catering Supplies.
>
> 109. This case shows that the requirement of a direct and immediate link between the two supplies is an important qualification which must be satisfied if the input tax is to be deducted. It was always clear that a but for test of causation was not sufficient in itself to satisfy the direct and immediate

> requirement. It is not enough to express the but for test in economic terms and then contend that the link must be considered to be direct and immediate. A requirement that the link be direct and immediate will produce the result in some cases that an indirect link or a non-immediate link will not meet the requirement. The present is such a case. We do not consider that the conclusion in this case is in any way a departure from economic reality."

The ROH's case on appeal

34. On this appeal, the ROH submits that it was the UT, not the FTT, that applied the wrong approach to the application of the direct and immediate test.

35. It advances four grounds of appeal:

1) The UT failed to apply the correct objective economic link approach required by the test of a direct and immediate link, in particular rejecting that the use of inputs (the Production Costs in this case) to attract customers to purchase taxable supplies (the catering services) could amount to a direct and immediate link, either as a matter of law generally or a matter of law on the facts of the present case.

2) The UT erred in concluding that there had been no development in the case law relevant to the specific attribution of inputs to particular outputs (as opposed to the law relevant to overhead costs) since the decision of the Court of Appeal in *Mayflower Theatre Trust Ltd v HMRC* [2007] EWCA Civ 116, [2007] STC 880 (*Mayflower*). In particular, it erred in holding that the developments in case law in, and prior to, *Sveda* and recognised by this court in *ANL* were immaterial to this case.

3) The UT erred in law in treating the requirement for a direct and immediate link as significantly different in specific attribution cases and overheads cases.

4) The UT erred in concluding that the FTT had erred in its reliance on *Sveda* and *ANL* and had applied a "but for" test of causation.

36. These grounds of appeal are aspects of the same central point raised by the ROH, that the UT failed to identify or apply correctly the test of a direct and immediate link. It accepts that the correct test is not a "but for" test of causation, satisfied when the inputs are "necessary" or "essential" for the relevant output supply to be made. It submits that the correct test is one of "objective use in the economic sense, not one of incorporation in a supply of goods or services". It argues that, since the decision in *Mayflower*, it has become fully recognised by the CJEU, and by this court in *ANL*, that consideration of economic and commercial realities is a fundamental criterion for the application of the VAT system. This correlates with a shift away from disregarding the ultimate economic purpose of expenditure on input supplies and towards applying an objective economic analysis, when applying the direct and immediate link test.

37. The specific criticism made by the ROH is that the UT failed to recognise that, in a specific attribution case (rather than a case of overhead costs), the objective economic link required by the direct and immediate link test might be found in the use of an input supply by a taxable person to attract customers to purchase output supplies from the taxable person. The UT acknowledged that, on the FTT's findings of fact, the Production Costs did serve to attract customers for the catering supplies. In support of the proposition that the use of inputs to attract customers for output supplies can, in objective economic terms, amount to the required direct and immediate link, Mr Mantle for the ROH relied, in particular, on *Sveda* and *ANL*.

38. The key point, the ROH submitted, is that investment in widely acclaimed opera and ballet productions not only attracts customers to buy tickets for a particular performance but also attracts customers to buy food and drink at the restaurants and bars at the Royal Opera House. Additionally, and viewed objectively, the ROH incurs Production Costs at a high level, in part with the purpose of attracting customers for its catering supplies, thereby generating income to be spent on productions and creating the virtuous circle to which Mr Mantle referred. The ROH does not rely on this factor as itself creating the required link, but it is part of the relevant circumstances. The authorities show that, in assessing the existence of a direct and immediate link, all the circumstances surrounding the transaction concerned are to be taken into account.

The authorities: an introduction

39. While it is straightforward to state the general principles or tests of a direct and immediate link and cost component, their application can be difficult. As this court said in *Cambridge* at [19]: "the test which the courts have applied to determine this issue is essentially a legal construct which explains the abstract language used and the difficulties involved in its application to particular factual circumstances". The court was echoing Advocate General Kokott in her opinion in *Sveda* at [2]: "Although the abstract requirements for this link [a direct and immediate link] have been set out previously, their specific application may sometimes require further clarification, as in this case".

40. Many of the leading authorities are decisions of the CJEU, which are necessarily confined to stating and developing general principles and are not concerned with their application to the facts of particular cases. The parties have cited and closely examined decisions of the CJEU and courts in the UK, before us as they did before the FTT and the UT. It is tempting to treat the application of the test as a question of fact, or a "jury question", but the authorities clearly establish it as a question of mixed law and fact. In any event, an examination of some of the authorities is necessary to an understanding of the decisions of the Tribunals below and of the competing submissions of the parties.

Parallel supplies

41. It is common ground that, in any particular case, there can be a direct and immediate link between one set of input costs and two (or more) specific output supplies, and that those output supplies may comprise both exempt and taxable supplies. There is no conceptual difficulty in the existence of direct and immediate links between the

same input costs and, for example, both the ticket sales and the catering supplies. It may be helpful to give examples.

42. In *Dial-a-Phone Ltd v Customs and Excise Commissioners* [2004] EWCA Civ 603, [2004] STC 987, this court held, affirming the decisions below, that advertising and marketing costs for the sale of mobile phones were directly and immediately linked both to the sale of airtime contracts, which were taxable supplies, and to the provision of insurance intermediary services, which were exempt. It may be noted that at [74]-[75], Jonathan Parker LJ (with whom Waller and Dyson LJJ agreed) said that a link with one supply may exist even though there may be an even closer link with another supply. What was required was a sufficient link, not the closest link. It therefore did not matter that one supply may be viewed in a commercial sense as secondary to another supply.

43. In *Mayflower*, the taxable person was a charitable trust which operated a theatre. It did not stage its own productions, but it bought in productions from independent production companies. This court held that there was a direct and immediate link between the input costs comprising payments made to the production companies and both the exempt supply of tickets for performances and the taxable sale of programmes, notwithstanding that the former accounted for some 80% of the trust's revenue. The link with the programmes existed because the productions "provided the subject-matter of the programmes". They contained information about, and photographs of, the play, the production, the actors and so on. At [43], Carnwath LJ said that the productions "were as much part of the raw material used in preparing the programme, as the paper and ink from which they were physically made".

44. The trust had also claimed to deduct input tax on payments to the production companies from output tax on the sale of confectionary and drinks at the theatre. The rejection of this claim was not appealed but Carnwath LJ said at [40]:

> "Rightly in my view, the Trust has not sought in this court to claim a sufficient link between such sales and the production services. Such sales are the same in character whether they are in an ordinary shop, a theatre kiosk, or a railway station. As with the bar sales in the *Royal Agricultural College* case (cited in *Dial-a-Phone*, see above), any link with the activities of the particular location is "indirect and not immediate"."

45. This comment illustrates the importance of the precise findings of fact in any particular case. The supply of drinks and refreshments in *Mayflower* appears to have had more in common with the sale of drinks at West End theatres, as referred to in the evidence in the present case, than with the catering supplies at the Royal Opera House, as described in the FTT's findings of fact. The comment does not assist on the facts of this case and HMRC did not seek to rely on it.

46. Applying the approach adopted as regards the decisions in cases such as *Dial-a-Phone* and *Mayflower*, it is difficult to see how the ROH can satisfy the requirement for a direct and immediate link between the Production Costs and the catering supplies. The Production Costs are incurred in order to create productions and to stage performances of them. Customers purchase tickets to attend those performances. Those costs do not relate directly to the catering supplies in a sense analogous to the

cases just mentioned. They are not, for example, costs incurred in advertising the catering services nor do they provide any of the contents for the catering supplies. These were the points that underlay the UT's decision that any link between the Production Costs and the catering supplies was neither direct nor immediate, as explained in their Decision at [108].

47. It is for this reason that the ROH seeks to apply a broader test than that used in *Mayflower*, based on a wider commercial or economic purpose of the ROH in using the productions to promote not only ticket sales but also catering supplies. The approach in *Mayflower* was based on the CJEU's judgment in *BLP*. The CJEU's decisions in *BLP* and the many cases that followed it were comprehensively reviewed by Lord Hodge, giving the judgment of the Supreme Court in *Frank A Smart*. I have found Lord Hodge's review to be of great assistance, but the parties are agreed that *Frank A Smart* is primarily concerned with a different issue and that the decision does not directly assist in resolving the present case.

48. It is necessary, for the purposes of addressing the submissions made in the present case, to refer to some of those cases, particularly *Sveda*, in some detail. Lord Hodge adopted the useful terminology of "initial transaction" and "downstream transaction" to describe respectively the transaction on which the input supply was used and the other (often subsequent) transaction with which it is said that the input had a direct and immediate link.

BLP

49. In *BLP*, the taxable person provided management services to a group of trading companies controlled by it. In order to raise funds to pay debts incurred in the course of its taxable activities, it sold shares in a subsidiary company. It claimed to deduct the input tax on professional fees incurred for the purpose of the sale. The sale of the shares was an exempt transaction and the claim was refused on the grounds that the fees were therefore attributable to an exempt supply. The CJEU held that where services (in that case, the professional services) were used for an exempt transaction (the initial transaction), the input tax was not deductible, even though the ultimate purpose of the transaction was to carry out a taxable transaction (the downstream transaction). The CJEU said at [19] that "the goods or services in question must have a direct and immediate link with the taxable transaction, and that the ultimate aim pursued by the taxable person is irrelevant in this respect". This followed from the wording of article 17 of the Sixth Directive (now article 168 of the PVD) and the fact that, otherwise, the attribution of the input tax would depend on a determination of the subjective intentions of the taxable person "contrary to the VAT system's objectives of ensuring legal certainty and facilitating application of the tax by having regard, save in exceptional cases, to the objective character of the transaction in question" (see [24]).

50. As Lord Hodge said in *Frank A Smart* at [28], it is clear that the ruling in *BLP* relates only to the use of services on exempt transactions. In contrast to the facts of that case, the CJEU gave the example of professional services provided for the purpose of taking out a bank loan to meet liabilities incurred in the course of its taxable activities. Such services would not have been directly and immediately linked to an exempt transaction, and the costs of such services would have formed part of the taxable person's overheads.

Kretztechnik

51. That approach was applied by the CJEU in *Kretztechnik AG v Finanzamt Linz* [2005] 1 WLR 3755 to professional services supplied for the purpose of the issue and listing of new shares, which was held to be outside the scope of VAT. As the new share issue was carried out to increase the capital of the company for the benefit of its economic activity in general, the costs formed part of its overheads and input tax on those costs was accordingly deductible. In such circumstances, where the initial transaction is outside the scope of VAT, it is for these purposes disregarded, and the enquiry is whether the input can, on an objective basis, be seen to have been incurred for the purpose of taxable downstream transactions.

52. As will be seen, HMRC relied on these cases as demonstrating a critical difference in approach depending on whether the input costs are incurred for the purpose of an output supply that is exempt or for the purpose of an output supply that is outside the scope of VAT. In the case of an exempt supply, VAT on the input costs is not deductible, whatever the ultimate economic aim of the taxable person in entering into the transaction, as the CJEU decided in *BLP*. The same is not the case where the costs are incurred for a transaction falling outside the scope of VAT. If, on an examination of all the circumstances in such a case, it can be seen that, viewed objectively, the input supply was for the purpose of the taxable person's economic activities, the necessary direct and immediate link with those activities will exist to permit deduction. This, HMRC submits, is the proper analysis of the decision of the CJEU in *Sveda*.

53. The ROH places great weight for its case on *Sveda*, which it is necessary to consider in a little detail.

Sveda

54. The taxable person, Sveda, was a commercial concern carrying on businesses which included the provision of food, beverages and leisure activities. It contracted with a Lithuanian public authority to construct "a Baltic mythology and discovery path", with paths, steps, observation decks, an information stand and car parks. Under the contract, the authority agreed to pay 90% of the construction costs, with the remaining costs paid by Sveda. Sveda agreed to admit the public free of charge to the path for a period of five years. It would offer food, drinks and souvenirs for sale to visitors at locations along the path.

55. The tax authorities refused Sveda's claim to deduct input tax on costs incurred in the construction of the path from the output tax on its supplies of goods and services, on the grounds that the purpose of the input costs was to construct and provide the path free of charge to the public. If Sveda was doing no more than providing a recreational path free of charge, its activity would not be an economic activity for the purposes of VAT and the input tax would not therefore be deductible.

56. The referring Lithuanian court had found that "the recreational path concerned may be regarded as a means of attracting visitors with a view to providing them with goods and services, such as souvenirs, food and drinks as well as access to attractions and paid-for bathing". The CJEU said at [23]:

> "Therefore, it would appear from those findings that Sveda acquired or produced the capital goods concerned with the intention, confirmed by objective evidence, of carrying out an economic activity and did, consequently, act as a taxable person within the meaning of art 9(1) of the VAT Directive."

57. In her opinion at [31], Advocate General Kokott analysed the construction of the path as having two aims. The first aim, which she described as the primary use, was the provision of the path to the public free of charge and the second aim (the secondary use) was the use of the path as a means of providing visitors with taxable services (supplies of food, drink and souvenirs), leading to the question as to which of these two aims was decisive under article 168. At [32]-[33], she referred to *BLP* and to the further development of the CJEU's case law to include overhead costs which are linked to the economic activity of the taxable person as a whole, and are thus cost components of all goods and services supplied by the taxable person.

58. Leaving aside the possibility raised by the Advocate General, but not raised by the parties or considered by the national court, that the construction of the path pursuant to the contract with the public authority was itself a taxable output, the only output transactions that might meet the requirement for a direct and immediate link were the taxable supplies of drinks, refreshments and so on to be made to visitors to the path. The right of deduction would depend solely on whether construction of the path was, within the meaning of article 168, for the purpose of the provision of chargeable services to visitors. For that to be the case, the construction costs of the path "would have to be incorporated into the cost of these services".

59. Having explained at [42]-[43] that the subjective intention of the taxable person was irrelevant, the Advocate General expanded on what incorporation into the costs of taxable services involved at [45]:

> "The existence of an objective economic link between input and output transactions is therefore crucial to the question whether the costs are incorporated into the price of a service as understood in case law. A merely causal link is clearly not sufficient. However, if an input transaction objectively serves the purpose of the performance of certain or all output transactions of a taxable person, there is a direct and immediate link between the two as understood in case law. This is because in such a case the input transaction constitutes, from an economic perspective, a cost component in the provision of the respective output transaction. As the wording of art 168 of the VAT Directive already indicates, that therefore depends on the objective purpose of the use of an input transaction."

60. Applying that test to the facts as found by the national court in Sveda, the Advocate General said:

> "46. In the present case the national court found that the creation of the recreational path serves to attract visitors who may then be supplied with goods and services for consideration. Consequently, the creation of the recreational

> path belongs, from an economic perspective, to the cost components of these transactions.
>
> 47. It follows that there is in principle a direct and immediate link, as understood in case law, between the acquisition or manufacture of the capital goods of the recreational path and the chargeable services offered to visitors."

61. As to the facts, Mr Mantle laid stress on the national court's finding that the creation of the path served to attract visitors who might then be customers for food and refreshments supplied by Sveda. As to the law, Mr Mantle laid stress on the Advocate General's opinion that the creation of the path was, consequently, a cost component of the taxable supplies and that the requirement for a direct and immediate link between the input supplies for the path and the output supplies by Sveda was therefore satisfied.

62. Mr Mantle further submitted that these paragraphs represented a development of the law by the Advocate General from the position as stated in *BLP*. She was recognising that, although there was a direct and immediate link between the input costs of the path and the provision of the path free of charge, there was also an objective economic link between those input costs and the output supply of drinks and refreshments to visitors to the path, because the path was a means of attracting visitors to the place where Sveda would make those supplies.

63. The Advocate General went on to say that the fact that admission to the path was free of charge did not exclude the right of deduction. Although the free use of the path was its primary use, it would not break the link with the secondary use (the supply of drinks and refreshments to visitors) save in two cases. The first would be if the primary use were an exempt supply. In such a case, "the input transactions belong to the cost components of exempt output transactions and are thus incorporated into their price" and articles 168 *et seq* provide, in principle, no right of deduction for those transactions. In those cases, it is irrelevant that the input transaction serves an additional 'ultimate' aim that involves taxable outputs. The second case would be if the primary use represented a non-economic activity of the taxable person, but the domestic court's findings established that this was not so in the case of Sveda's use of the path.

64. The Advocate General therefore proposed that the answer to the question posed by the referring court should be that a taxable person had the right to deduct input tax paid on the construction costs of the path, which was directly intended for use by the public free of charge but which was also used as a means of attracting visitors to a place where the taxable person would make taxable supplies of goods or services.

65. In its judgment, the court reformulated the question referred to it, not, I think, in a way which significantly altered its substance, although it may be noted that, in place of the reference to the capital goods (the path) being "a means of attracting visitors to a location where the taxable person, in carrying out his economic activities, plans to supply goods and/or services" , the reformulated question refers more shortly to "a means of carrying out taxed transactions".

66. At [26], the CJEU said, as regards the question whether the input costs relating to the construction of the path were incurred for the purpose of Sveda's taxed outputs, as required by article 168, that it followed "from the findings made by the referring court that the acquisition or production of these capital goods is directly intended for use by the public free of charge, but that, at the same time, it is part of the taxable person's objective of carrying out subsequent taxed transactions". At [27]-[28], the court discussed the need for a direct and immediate link either between particular input and output transactions or between general costs and the taxable person's "economic activity as a whole" (i.e. overhead costs).

67. At [30], the court said that the findings of the national court established that Sveda's expenditure on the construction costs "should come partly within the price of the goods or services provided in the context of its planned economic activity". Nonetheless, the CJEU recorded at [31] that the referring court was uncertain whether the necessary direct and immediate link existed "owing to the fact that the capital goods concerned [the path] are directly intended for use by the public free of charge".

68. At [32], the court observed that "the case law of the court makes it clear that, 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…In both cases, the direct and immediate link between the input expenditure incurred and the economic activities subsequently carried out by the taxable person is severed".

69. The CJEU went on to say at [33] that making the path available to the public free of charge was not an exempt transaction and that "given that the expenditure incurred by Sveda in creating that path can be linked…to the economic activity planned by the taxable person, this expenditure does not relate to activities that are outside the scope of VAT". It continued at [34]:

> "Therefore, immediate use of capital goods free of charge does not, in circumstances such as those in the main proceedings, affect the existence of the direct and immediate link between input and output transactions or with the taxable person's economic activities as a whole and, consequently, that use has no effect on whether a right to deduct VAT exists."

70. The answer given at [37] to the referring court's question, as reformulated by the court, was that article 168 was to be interpreted as granting, in circumstances such as those in *Sveda*, a right to deduct the input tax paid:

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

71. In accordance with its function and practice, the court did not state whether the necessary link existed between the costs incurred in the acquisition or production of the capital goods and either output transactions such as the supply of drinks and refreshments along the path or Sveda's business as a whole. However, the fact that the most obviously direct and immediate link was with the provision of the path to the public free of charge would not prevent the existence of a direct and immediate link with either the output transactions comprising supplies made for consideration along the path or, as overheads, with Sveda's business as a whole.

72. I pause here to say that the passages in the CJEU's judgment to which I have just referred seem to me to make clear that the link discussed by the court may be either with specific output supplies or with the taxable person's economic activity as a whole, although in that particular case, on the basis of the domestic court's findings, it appeared to fall into the latter category. Lord Hodge said as much in his review of the CJEU's case law in *Frank A Smart* at [52]. Mr Mantle submitted that the UT was suggesting in its Decision at [80]-[83] and in the last sentence of [97] that the principle expounded in *Sveda* was applicable only where the input costs are part of the overhead costs, and not when they are attributable to any particular output transactions. I do not read them as making that suggestion but, if they were, I would not agree with it.

73. HMRC submits that the crucial element in *Sveda*, which distinguishes it from *BLP*, is that the immediate use of the capital goods was in a supply – the provision of the path to the public free of charge – which fell outside the scope of VAT, while in *BLP* the immediate use of the professional services was in the sale of shares, an exempt transaction. If Sveda had not been intending to carry on economic activity along or in connection with the path, the construction of the path could not have formed part of its economic activity and would therefore have fallen outside the scope of VAT. However, because Sveda was intending to carry on economic activities along the path, the relevant input costs were found to be for the purpose of its economic activities. This is the significance of the reference in the court's judgment at [37], quoted above, to such acquisition and production being "for the purposes of a planned economic activity related to rural and recreational tourism".

74. To summarise, there was, in principle, a direct and immediate link between the construction costs of the path and the supply of chargeable services, such as drink and refreshments, to visitors to the path. That link would not exist in two circumstances. The first would be if the path was made available for consideration but it was an exempt transaction (as in *BLP*): see [50]. The second would be if Sveda's primary use of the path was a non-economic activity: [52]. Neither applied on the facts of *Sveda*. By contrast, HMRC submitted, the first applies in the present case, just as it did in *BLP*.

ANL

75. The ROH also relied on the judgment of Patten LJ in *ANL*, with which Jackson and Black LJJ agreed, in which he commented on *Sveda*. The taxable person, a newspaper publisher (ANL), purchased vouchers for retail goods, which it distributed without charge to customers who had bought its newspapers for a set period. Newspaper sales were zero-rated and ANL claimed repayment of the input tax on the purchases of the vouchers. HMRC refused the claim on the grounds that the input tax was directly and

immediately linked to the onward supply of the vouchers for free, which was accordingly outside the scope of VAT. On this issue, ANL succeeded before both tribunals and before this court.

76. Patten LJ quoted from the decision of the Upper Tribunal where it had said that "having regard to all the circumstances and viewed objectively from an economic perspective, the answer in this case is plain. The vouchers were acquired for the purpose of the business promotion scheme to increase the circulation of ANL's newspapers, and also to facilitate the associated sales of advertising". The vouchers were designed to, and did, boost the circulation of the newspapers. The immediate use of the vouchers in providing them to its customers free of charge could not affect the direct and immediate link with the sales of newspapers and advertising.

77. Patten LJ reviewed the CJEU's decision in *BLP* and then two of its decisions concerned with overhead costs, before coming to *Sveda* which, as I have said above, addressed both overheads and the attribution of costs to specific transactions. In a passage on which Mr Mantle placed some reliance, Patten LJ said:

> "47. It seems to me that the CJEU has clearly moved away in these recent decisions from any disregard of the ultimate economic purpose of the relevant expenditure in considering whether it should be treated as linked to the taxpayer's wider economic activities. This is not a question of subjective intent but requires an objective analysis in terms of the taxpayer's identifiable economic activities of why the input supplies were acquired. Although there must, I think, be some evidence that the cost of the input supplies was passed on as part of the cost of the supplies which the taxable person subsequently makes, the absorption of those costs as part of the expenditure of running the business is not to be ignored merely because they also facilitated the making of supplies which in themselves were either exempt or outside the scope of the PVD.
>
> 48. So in the present case the cost to ANL of acquiring the vouchers can be treated in purely causal terms as attributable to the onward supply of the vouchers. Without the purchase of the vouchers their free distribution could not have taken place. However, in economic terms, the cost of purchasing the vouchers was also part of ANL's overall expenditure in the production and sale of its newspapers which the vouchers were intended to promote. The fact that the vouchers were provided free to buyers of the newspapers merely serves to confirm that they were cost components of the business rather than the onward supply of the vouchers."

78. It is clear that in these paragraphs, Patten LJ is dealing with overhead costs and referring to the development in the CJEU's case law after *BLP* as regards the treatment of those costs, to which Advocate General Kokott also referred in her opinion in *Sveda* at [33].

79. Mr Mantle, and the FTT, placed some weight on what Patten LJ said about *Mayflower*. Patten LJ said at [54] that it was there held that "the expenses were linked to the exempt supply of tickets even though the purpose of the performance was in part to enable the Trust to make taxable supplies of refreshments". He continued at [55]:

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

Discussion

80. Central to the ROH's appeal is its submission that, on the facts as found by the FTT, a direct and immediate link existed between the Production Costs and the catering supplies. It submits that there was a clear, close economic link, because the Production Costs functioned, in part, to attract customers to consume and pay for the ROH's catering supplies. Relying in particular on what Patten LJ said in *ANL* at [47], it submits that, while *BLP* was authority for the proposition that the "ultimate purpose of the transaction" was irrelevant, *Sveda* established the need to look at the ultimate economic purpose of a particular input. It relies on the CJEU's judgment at [33] and [34], referring to a direct and immediate link between Sveda's expenditure on the path and its planned economic activity as a whole, and to the Advocate General's opinion at [45], where she says that the existence of "an objective economic link between input and output transactions" is crucial. The ROH also relies on *ANL* at [47] where Patten LJ said that the CJEU had clearly moved away from any disregard of the ultimate economic purpose of the relevant expenditure in considering whether it was linked to the taxable person's wider economic activities. At [48], Patten LJ emphasised that, in economic terms, the cost of purchasing the vouchers in that case was part of the taxable person's overall expenditure in the production and sale of its newspapers.

81. In considering these submissions, it is important to have clearly in mind the facts in *Sveda* and *ANL* which, as they must in all cases, formed the basis for finding a direct and immediate link. In *Sveda*, the taxable person was a commercial concern carrying on business for profit. It incurred expenditure in constructing the recreation path to which it admitted members of the public free of charge. Although viewed in isolation, the provision of the path so as to give free access to the public would not be an economic activity, Sveda planned to make taxable sales of drinks, refreshments and souvenirs along the path to visitors. It can readily be seen that construction of the path was integral to the supplies it proposed to make. From Sveda's economic point of view, objectively identified, the only purpose of the construction of the path was to give access to those supplies. The link was plainly direct and immediate.

82. The same may be said, perhaps with even greater force, about *ANL*. It is fair to ask what other economic purpose could ANL have had when it provided retail vouchers free of charge to buyers of its newspapers, if it was not to promote the sale of those newspapers? The UT in that case considered, and this court agreed, that it was a plain case of a direct and immediate link.

83. The use of phrases in *Sveda* focusing on an economic link, on which the ROH relies, do no more than explain the nature of the connection required to satisfy the test of a direct and immediate link in cases where there is also a link with non-economic activities, such as the gratuitous provision of the path and of the retail vouchers. They do not herald a new and broader test for determining the existence of a direct and immediate link. As is made clear in the Advocate General's opinion and the CJEU's judgment in *Sveda*, and in Patten LJ's judgment in *ANL*, the legal developments after *BLP* related to the recognition that overhead costs, which could not be linked to specific transactions, could be linked to the output transactions of the taxable person's general economic activity.

84. Mr Mantle supported the approach and reasoning adopted by the FTT. However, I consider that the UT was correct to reject it.

85. In its decision at [81], the FTT said that, like the programmes in *Mayflower*, the catering supplies by the ROH were separate supplies, rather than links in the same chain. I will come back to the question of links in a chain but, on the facts, I would observe a clear distinction between the programmes and the catering supplies. This court in *Mayflower* held that a direct and immediate link existed between the costs of buying in productions and the programmes because the former provided the content for the latter. It was not a promotional link.

86. At [82]-[83], the FTT relied on *Sveda*, *Cambridge* and *ANL* as showing that a different approach to this question had developed, so that what was required was "to objectively consider whether there is a 'necessary economic link between the initial expenditure and the economic activities which follow'". The quotation in that passage is taken from the judgment of this court, given by Patten LJ, in *Cambridge*, although it is inaccurate because the court referred to "*the* necessary link". More importantly, it is taken out of context. The court was there explaining the approach taken in *Sveda* to the question of a direct and immediate link where the expenditure is factually attributable to a more immediate, non-taxable activity, such as the construction of the recreation path in *Sveda*. For the reasons given above, I do not accept that the test of a direct and immediate link has been re-interpreted as a test of economic necessity.

87. The FTT proceeded at [84] to apply a test of economic necessity. It observed, correctly, that it is the performances at the Royal Opera House that bring the bars and restaurants their clientele. It said that, taking an economically realistic view, the performances provide more than a "but for" link and were essential for the ROH to make its catering supplies. It therefore satisfied the direct and immediate test. As Mr Donmall for HMRC submitted, this is no more than a test of commercial necessity, without grappling with the need for the link to be direct and immediate.

88. I accept the criticisms of this approach made by the UT in its decision at [98]. For the reasons given by the UT, there was no direct and immediate link between the Production Costs and the catering supplies.

89. There is a paradox in the ROH's reliance on the analysis in *Sveda*, a case concerned with the sufficiency of a link between a taxable input supply and a taxable output supply in circumstances where there was a chain of supplies and the immediate link of the input costs was, on the facts, with the provision of the path, rather than with the output supplies of drinks and refreshment. However, the provision of the path was, viewed in isolation, a non-economic activity and so could be disregarded, with the result that there was for VAT purposes a direct and immediate link between the taxable supplies and the chain of supply was not severed. By contrast, in the present case, the ROH argues that there is no link to be disregarded but that there are two separate supplies of tickets for performances of productions and of catering, each of which is directly and immediately linked with the Production Costs. It argues that the supplies were not in a single chain and no question of severing a chain of supply arises.

90. The UT agreed with the FTT that the sales of tickets and the catering supplies were separate supplies and not links in a chain of transactions. HMRC ran an alternative case that, if there were a direct and immediate link between the Production Costs and the catering supplies, it could only be because the supplies of tickets for performances were promotional of the catering supplies and were thus links in a chain of transactions. By a respondent's notice, HMRC repeat this alternative submission before us.

91. I am willing to decide this appeal on the same basis as the UT, but I see great force in HMRC's alternative analysis. High Production Costs lead to performances of prestigious and high-quality productions for which customers buy tickets and are thereby encouraged to make use of the catering supplies. This link between the Production Costs and the catering supplies is not perhaps as striking as that between the recreation path and the retail supplies in *Sveda* or the retail vouchers and newspaper sales in *ANL*. Nevertheless, if one postulates a situation in which the tickets to performances are supplied free of charge, it would be arguable on the basis of *Sveda* that a direct and immediate link existed between the Production Costs and the catering supplies, although it would depend on all the circumstances of such a startlingly different counter-factual situation. As in fact the supply of tickets was exempt, such a link could not be made, as passages from *Sveda* quoted above make clear. However, I do not reach my conclusion on the basis of HMRC's respondent's notice and I need say no more about it.

Conclusion

92. For the reasons given in this judgment, I would dismiss this appeal.

Lady Rose of Colmworth:

93. I agree.

Lord Justice Dingemans:

94. I also agree.