[2018] UKUT 218 (TCC)

Appeal number: UT/2017/0132

VAT – Input tax – Claim for recovery of input tax under-claimed between 1974 and 1997 – Quantification and substantiation of claim – Whether the First-tier Tribunal erred in refusing appeal because amount not quantifiable with sufficient precision – No – Finance Act 2008, section 121 – appeal refused.

UPPER TRIBUNAL
(TAX AND CHANCERY CHAMBER)

ON APPEAL FROM THE
FIRST-TIER TRIBUNAL (TAX CHAMBER)

NHS LOTHIAN HEALTH BOARD

Appellant

v

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS

Respondents

TRIBUNAL: LORD TYRE

Sitting in public at George House, 126 George Street, Edinburgh on 25 and 26 April 2018

David Southern QC, instructed by Liaison, for the Appellant (NHS Lothian Health Board)

Elizabeth Roxburgh, Advocate, instructed by the Office of the Advocate General for Scotland, for the Respondents (HMRC)

LORD TYRE:

Introduction

1. This is an appeal against the refusal by the First-tier Tribunal (FtT) of a claim for repayment of input tax relating to services supplied to 44 scientific laboratories operated by the appellant during the period from 1974 to 1997. It is the latest in a series of claims made by health boards in Scotland to attempt to recover underclaimed input VAT following the decision of the House of Lords in *Fleming (t/a Bodycraft) v HMRC* [2008] STC 324 and the subsequent amendment of the law made by the Finance Act 2008, section 121. As with other such historical claims, the difficulty facing the appellant has been finding a reliable means of quantification of the VAT said to have been paid but not recovered at the time when it ought to have been claimed.

Factual background to the present appeal

2. Most of the work done in the laboratories during the period in question was carried out for the clinical purposes of the appellant itself and accordingly consisted, so far as VAT was concerned, of non-business activities. Input tax incurred for the purposes of non-business activities is not recoverable. It is, however, a matter of agreement that the laboratories also carried out work for persons other than the NHS (such as local authorities and pharmaceutical companies) which, for VAT purposes, constituted business activities. That work included:

    - Non-patient tests;
    - National External Quality Assessment Scheme (NEQAS) work;
    - Drug trials; and
    - Food and water testing.

    It is further agreed that input tax paid in respect of laboratory expenditure attributable to those activities between 1974 and 1997 was not reclaimed by the appellant or by any government body on its behalf.

3. The FtT heard evidence from four witnesses who had worked during the material period, and continued to work, as scientists (not clinicians) in laboratories operated by the appellant. Each described the work that he or she had carried out for external agencies. The four witnesses gave varying evidence as to the amount or proportion of their time spent on non-NHS work, and as to the periods of time during which they were involved in such work. Evidence was also led from two accountants employed or formerly employed by the appellant regarding aspects of the appellant's financial management.

4. The first non-historical claim by the appellant for recovery of business-related input tax was made in relation to the year 2006-07. This claim was made on a "sectorised" basis with the laboratories constituting one of the sectors. After lengthy negotiations, an agreement was reached between the appellant and the respondents that the taxable proportion of costs in the laboratories sector for 2006-07 was 14.70%.

5. On 30 March 2009, the appellant submitted a global *Fleming* claim which included a claim for £2,377,686 in respect of the laboratories sector for the years from 1974 to 1997. The 14.70% figure agreed for 2006-07 was used as a baseline for the laboratories claim, although in some years that figure was reduced because no NEQAS income was taken into account, and/or because no public health and biochemistry income was taken into account. The claim was rejected in full by the respondents, as was a revised and slightly reduced claim submitted on 12 April 2011. The appellant appealed to the FtT.

The decision of the First-tier Tribunal

6. The FtT began by rejecting two arguments presented on behalf of the respondents, the first being that the claim was new and therefore time barred, and the second being that certain of the appellant's business activities had consisted of the making of exempt rather than taxable supplies. Neither of those arguments was renewed by the respondents in the present appeal.

7. The FtT then proceeded to consider whether the claim as calculated represented the amount of VAT recoverable in respect of business activities during the *Fleming* period. It noted that the material relied upon by the appellant did not permit the calculation of the business income of the laboratories, and continued:

> "194. While the Tribunal accepts the officials' testimony about a general level of activity providing *business* supplies and their nature, it is not sufficiently precise to use as a basis for quantification of the claim throughout the relevant period.
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> 195. This shades into the final and major consideration in the appeal, which is the calculation of the taxable percentage. This, it is acknowledged by HMRC, was agreed at 14.70% for 2006/07. That, certainly, was the figure acted upon for that year. However, that agreement did not extend to other years. The appellant's advisers, Liaison, adopted it as a starting-point, then 'extrapolated' that back about ten years to the end of the relevant period, and then further back to its start.
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> 196. The Tribunal does not consider such an approach reasonable or acceptable. While the witnesses confirmed that there had been no changes to the general pattern of activity, there had not been any reference to reliable primary data. The time-scale involved also undermines the likely accuracy of the process of extrapolation. There is an interval of ten years between the end of the relevant period and 2006/07, and that is preceded by a taxable period of about 25 years. The value of the claim (about £900,000 as now adjusted) is substantial. The ratio of each activity might vary over

an extended period: so too might profit margins. The Tribunal finds that there is no written agreement concerning use of 14.70% for any period. It was used in calculating an agreed amount recoverable in 2006/07. All this tends to undermine the validity of 14.70% as a *business/non-business* fraction used over an extended period…

197. The Tribunal would suggest that there is a need to have a verifiable percentage, calculated by reference to prime records at regular intervals. For example, it might well be acceptable in a 25 year period to have verifiable figures every five years, and if there is not significant variation, to use extrapolated figures for the intervening four years. The Tribunal observes that in the actual calculation of the claim… 14.70% was not used throughout; 11% was used, and also 12.15%.

…

199. The Tribunal is conscious of the efforts made by the appellant's advisers in researching the Claim. The essential flaw, however, is in seeking to apply the taxable percentage of 14.70% throughout the relevant period. There is no basis in our view for invoking the percentage used for 2006/07 to other years, especially given the interval of time involved. Levels of turnover, expenditure, and profit, all of which tend to affect the calculation of this claim, are unlikely to remain constant. The Blue Books have value as prime records. But they show essentially the level of expenditure with a coded breakdown. The witness evidence, while we accept it, speaks only very generally to the types and level of *business* activity, but is not sufficiently precise or satisfactory as a basis for the claim."

(Emphasis in the original.)

8. The FtT then made certain observations in paragraphs 200 and 201 of its decision about partial exemption methods, and about the need for direct attribution of input tax to be carried out to the fullest possible extent. It expressed the view that the dearth of information concerning income and its tax liability called into question whether direct attribution had been done to an adequate extent.

9. For all of these reasons the FtT rejected the claim and dismissed the appeal.

Grounds of appeal to the Upper Tribunal

10. The grounds of appeal were as follows:

    (i) The FtT erroneously approached the matter as if it involved questions of direct attribution or partial exemption, when the appeal only involved a business/non-business apportionment claim.

    (ii) Because of this, the FtT adopted an incorrect evidential standard by adopting the prescriptive approach relevant to partial exemption, when it ought simply to have

considered whether the appellant's method produced a fair and reasonable apportionment.

(iii) The FtT failed to draw the correct conclusions from the evidence before it.

(iv) The FtT erred in rejecting the 14.70% figure as an appropriate baseline for the years to which the appeal related.

(v) The effect of these errors was that the FtT failed to ascertain the amount of input tax under-recovered and, moreover, thereby breached the effectiveness principle.

It was acknowledge in the course of the hearing before me that there was a degree of overlap among the grounds of appeal.

Argument for the appellant

11. In his submissions on behalf of the appellant, senior counsel distilled the grounds of appeal into two elements. Firstly, the FtT had failed to recognise that the claim required only a business/non-business apportionment, and had allowed itself to be distracted by the rules applicable to partial exemption. Secondly, and because of this, it had wrongly failed to appreciate that the appellant's calculation of its claim was supported by sufficient evidence and fell within the range of acceptable methods. The circumstances of the present case differed from the previous unsuccessful appeals (*Lothian NHS Health Board v HMRC* [2015] STC 2221; *Greater Glasgow & Clyde NHS Health Board v HMRC* [2017] UKUT 0019 (UCC)) in the following respects:

    - The FtT had had available to it detailed evidence of expenditure, including the VAT element, for all years up to 1992-93;
    - The proposed rate of recovery was one which had been agreed with the respondent for the year 2006-07;
    - The FtT had heard evidence from witnesses employed in laboratories during and since the period at issue which demonstrated continuity and supported the use of the percentage agreed for 2006-07.

12. As a matter of law, direct attribution had no relevance to a business/non-business apportionment. The only material provision of the Principal VAT Directive (2006/112) was Article 173(1), which stated that "in the case of goods or services used by a taxable person both for transactions in respect of which VAT is deductible… and for transactions in respect of which VAT is not deductible, only such proportion of the VAT as is attributable to the former transactions shall be deductible". Direct attribution was accordingly a red herring: it was a right exercisable by the taxpayer and not an obligation. In a sectorised claim it was effected, if at all, at organisational and not sectoral level.

Article 173(1) did not require direct attribution of input tax wholly attributable to non-business supplies. In the circumstances of the present case it was not necessary to descend to the level of individual laboratories in determining the recoverable proportion.

13. It was evident from the discussion in paragraphs 200-201 that the FtT had strayed off track into an irrelevant consideration of partial exemption, which might suggest a lack of understanding of the distinction between a business/non-business apportionment and a partial exemption calculation. There was no set prescribed method of carrying out the former, and direct attribution was irrelevant. Because of this, the FtT had approached the evidence in the wrong way, requiring a standard of proof which was impossibly high but unnecessary as a matter of law. The baseline figure of 14.70% was one that had been agreed for 2006-07. The witnesses covered the whole period back from then to the *Fleming* years, and confirmed that the laboratories' business activities had been consistent during that period. The FtT ought not to have been concerned about the gap between 1997 and 2006-07. Application of the 14.70% proportion throughout the relevant period was not an "essential flaw" as the FtT seems to have thought: it was a reasonable method of arriving at an acceptable business/non-business apportionment. If the FtT had not been distracted by the concept of direct attribution, it would have been bound to regard the evidence presented to it as adequate to justify the claim that had been made.

Argument for the respondents

14. On behalf of the respondents it was submitted that no error of law in the FtT's decision had been identified. The FtT had not erred in proceeding on the basis that direct attribution had to be undertaken as far as possible, whether that attribution was to taxable supplies, exempt supplies, or non-business activities. It was not correct that direct attribution had to be carried out only at organisational level; as a matter of fact it had been done in the 2006-07 calculation. The evidence before the FtT related only to certain laboratories; it was insufficient to exclude the possibility that in others only non-business activities were undertaken, so that none of the input tax attributable to those laboratories was recoverable. Nor, it was submitted, could the evidence exclude the possibility that there had been exempt business income. The FtT's comment about the dearth of information concerning income was therefore justified. In any event, its comments regarding partial exemption were made when it had already rejected the appellant's reliance on a taxable percentage of 14.70%.

15. The FtT had been entitled to proceed on the basis of the approach described in *Lothian NHS Health Board v HMRC*, and to conclude that reliance on the percentage of 14.70% as a baseline figure for the whole *Fleming* period was neither reasonable nor acceptable. It was bound to assess the quality of the evidence, and entitled to criticise the use of the 2006-07 percentage over an extended period without its accuracy being tested at regular intervals. As the FtT had noted, the witness evidence as to the volume of business

activities was "impressionistic and imprecise". References in the FtT decision to "the nature of the work not having changed" had been taken out of context.

16. The FtT had set out clearly its concerns in respect of the use of the 14.70% figure as a basis for the whole claim. It had explained why the imprecise evidence as to pattern of activity had not been sufficient to convince it that it produced a reasonable apportionment for the whole of the *Fleming* period. Those were conclusions that it was reasonably entitled to reach. They were not inconsistent with or contradictory of the evidence. In essence, the FtT considered that the appellant had failed to prove its case. There was, in the circumstances, no breach of the principle of effectiveness.

The role of the Upper Tribunal

17. An appeal from the FtT to the Upper Tribunal can only be made on a point of law (Tribunal, Courts and Enforcement Act 2007, section 11(1)). In *Advocate General for Scotland v Murray Group Holdings Ltd* 2016 SC 201 (at paragraph 42), Lord Drummond Young identified four possible categories of appeal on points of law. The fourth of these was said to comprise

> "…cases where the First-tier Tribunal has made a fundamental error in its approach to the case; for example, by asking the wrong question, or by taking account of manifestly irrelevant considerations, or by arriving at a decision that no reasonable tax tribunal could properly reach."

The argument presented on behalf of the appellant appears to me to fall within this category. In certain respects, the submissions of counsel for both parties went somewhat further by seeking to persuade me that the apportionment method contended for by the appellant either was or was not a reasonable one, but that would go beyond this Tribunal's appellate jurisdiction, and I restrict myself to addressing the parties' arguments against the background of Lord Drummond Young's formulation of the law.

Decision

18. In the present case, the fundamental error that the FtT is said by the appellant to have made was to adopt an approach appropriate to partial exemption instead of that appropriate to business/non-business apportionment. I accept the submission of senior counsel for the appellant that these are two distinct exercises. In *Securenta Göttinger Immobilienanlagen und Vermögensmanagement AG v Finanzamt Göttingen* [2008] STC 3473 (ECJ), the taxpayer sought to argue that the method of apportionment as between taxable and exempt supplies should be applied *mutatis mutandis* to supplies used for the purposes of both economic and non-economic activities. That argument was rejected by

the Advocate General (Mazák) at paragraph 42 of his opinion and does not appear to have been accepted by the Court, which stated as follows:

> "33. …It should be noted that the provisions of the Sixth Directive do not include rules relating to the methods or criteria which the Member States are required to apply when adopting provisions permitting the apportionment of input VAT paid according to whether the relevant expenditure relates to economic activities or to non-economic activities. As the Commission has noted, the rules set out in Articles 17(5) and 19 of the Sixth Directive relate to input VAT on expenditure connected exclusively with economic activities, and distinguish between economic activities which are taxed and give rise to the right to deduct and those which are exempt and do not give rise to such a right.
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> 34. In those circumstances, and so that taxpayers can make the necessary calculations, it is for the Member States to establish methods and criteria appropriate to that aim and consistent with the principles underlying the common system of VAT.
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> …
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> 37. …The Member States must exercise their discretion in such a way as to ensure that deduction is made only for that part of the VAT proportional to the amount relating to transactions giving rise to the right to deduct. They must therefore ensure that the calculation of the proportion of economic activities to non-economic activities objectively reflects the part of the input expenditure actually to be attributed, respectively, to those two types of activity."

The only relevant provision in UK domestic legislation is section 24(5) of the Value Added Tax Act 1994, which provides that where goods or services supplied to a taxable person are used or to be used partly for the purposes of a business carried on or to be carried on by him and partly for other purposes, VAT on supplies shall be apportioned so that so much as is referable to the taxable person's business purposes is counted as that person's input tax.

19. On the basis of the foregoing guidance from the Court of Justice, I accept that it would constitute an error of law if the FtT were to attempt to apply principles relevant to partial exemption in assessing whether, or to what extent, input tax was referable to a taxable person's business, as opposed to non-business, purposes. As I have already noted, paragraphs 200 and 201 of the FtT's decision in the present case consist of a discussion of partial exemption, including the need for direct attribution to the greatest degree possible. It is not entirely clear why the FtT considered it necessary to address these matters when it had previously rejected two arguments by the respondents: firstly (paragraph 190) that the appellant's business supplies were exempt and, secondly (paragraph 192) that the NEQAS work in particular consisted of the making of exempt supplies. Perhaps it would be reading too much into these two paragraphs to conclude that the FtT was satisfied that *all* of the appellant's business supplies were taxable. It may also be that the FtT had in

mind the partial exemption adjustment that had been carried out in relation to contracted-out services (COS) VAT.

20. In any event, I am not persuaded by the appellant's submission that the discussion in paragraphs 200 and 201 indicates that the FtT confused partial exemption and business/non-business apportionment so as to vitiate the reasoning contained in the preceding paragraphs of its decision. It is, in my view, quite clear that the FtT was aware of the distinction and that the question that had to be answered was whether the appellant's proposal for business/non-business apportionment was a reasonable one. The word "business" is italicised in several places in the decision, as is the expression "business/non-business" fraction. In my opinion the core of the FtT's decision is contained in paragraphs 194 to 196 set out above. Having found that there was no reliable means of calculating the business income received by the laboratories during the years in the *Fleming* period, the FtT turned to consider the alternative method of calculation proposed by the appellant, namely use of the percentage agreed for the year 2006-07. At paragraph 196, the FtT stated that it did not consider such an approach to be reasonable or acceptable. In other words, the FtT applied the correct test in law for business/non-business apportionment. It did not, at this critical stage of the decision, apply any erroneous test derived from partial exemption.

21. Having thus enunciated the correct test, the FtT then set out the reasons why it did not consider the appellant's approach to be reasonable. In summary, it found that the *Fleming* period was too long and too far removed in time from 2006-07 for a process of extrapolation to produce a result that could be regarded as acceptably accurate. It noted that the ratio of activities and profit margins might vary over such an extended period, and that the figure of 14.70% was specific to 2006-07. In paragraph 199, the FtT expanded on those reasons but they are essentially the same. It held that the oral evidence of the witnesses, taken together with the agreement of 14.70% for 2006-07, did not provide a sufficiently precise or satisfactory basis for a claim for the period between 1974 and 1997. In my opinion the FtT was entitled, on the material before it, to reach that conclusion, and did not err in law in so doing. For the same reasons as set out in my decision in *Lothian NHS Health Board v HMRC* (above) at paragraph 22, there has been no breach of the community law principle of effectiveness. There is accordingly no basis upon which this Tribunal ought to interfere with the FtT's decision.

22. In so far as the FtT went on to discuss partial exemption, I accept the submission on behalf of the respondents that the FtT had already reached its decision, and that nothing in paragraphs 200 and 201 should raise any concern that in doing so it had misapplied the law, or, in particular, that it had been distracted by concepts relevant only to partial exemption. Nor, in my opinion, was it incumbent upon the FtT, having rejected the appellant's proposed percentage of 14.70%, to carry out its own calculations with a view to attempting to arrive at an alternative figure. This is so even in a case where, as here, it was common ground that the appellant had, during the relevant period, carried out business activities in respect of which VAT had not been reclaimed. A clear contrast can

be drawn with *HMRC v General Motors (UK) Limited* [2015] UKUT 605 (TCC), where the FtT had sufficient material before it to enable it to form its own conclusions; in the present case the FtT did not.

Disposal

23. For these reasons the appeal is refused.

LORD TYRE

RELEASE DATE: 2 JULY 2018