TC03397

Appeal number: TC/2012/00196

Value Added Tax – Capital expenditure – recovery of residual input tax – VATA 1994, Ss 25 & 26 - Fleming rule/Section 121 FA 2008 – VAT Regulations 1995, nos. 101 & 102 - principles of quantification – onus and standard of proof – appeal refused

FIRST-TIER TRIBUNAL
TAX CHAMBER

NHS LOTHIAN HEALTH BOARD **Appellant**

- and -

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

TRIBUNAL: JUDGE KENNETH MURE, QC
MR S A RAE, LLB, WS
MR P R SHEPPARD, FCIS, FCIB, CTA

Sitting at George House, 126 George Street, Edinburgh on 21-25 October and 17 & 18 December 2013

For the Appellant, David Southern, Barrister;

For the Respondents, Sean Smith, QC and Ian Mowat, Solicitor, Office of the Advocate General for Scotland

Preliminary

1. This is the second of the related Scottish Health Board appeals. It is at the instance of NHS Lothian Health Board and relates to the recovery of input tax paid on capital expenditure over a 23 year period from 1974 to 1997.

2. Substantially the appellant provides a public service, outwith the VAT system as being *non-business* in nature. However, a small element of its and other Health Board's activities are of a *business* nature and within VAT. For instance, catering for persons other than hospital patients and for which charges are made, is a standard rated supply. This appeal relates to the recoverable input tax on capital expenditure referable to taxable (standard and zero rated) supplies.

3. This is a *Fleming*-type claim, proceeding on the basis of Section 121 FA 2008. In his introductory remarks Mr Southern acknowledged that he had to demonstrate that the VAT which the appellant now sought to recover had in fact been paid earlier, and that it has not been reclaimed or recovered to date. A complication arose under the Contracted-out Services ("COS") scheme: where VAT had been recovered in relation to that earlier, it had to be allowed for in the claim, to avoid any duplication of recovery. Finally, and most problematical, is the devising of a "fair and reasonable" formula to calculate how much input tax paid is recoverable as relating to *business* supplies. Thereafter this has to be allocated between exempt and taxable supplies.

The Law

4. A common Bundle of Authorities was prepared for this and the other related Health Board VAT appeals. These are listed in the Appendix hereto together with certain other authorities referred to.

Evidence

5. In addition to voluminous documentation both parties led evidence from their respective technical specialists, Mr Muir for the appellant and Miss Langley for HMRC. However, Mr Southern prefaced this by leading evidence of matters of fact from four Health Board employees. All of the witnesses read and confirmed the terms of their Witness Statements.

6. Firstly, **Robert Martin** gave evidence. He is currently head of Corporate Reporting & Governance with the appellant. He has over 20 years' experience of financial accounting and management in the NHS in Scotland. He explained that until April 1994 there had been one collective VAT registration for the Scottish Health Boards. Thereafter financial matters within the NHS had been devolved to directly managed Trusts, each with its own VAT registration. He observed by reference to the documentation that the Trusts were not regularly reclaiming monthly input tax. He

confirmed that the appellant's income from private patients was very minute and fell to be treated as *exempt*.

7. Mr Martin explained that where an NHS body bore the cost of VAT, the practice was to record it inclusive of VAT. Where VAT was attributable to a particular outlay and was recovered, expenditure was shown net of VAT. VAT was not recovered where it was only indirectly attributable to an asset. Mr Martin confirmed this throughout cross-examination. He spoke to the appellant's growing awareness latterly of its right to recover residual input tax.

8. Secondly, **Michael Shiels** gave evidence. He is assistant head of Financial Services at NHS Greater Glasgow & Clyde. He has worked in NHS finance for about 20 years, although not for the appellant. He confirmed the practice that where VAT was attributable to a particular asset and taxable supply, it would be recovered. Where this was not possible, the "default" position was that it was treated as irrecoverable. He confirmed too that the supply of services to private patients was minimal and treated as exempt.

9. Next, **Derrick Douglas** gave evidence. He is presently assistant Director of Finance with NHS Forth Valley. Since 1993 he has worked for various NHS bodies in Scotland. He works as a capital accountant and would have been involved in VAT recovery in relation to all capital projects. He was familiar with the recovery of VAT on professional services in COS schemes. He had no recollection of recovering VAT under business activities for capital schemes. He was unaware of proportional recovery of VAT. Repairs and maintenance would have been regarded as revenue and not capital expenditure within the NHS.

10. Mr Douglas indicated that until about 1993 and the structural re-organisation of NHS bodies, the matter of VAT recovery was not pursued methodically. As a general practice VAT on business activities was regularly not recovered.

11. The final introductory witness as to the nature of the financial "background" was **George Curley**, a chartered engineer, presently Director of Operations with the appellant, with responsibility for Estates and Facilities. He was involved in the financial aspects of capital developments. So far as he was aware, no VAT recovery had been made in respect of capital schemes, and he too indicated that he was only aware of VAT recovery under the COS regulations in relation to a small element of professional consultancy fees These works had included the provision of kitchen and dining facilities.

12. We found each of these witnesses credible and reliable. Collectively they tended to confirm as broad propositions the first three Findings-in-Fact suggested by Mr Southern and noted by us at para 33. However, their evidence fell short of supporting the value of the claim or the manner of its calculation. They did not speak to the records relied on by Mr Muir, their compilation or their accuracy, for instance. Their evidence was in very general terms.

13. Evidence was then taken at length from each of the Parties' technical experts, **Ross Muir** for the appellant, and **Miss Kathleen Langley** of HMRC. (They both gave specialist evidence in the related appeal by Dumfries & Galloway Health Board.) Mr Muir is an economics and accountancy graduate, employed by Liaison, a specialist VAT consultancy, and is experienced in advising NHS bodies on indirect taxation. Miss Langley is a specialist Revenue officer, with considerable expertise in this area too. They both spoke to their Witness Statements and to the documentation at some length.

14. Mr Muir explained that there were organisational changes in the NHS in about 2004. There was a need to develop a common methodology in pursuing these claims. An *inputs* based method was agreed, he claimed, to apportion between business and non-business activities. An annual adjustment was required thereafter usually.

15. Mr Muir explained that because of a dearth of records retained by the appellant, he relied on archive information relating to Lothian Health Board in Edinburgh University Library. He sourced their annual accounts from 1976 to 1997. The "blue books" (cost record books maintained by the Scottish Health Service) also provided relevant financial information. The methodology used was approved by HMRC for 2004-2009 as being "fair and reasonable", he claimed. In his *Fleming* calculations Mr Muir used an *inputs* method, with costs taken from annual accounts. These costs, he said, were clearly shown. There were three steps in his calculation. The residual VAT on capital expenditure was calculated. A taxable business percentage was ascertained, using the *inputs* method. That percentage of the amount of the residual VAT was recoverable in his view. He amplified the steps in this calculation. Allowance fell to be made for VAT on professional fees, and VAT attributable to dwellings, being exempt expenditure, was not included. Due allowance had to be made in respect of VAT recovered on works done under the Contracted Out Scheme ("COS").

16. In addition to his Witness Statement there are produced the claim made by Mr Muir on behalf of the appellant with some elaboration and supporting documents (pages 1 and 2). A claim of £1,416,737.87 was made, which represented an increase on the original claim submitted in March 2009 for £1,354,031.36. No doubt the accompanying documentation tends to support this enhanced claim (it extends to about 200 pages), but in his evidence Mr Muir was not taken through this calculation in totality or even for an individual Year or Return period. However, we fear that any such calculation is bound to founder. These are historical records not spoken to by those processing or recording them. Critically, we did not hear any satisfactory evidence as to the manner and practice of their compilation and the crucial aspect of the inclusion or exclusion of VAT and any *interim* recovery of VAT under COS, for instance.

17. In cross-examination Mr Muir seemed to accept that certain correspondence from HMRC had not been replied to in full. There was a need for extrapolated calculations by reference to base figures for certain Years. We note in the papers a divergence in the business: non-business ratio, *viz* 4.71% in 1989/90, 2.77%

(corrected in evidence to 2.59%) in 1990/91, and 4.47% in 2009/10, recorded respectively at pages 248, 265 and 548.

18. We note in Liaison's letter of 28 April 2011 to the respondents that Mr Muir wrote (at page 13) –

> "Since early 2009, we have undertaken a thorough and time consuming exercise to gather as much evidence as possible. … this has included searches within Health Board archives, Scottish Government, The National Library of Scotland, Liaison archives and District Valuation reports. <u>While this information is obviously not complete for each Health Board</u>, it nevertheless provides a clearer and consistent overview of practices within NHS Scotland."

The words underlined by us seem to acknowledge the misgivings which we have expressed about the appellant's evidence.

19. The respondents' only witness was **Miss Kathleen Langley,** the officer of HMRC who was responsible for the decisions dated 21 December 2010 and 6 April 2011 (pages 4 and 11) to refuse the repayment claims, which are the subject of this appeal. Miss Langley read her Witness Statement and there and in evidence she dealt with the broad issues of whether there was an outstanding liability to account to the appellant and its quantification and, also, the appropriate formula to calculate the recoverable proportion of residual expenditure.

20. Miss Langley is a VAT specialist with HMRC and has particular experience of the VAT affairs of NHS bodies. She is familiar with *Fleming* claims to recover input tax on capital building projects similar to the present claim.

21. Miss Langley disapproved of the cost (or inputs) based method adopted by the appellant. She preferred an income (or outputs) based method as being simpler and had suggested this to Mr Muir in relation to the appellant's claim but without success. However, she confirmed (para 7) that the appellant had proved its entitlement to reclaim tax for the period from April 1974 to May 1997. Notwithstanding, quantification, she confirmed, had not been agreed. She stressed that there were in her view evidential difficulties. The original claim of £1,354,031 was increased to £1,416,737, but without adequate explanation.

22. Miss Langley had several reservations about the claim. Firstly, had account been taken of VAT already recovered? For instance had VAT been recovered in respect of Contracted Out Services ("COS")? In particular she doubted whether recovery would have been limited to professional fees. Significantly, she argued, there was no audit trail linking source documents to the final claim. Secondly, the matter was complicated by all the NHS bodies in Scotland having one registration until April 1994, with one consolidated Return being submitted. There was only one VAT 21 form submitted for the appellant Health Board, that for January 1995.

23. Next, had the input tax sought in the repayment claim been incurred? One special feature was that the VAT treatment of construction and maintenance of buildings changed during the period of the claim. In particular land transactions were

exempt from VAT until 1989. As the nature of works undertaken was unclear, it was uncertain whether VAT had ever been incurred, she considered.

24. Also questions of attribution arose. Was the input VAT paid referable to taxable supplies or otherwise? Input tax so far as directly attributable to taxable supplies was recoverable. So far as it was not directly attributable, residual VAT then had to be apportioned, which shades into the second major issue. How should the appropriate formula be calculated? It had to be *fair and reasonable*. It had to take account of the *non-business* activities of the appellant and also the element of exempt supplies in its *business* activities.

25. A *cost* method had been adopted by the appellant to apportion the residual input VAT. This produced a far higher claim than an *income* method, which Miss Langley regarded as more appropriate and straightforward. Moreover, the extent of the various business activities was uncertain. Schedule 5, being the "Business/Non-business Apportionment" for each Year, was crucial to the appellant's claim in asserting a taxable percentage. It referred to taxable costs in relation to catering, IVF and laboratories. There was inadequate documentation, however, to support the percentages of business and non-business activity attributable to catering. There were generally inadequate source documents, and no audit trail was shown. It had been assumed without sufficient consideration that the taxable activities had remained unchanged over an extended period.

26. While reference was made to "direct taxable supplies" this term was not explained, Miss Langley argued. Goods and services bought in for private patients were uncertain. Similar uncertainties existed for entries for laundry, IVF, and laboratory costs. This confused the business/non-business apportionment and undermined the calculation of the taxable percentage. HMRC, Miss Langley explained, would accept a fair and reasonable method of apportioning business and non-business expenditure, but Liaison's method was complex and not accurate or credible in her view.

27. Miss Langley insisted that the agreement of figures for 2004 extended to that Year alone. The method had changed significantly since then. Similarly the letter of 20 December 2010 from Mr Hoad, another HMRC officer, which followed an extended visit (p538-540) related simply to the Year 2009/10. Miss Langley made extensive criticisms of the 2009/10 claim. The partial exemption summary was not included. An adjustment required to be made for exempt activities. This affected the accuracy of other *Fleming* claims. In failing to take account of exempt costs the calculations were seriously flawed. Miss Langley considered with respect to Mr Hoad's remarks that a sufficient analysis had not been made of the 2009/10 calculations.

28. Miss Langley explained that in correspondence – her colleague, Mrs Matthews', letters of 1 December 2009 and 30 July 2010 (pages 2i and 2l) HMRC had urged the appellant to use an alternative suggested method. There had been no response to this. She acknowledged that for 2009/10 catering and laboratory costs were substantial.

However, she insisted that evidential difficulties remained in relation to the evaluation of the *Fleming* claims.

29. Finally, Miss Langley addressed the matter of partial exemption. Exempt outputs had been identified, including private health care income and forensic medical income. Due account has to be taken of this. This calculation is further complicated by VAT on Contracted Out Services. Liaison's method did not include a valid partial exemption calculation for 1984-1997. Another flaw in Liaison's calculation, Miss Langley argued, was failure to take account of the Capital Goods Scheme.

30. Miss Langley maintained her stance in cross-examination. In particular she was insistent that the value of the claim had not been satisfactorily evidenced and that quite apart from more detailed technical shortcomings.

31. As in the earlier appeal we found both Mr Muir and Miss Langley conscientious witnesses of utter professional integrity. Such criticism as we have made of Mr Muir's evidence reflects the nature of the task which confronted him. He had taken over this complex negotiation from a senior colleague. He did his best for his clients in difficult circumstances.

Submissions

32. Both Parties provided us with Notes of written submissions, which they developed in oral argument.

33. Firstly, Mr Southern suggested that the following broad Findings-in-Fact should be made, *viz*:-

(i) During the lengthy period of the claim there had been very limited recovery of residual input tax on capital expenditure;

(ii) The reason for this was that the default position was for non-recovery and that, accordingly, the figures recorded for capital expenditure were VAT inclusive;

(iii) While VAT was recoverable on COS operations, it had been recovered only to a limited extent. That recovery had been far more restricted than the respondents had suggested;

(iv) The respondents apparently were seeking to disengage from a method which had already been agreed and adopted in practice;

(v) Notwithstanding Miss Langley's criticisms it was possible and appropriate to combine both stages of apportionment ie as between non-business and business expenditure and as between exempt and taxable business expenditure.

The evidence, Mr Southern argued, fell to be viewed as a totality. Messrs Martin, Shiels, Douglas and Curley had all given helpful and consistent evidence supporting

the Findings-in-Fact suggested in the preceding paragraph. Mr Muir had survived a rigorous cross-examination. He had been conscientious and responsible in his quantification of the appellants' claim.

34. There was no doubt that there had been an under-recovery of VAT on capital expenditure, and overpaid VAT should clearly be refunded. Thereafter issues affecting quantification arose. Miss Langley had criticised Mr Muir's methodology, but apparently rejected the claim in full. That was unreasonable, Mr Southern suggested. Her criticisms were directed at the attribution between *business* and *non-business* activities and then that between *taxable* and *exempt* supplies. That was a topic not covered in detail by the Regulations which required simply a *fair* and *reasonable* result. This was a "jury" question, with the recovery of input tax corresponding to outputs made, and merited a proportionate response.

35. Here the standard method could produce a reasonable result but HMRC sought to revisit that so producing a disproportionately low rate of recovery.

36. In contrast to Mr Southern, who sought a decision in principle, Mr Smith raised fundamental objections to any award in favour of the appellants. He argued that the "primary issues" as described by Mr Southern and which relate to the calculation of an amount of input tax incurred, relating to *business*/taxable activities, and not otherwise relieved, had not been resolved. He submitted that in *Fleming* type claims the *onus* of proof remained on the taxpayer and that the burden of proof was unchanged. The repayment claim in the present appeal should more appropriately be viewed as a series of mini-claims. The issue of liability as well as that of quantum remained for each period, Mr Smith insisted. The stance adopted by the appellant was, Mr Smith continued, an "inferential" case, the integrity of which required all other possibilities to be excluded. Only then could the necessary apportionments be made to calculate a recoverable percentage. By analogy he referred to the decision of Lord Menzies in *Henderson v Eddie Mair* (which related not to a tax appeal but to a franchising dispute).

37. Then, Mr Smith submitted, a process of attribution of inputs fell to be made as a preliminary to apportionment of residual input tax. Inputs could be attributed to outputs so far as possible to determine the residual balance or "pot", which only then could be satisfactorily apportioned.

38. In particular the possibility and quantification of any input VAT having been recovered under the COS rules had not been dealt with satisfactorily, Mr Smith continued. Also, while it was conceded that there was limited awareness on the part of health board personnel involved of the ability to recover input tax incurred, the evidence was too vague and unspecific. Evidence as to the appellant's own accounting practices was inadequate, and the possibility of a later recovery of VAT had not been sufficiently excluded. The burden of proof should not be transferred onto the respondents to demonstrate that they had not made a repayment. (In fact their records were not sufficient currently to show this.) Further, there had been a failure to establish what amounts of input tax had been incurred and on what projects. The "blue book" records were insufficient for this exercise.

39. Then there remained the final preliminary hurdle of attributing input tax to firstly non-business and business outputs, and thereafter between standard rated, zero rated, and exempt business outputs to determine the "pot" of residual input tax remaining.

40. Thereafter, the application of Regulations 101-102 of the VAT Regulations 1995 (1995/2518) fell to be considered in determining how the residual input tax fell to be apportioned. In the first instance the standard method applies, but may be displaced by a special method. Any special method has to be "fair and reasonable". If not, the standard method of apportioning the "pot" between standard and zero-rated and exempt supplies, applied.

41. Mr Smith then considered the functions of the Tribunal. It had an appellate, not a review jurisdiction. That had been confirmed in *DCM (Optical Holdings Limited) v HMRC* (2007) SC813.

42. However, in the present case a "special method" had not been applied for, let alone approved by the respondents. There was a due form prescribed in Regulation 102 for this approval. It had not been followed. There was no approved "Lothian" method as had been argued on behalf of the appellant.

43. In short the appellant's claim was fragile, unsound in principle, and exaggerated, Mr Smith submitted. There remained fundamental obstacles which had not been overcome. Accordingly, he continued, the claim should be refused and the appeal disallowed.

44. In his response to the respondents' submissions Mr Southern made 11 points. These may be summarised as follows. Primarily, this was a claim for fractional recovery relating to the *business* activities of the appellant. The question for the Tribunal was what was a "fair and reasonable" amount. Article 174 of the principal VAT Directive (2006/112/EC) permitted a deductible proportion. Section 26(3) VATA 1994 reflected this. A "fair and reasonable" result, taking account of all the factual aspects, was required, reflecting principles of proportionality.

45. The evidence available, principally the "blue books", supported a claim, Mr Southern continued. It was a question of fact whether the entries were VAT inclusive or not. A substantial repayment was due if they were VAT inclusive. HMRC's approach inevitably fails to produce a "fair and reasonable" result because of distortions resulting from wage-costs, he argued.

46. Section 121 FA 2008 in allowing such historic claims indicates that Parliament contemplated that certain claims could not be exact, he submitted. The context was a public law statutory framework. The *University of Sussex* decision acknowledged that special considerations arose in historic claims. Additionally, special considerations arose in relation to VAT on COS schemes. Mr Southern noted Section 41(3) VATA.

47. Mr Southern stressed that knowledge of contemporary practice was important. Miss Langley had joined the NHS group in 1991 and thus had no contemporary

knowledge of a substantial part of the period of claim. The matter of attribution fell to be viewed in a contemporary context.

48. Mr Southern then referred to the *Lothian* method. He conceded that the appellant did not have a formal documentary acknowledgement of an approved method, but there had been negotiations with HMRC, who in effect could relax their own rules. He noted the circumstances of the 1996/97 reclaim.

49. Mr Southern commended Mr Muir's credibility and the thorough nature of his investigation. He then urged us to find the appellant's method "fair and reasonable". "4%", he suggested, represented fairly *business* activity. The appellant's method of apportionment would produce about a 4% recovery. That could be applied aptly both prospectively and retrospectively. Wage-costs should appropriately be removed from the denominator in his view.

50. Finally, Mr Southern suggested that tax law was a distributional law, distributing costs between the various interested parties.

Decision

51. We consider the criticisms of Mr Smith of the appellant's arguments to be well-founded.

52. There is no agreement in relation to the preliminary matter of the arithmetical calculation of the total amount of unrecovered input tax – and that before the secondary consideration of gauging the recoverable percentage of residual input tax. That is indicated in the respondents' skeleton argument and was maintained by Mr Smith in closing submissions. Miss Langley in her Witness Statement and early in cross-examination confirmed this too.

53. Negotiations between the parties have been protracted. They are both public authorities. We heard evidence from their witnesses, especially and at length from their experts, and detailed written and oral submissions have been presented. There have been suggestions of intransigence on the part of certain of those involved – a matter on which we make no comment. Accordingly, we feel a sense of frustration in that we cannot deal satisfactorily with the technical issue of the recoverable percentage of input tax (a mixed question of fact and law and as such appropriate for the Tribunal's determination) which is in dispute in this and perhaps some other of these related appeals.

54. We agree with Mr Smith that satisfactory calculations of the amount of unrecovered tax – at least fair and reasonable ones given the context of Section 121 – have to be established by the appellant as the preliminary stage in the appeal. Mr Southern accepted that a "best judgement" approach, adopted for assessment purposes in certain contexts in VAT legislation, had no place in the present appeal. It did not seem to be in dispute that the *onus* of proof lay on the appellant. We note the approach of the Tribunal in *General Motors UK Ltd v R&C Commissioners* (paras 60 and 61), where a somewhat comparable evidential difficulty was encountered. There a rigid stance was adopted by the Tribunal. In fairness given the context of

Section 121 claims we consider that the appellant still has to show on the balance of probabilities a reasonably precise figure for unrecovered input tax on capital expenditure over the *Fleming* period. In the present appeal there remain too many imponderable factors which preclude us making such a finding. Moreover, there is in our view logical force in Mr Smith's submission that the appellant's argument is inferential. There remain uncertainties such as isolated repayments of significance and possible recoveries in relation to Contracted Out Services.

55. On the eve of a Case Management Hearing on 3 March 2014 to review preparation for another related Health Board Appeal, the appellant's counsel produced for our reference a recent FTT decision, *St George's Healthcare NHS Trust v HMRC*, which addresses the standard of evidence required in such claims. At para 18 it notes the terms of Section 121 and certain guidance on such claims issued by the respondents. (We think that this refers to the Notes produced as no. 29 of the Authorities in this appeal, and we read in particular paras 4.3, 4.4 and 4.9 thereof). Mr Smith did not raise any particular objection to our considering this decision which would only be of persuasive significance, but in any event having reviewed it we do not consider that it assists the appellant in the present case. In *St George's Healthcare* there was a significant measure of agreement between the parties, and the amount at issue was comparatively small. Parties also sought a decision in principle. Here, by comparison, each party proposes a different total sum, and these are substantially divergent. The correct figure most probably is somewhere in between, but the evidence, even viewed sympathetically, does not guide us towards an approximate, far less a precise, figure. The decision in *St George's Healthcare* does not cause us to review our initial opinion, set out in the preceding paragraph.

56. In general terms we do agree with the suggested Findings-in-Fact (i), (ii) and (iii) proposed by Mr Southern and as set out by us in para 33 *supra*. In relation to (ii) we consider that generally, if not invariably, the figures included for capital expenditure were VAT inclusive. In any event it seems to be common ground between the parties that in principle a substantial repayment of input tax on capital expenditure is due. Bookkeeping practices seem to have been far from ideal in identifying whether expenditure was recorded as being VAT inclusive or exclusive, and in recording any occasional recoveries of input tax. There are also uncertainties in relation to recovery in respect of COS schemes. The four witnesses led by Mr Southern as to general NHS authorities' financial practice, while credible, were not all immediately involved in relation to the maintenance of the financial records of the appellant. They did not speak in particular to the records relied on by Mr Muir. All that, accordingly, falls far short of establishing, if not a precise value of unrecovered VAT, a tolerably acceptable calculation. Accordingly no Finding-in-Fact thereanent is made. Even if it were appropriate for the Tribunal to adopt an investigative role, we do not consider that the source material available would prove sufficient in the context of the evidence led.

57. It may be helpful for us to address the various stages in the calculation and indicate our misgivings. In particular we set out in some detail our views on the Partial Exemption Special Method ("PESM"), the form of which loomed large in the

course of the hearing. It is to be hoped that all of this will assist Parties in any further negotiations.

58. There are two major hurdles for the appellant to overcome. Firstly, it has to establish a net figure of unrecovered input tax relating to capital works. This has been noted and the practical difficulty of interpreting inadequate or less than ideal records adverted to. But, thereafter, matters of attribution arise. To be recoverable input tax must be attributable to *business* rather than non-business supplies, and further the business supplies must be taxable (standard or zero-rated) rather than exempt. Where there remains a balance or "pot" of residual input VAT partly attributable to taxable and exempt supplies, a PESM has to be formulated to produce essentially a "fair and reasonable" result. Reference may be made to the principles governing this as set out in regulations 101-102 of the VAT Regulations 1995.

59. Frequent reference was made to the percentage of *business* activities undertaken by the appellant, ie non-public service supplies within the scope of VAT. Reference was made by Mr Southern to 4% and 5% but no definite percentage has been agreed by the parties. Even a 1% variation would be substantial in cash terms. Within the category of *business* activities a further sub-division between taxable supplies (both standard and zero-rated) and exempt supplies falls to be made. While the various categories of supply can be identified and distinguished satisfactorily, their relative values *inter se* are more controversial.

60. Where input tax can be wholly attributed to a particular taxable supply, then it is in principle recoverable. Where attributable to an exempt supply, it is not. Where (as arguably in this appeal) there remains a residual "pot" of VAT referable to a mixture of supplies then a partial recovery can be made in terms of a PESM under Regulations 101-102.

61. Finally and fundamentally the parties diverged over what was a *fair and reasonable* formula for apportioning residual input tax paid, ie input tax not directly attributable to a particular supply. The task is to identify an appropriate proxy figure. The primary rule is set out in Regulations 101-102. The method has varied somewhat, but currently depends on the ratio of taxable supplies to all supplies. This "standard method" may be substituted by a "special method" where that produces a *fair and reasonable* result. In the circumstances of the present case an income or output tax method as recommended by Miss Langley has the merit of using reasonably readily available information. On the other hand Mr Muir's *input* approach is problematical inasmuch as it involves practical problems of incomplete information and too many uncertainties and imponderables in our view. In response to questioning by the Tribunal Miss Langley seemed to approve the following formula, *viz*:-

- Having calculated the total input VAT paid (and allowing for any miscellaneous recoveries, eg in terms of the COS), take out the amount of input VAT wholly attributable to *non-business* activities (irrecoverable);

- Next, take out the input VAT wholly attributable to exempt supplies made by the taxpayer (irrecoverable);

- Thirdly, take out the input VAT wholly attributable to taxable supplies made by the taxpayer, both standard and zero-rated (recoverable);

- Finally, the balance which represents the residual VAT ("the pot") not directly attributable to any of the above categories of supply, falls to be apportioned between non-business, exempt, standard and zero rated supplies (whether by reference to *inputs* or *outputs* remains controversial, however);

- The proportion of the "pot" attributable to taxable supplies is recoverable.

62. There had been some controversy in correspondence about the removal of input VAT wholly attributable to exempt supplies. In principle it seems correct to exclude it in calculating the residual input VAT. Also, we consider it appropriate to include the value of the exempt supplies in the denominator of the fraction used to calculate the recoverable residual VAT.

63. Miss Langley had suggested repeatedly in correspondence that an *income* (or output) based method be used to ascertain the recoverable percentage. This broadly accords with the present form of the "standard method" set out in Regulation 101. Previously and during the relevant period for the appellant's claim this had varied somewhat, but the formula tended to rely on output or income figures rather than inputs. Inputs might be favoured as a "special method" for purposes of Regulation 102, but this had to be *fair and reasonable*. There are practical reasons for favouring an *income* approach in the present case, particularly given the difficulties of obtaining satisfactory information.

64. However, we have a major reservation about the fairness of the *income* method in the present case. That relates to the element of funding for wage and salary costs. The element of funding is included as a source of income of the appellant. However, we consider that a disproportionate element of wage and salary costs is attributable to the *non-business* activities of the appellant, ie the relatively high professional salaries payable to senior medical staff and research staff. Their activities are non-business. On the other hand wage levels paid to catering staff are likely to be relatively low. Their services in part will provide taxable supplies. We consider, therefore, that the funding of wage-costs should be removed as an element in the computation.

65. We note that a somewhat comparable approach was taken in relation to the calculation of a PESM in *DCM (Optical Holdings Ltd) v HMRC* (EDN/02/182). That related to residual expenditure in an optician's business, in which the costs of optometrists' relatively high salaries distorted a somewhat comparable calculation.

66. We understand from Mr Southern that about 70% of the funding figure of £987,100,000 is to reimburse wages and salaries. (During submissions we were

provided by the appellant with a document entitled "Letter of Confirmation", dated 26 November 2013, which cites 77.08% as representing wages and salaries. This was not formally admitted or spoken to, but for our present limited purposes we assume that it is reliable.) This high percentage, we consider, distorts the recoverable fraction and reduces it unreasonably. While the *non-business* provision of medical services requires highly paid medical staff, catering on the other hand, generally does not. By eliminating wages and salaries from the equation a broadly *fair and reasonable* result is achieved.

67. On the basis that wages and salaries represent (a relatively conservative) 70% of the figure for funding of £987,100,000, we calculate the percentage of residual input VAT referable to taxable supplies to be 1.87%. The *business* supplies provided by the appellant, given its principal NHS responsibilities, is reckoned by it to be about 4-5% of its total, which includes both taxable and exempt supplies. The latter are considered to be less than the taxable supplies. Accordingly the 1.87% on our calculation seems fairer than HMRC's figure of 0.87% and has, we consider, a logical basis. Unfortunately the appellant did not respond to Miss Langley's encouragement to suggest an income-based formula with which comparison could be made.

68. Notwithstanding our suggesting a revised percentage of recoverable residual input tax, in view of the misgivings which we have expressed earlier, this appeal is refused.

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

KENNETH MURE, QC
TRIBUNAL JUDGE

RELEASE DATE: 14 March 2014

APPENDIX

Joint List of Authorities

Statutes

1. Finance Act 1972, Schedule 4, Group 1
2. VATA 1983, Schedule 5, Group 1
3. Value Added Tax Act 1994: sections 41, 78, 80, 83-83G
4. VAT Regulations (SI 1995/2518), regulation 37
5. Finance Act 2008: section 121

Case Law

6. *Blamire v South Cumbria Health Authority* [1993] PLQR Q1 Court of Appeal
7. *John Doyle Construction Ltd v Laing Management Scotland Ltd* 2004 SLT 678 (Outer House)
8. *John Doyle Construction Ltd v Laing Management Scotland Ltd* 2004 SC 713 (Inner House)
9. *Compass Contract Service UK Ltd v C & E Comrs [2006] STC 1999*
10. *Drake v Harbour* [2008] EWCA Civ 25
11. *Fleming (t/a Bodycraft) v R & C Comrs* [2008] STC 325
12. *Red 12 Trading Ltd v R & C Comrs* [2010] STC 589
13. *Morrison Bowmore Distillers Ltd v R & C Comrs* [2010] UKFTT 394 (TC)
14. *Guide Dogs for the Blind Association v R & C Comrs* [2012] UKFTT 687 (TC)
15. *Irene Henderson v Eddie Mair Limited,* unreported, Lord Menzies, 20 April 2012
16. *General Motors UK Ltd v R & C Comrs* [2013] UKFTT 443 (TC)
17. *KDM International Ltd v HMRC* [2013] UKFTT 315 (TC)
18. *Loss Relief Group Litigation Order v CRC* [2013] EWHC (Ch)
19. *Reed Employment Ltd v R & C Comrs* [2013] STC 1286 [2013] UKUT 0109 (TCC)
20. *Why Pay More for Cars Ltd v HMRC,* UKFTT (TC) 19 September 2013
21. *WMG Acquisition Co UK Ltd v HMRC* [2013] UKFTT 215 (TC)
22. *St Helen's School Northwood Ltd v Revenue and Customs Commissioners* [2006] EWHC 3306; [2007] STC 633
23. *Revenue and Customs Commissioners v London Clubs Management Ltd* [2011] EWCA Civ 1323; [2012] STC 388
24. *DCM (Optical Holdings) Ltd v Commissioners for Her Majesty's Revenue and Customs* [2007] CSIH 58; 2007 SC 813; further reported at [2010] UK FTT 393
25. *McInroy & Wood,* VAT Tribunal, EDN/07/130

Noted additionally

26. *C&E Commissioners v University of Sussex,* CA 2003 [2004] STC 1
27. *St George's Healthcare NHS Trust v HMRC* [2014] UKFTT 170 (TC)

Guidance – HMRC

28. Business Brief 12/06 [2006] ST1 2126

29 HMRC's Fleming Guidance on Section 121 of the Finance Act 2008 (17.9.10 version)