[2017] UKFTT 329 (TC)

TC05806

Appeal number: TC/2015/03805

VAT – repayment of VAT to trader established outside the EU – whether input transactions used for the purposes of taxed transactions – application of principle in Sveda – appeal dismissed

FIRST-TIER TRIBUNAL
TAX CHAMBER

JDI INTERNATIONAL LEASING LIMITED **Appellant**

- and -

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

TRIBUNAL: JUDGE JONATHAN RICHARDS

Sitting in public at The Royal Courts of Justice, Strand, London on 15 and 16 March 2017

Raymond Hill, instructed by KPMG LLP, for the Appellant

Michael Jones, instructed by the General Counsel and Solicitor to HM Revenue & Customs, for the Respondents

DECISION

1. The appellant, JDI International Leasing Limited ("JDI") is a trader established outside the EU and is a member of the Baker Hughes group of companies. It leased, and then bought, tools from a UK VAT-registered trader and was charged VAT on those transactions. It then leased the tools to Baker Hughes Nederland BV ("BHN"), a trader established in the Netherlands, for no monetary consideration. HMRC have refused to repay JDI the VAT that it incurred under s39 of the Value Added Tax Act 1994 because they consider that JDI did not use the tools for the purposes of an economic activity (since JDI did not charge BHN a lease rental). JDI is appealing against that decision.

Evidence

2. JDI relied on evidence from Mr William Hadden Smith who is the Indirect Tax Team Lead at Baker Hughes Limited and Mr Jones cross-examined him. Although I have not drawn all the conclusions from Mr Smith's evidence that JDI wanted me to draw, I have no doubt that Mr Smith was a reliable witness who gave his evidence honestly.

3. HMRC did not rely on witness evidence.

4. I had documentary evidence in the form of an agreed bundle of documents.

Findings of fact

5. There was little dispute between the parties as to the underlying primary facts.

High level overview of JDI's activities

6. JDI was incorporated in the Cayman Islands on 3 December 1996 and is a member of a group of companies (the "Baker Hughes Group"). At times material to this appeal, JDI owned a number of highly specialised oilfield drilling tools (the "Tools")[1] and intellectual property rights (the "Intellectual Property") relating to the Tools having acquired[2] both the Tools and the Intellectual Property pursuant to the intra-group reorganisation described at [17] below. I will make detailed findings relating to that intra-group reorganisations in subsequent sections. However, at this stage, I simply note that the reorganisation involved JDI receiving supplies of Tools located in the UK ("UK Tools") and of services relating to UK Tools that were

[1] That is something of a shorthand since, as noted at [17(5)], there was a period in which JDI did not own all Tools, but rather leased some of them from another company in the Baker Hughes Group. However, it is not relevant to this appeal whether JDI owned the Tools or leased them and therefore, throughout this decision, except where necessary, I will not make any distinction between JDI's ownership of the tools and its leasing of them.

[2] Similarly, references to JDI "acquiring" Tools include both a reference to its outright acquisition of Tools and its leasing of Tools from Oilfield Technology referred to at [17(5)].

standard-rated for UK VAT purposes. This appeal relates to JDI's claim for repayment of that VAT.

7. JDI's ownership of the Intellectual Property entitles it to manufacture, or procure the manufacture, of further Tools and of spare parts and other consumables ("Spare Parts") used in connection with the Tools. JDI does not manufacture Tools or Spare Parts itself. Rather, it has entered into Manufacturing Services Agreements with members of the Baker Hughes Group (the "Manufacturers"). Under the Manufacturing Services Agreements, JDI pays the Manufacturers to make Tools and Spare Parts to JDI's specification and JDI grants the Manufacturers the right to use the Intellectual Property for these purposes.

8. As noted at [6], JDI has at material times either owned the Tools or had the right to use the Tools under the terms of a lease granted to it. Pursuant to an Equipment Lease Agreement (the "Headlease") dated 1 October 2012, JDI has leased UK Tools to BHN, a member of the Baker Hughes Group. JDI does not charge any lease rental pursuant to this agreement[3].

9. BHN in turn subleases Tools to other members of the Baker Hughes Group (the "Operating Companies"). Unlike JDI, BHN does charge the lessees of UK Tools a lease rental.

10. The Operating Companies in turn make Tools available to third parties engaged in oil exploration and production activities and charge those third parties for use of the Tools. From time to time, the Tools require Spare Parts. JDI supplies the necessary Spare Parts to the Operating Companies and charges a significant mark-up on the price that JDI paid the Manufacturers to manufacture them. JDI does not sell Spare Parts, at least for UK Tools, to BHN.

11. Mr Smith said in his witness statement that:

> [JDI's] business is the sale and lease of oilfield tools. This includes the supply of spare parts and consumables for use with those tools…

He also referred in his witness statement to the manufacture of both Tools and Spare Parts. In cross-examination, he clarified that JDI does not sell any UK Tools (although it does sell Tools located in some non-UK jurisdictions); it only leases UK Tools out. Since the only lease of Tools by JDI that I was shown was that referred to at [8] (under which no lease rental was charged), I have inferred that JDI leases UK Tools (consisting of both UK Tools that it acquired pursuant to the intra-group reorganisation and new UK Tools that it manufactures) in all cases for no monetary consideration. It also sells Spare Parts (for consideration) to the Operating Companies.

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[3] The Headlease that I was not shown is not expressly limited to UK Tools. There was evidence that JDI did charge a lease rental for the lease of some Tools located outside the UK (for example the Netherlands). I do not, however, consider it makes any difference whether the Headlease applied to other Tools since this appeal is concerned only with the VAT recovery of supplies associated with UK Tools.

The nature of the Tools and the Spare Parts

12. The Tools are highly specialised tools that can be used only in oil exploration and production activities and contain a large number of specialist components. They are used in highly demanding and challenging environments (the UK Tools are used largely in the North Sea for example) which results in parts becoming damaged or worn and a corresponding need for Spare Parts. When a third party returns a Tool, it is subjected to an exacting inspection and maintenance schedule and it would be unusual for the Tool not to require Spare Parts. Even when a particular Tool is not being used by a third party, and it is lying idle within the Baker Hughes Group, it is subject to an ongoing servicing and maintenance programme which could result in the Operating Companies buying Spare Parts from JDI.

13. The Spare Parts can only be used with the Tools. Since the Tools are so specialised, and since JDI is entitled to exclusive use of the Intellectual Property, in the main Spare Parts can only be obtained from JDI subject to the limited exception that certain small, standardised parts could conceivably be obtained from manufacturers outside the Baker Hughes Group.

14. JDI makes a significant sum of money from its activity of selling Spare Parts. In the calendar year 2013, for example, it generated $4.7 million from the sale of Spare Parts for UK Tools. In the calendar year 2014, it generated a further $6 million.

The intra-group reorganisation that resulted in JDI acquiring the Tools and the Intellectual Property

15. Prior the group reorganisation referred to below, the Tools were owned by a variety of companies in the Baker Hughes Group. UK Tools were held by Oilfield Tools Limited ("Oilfield Tools"), a member of the Baker Hughes Group incorporated in the UK. The Intellectual Property was held by Oilfield Technology Limited ("Oilfield Technology"), a member of the Baker Hughes Group incorporated in the Cayman Islands. Oilfield Technology had granted Oilfield Tools a licence (the "IP Licence") to use the Intellectual Property everywhere in the world, other than the United States.

16. The Baker Hughes Group considered that it would be more efficient for all its leasing activity outside the US to be centralised within a single entity and JDI was chosen for this purpose. The initial hope was that, as part of that reorganisation, JDI would acquire outright ownership of all the Tools from the various members of the Baker Hughes Group that owned them. However, events turned out differently as it became clear that, in some jurisdictions, regulatory approvals were needed before the Tools could be transferred outright to JDI. In particular, the Baker Hughes Group was seeking advance confirmation from HMRC as to the VAT treatment of a transfer of UK Tools (with which this appeal is concerned) and this delayed the point at which UK Tools were transferred to JDI.

17. Insofar as relevant to UK Tools, the intra-group reorganisation involved the following steps:

(1) Oilfield Technology transferred the non-US Intellectual Property to JDI. (I was not referred to the agreement effecting this transfer and therefore have not recorded its date).

(2) The IP Licence was "transferred" to JDI with the result that JDI became the licensor of Intellectual Property to Oilfield Tools under the IP Licence[4].

(3) JDI, as new owner of the Intellectual Property, and licensor under the IP Licence, sent Oilfield Tools notice terminating the IP Licence with effect from 1 October 2012.

(4) With effect from 1 October 2012, Oilfield Tools terminated all then current operating leases of Tools to which it was party.

(5) Since discussions were ongoing with HMRC as to the UK tax treatment of a transfer of the UK Tools, Oilfield Tools did not transfer UK Tools immediately to JDI. Rather, pursuant to an equipment lease agreement dated 1 October 2012, Oilfield Tools leased UK Tools to JDI and gave JDI the right to make the Tools available to customers and to affiliated companies of JDI. That agreement was in place from 1 October 2012 to 23 November 2013 and, under that agreement, JDI paid a VAT-exclusive consideration of £12,056,944.98 (the equivalent of USD 18,928,496.72) for the hire of the UK Tools. The supplies that Oilfield Tools made pursuant to this agreement were subject to UK VAT and Oilfield Tools duly accounted to HMRC for that VAT.

(6) On 1 October 2012, Oilfield Tools entered into an agreement to sell Tools to JDI. However, for the reasons noted at [(5)] above, UK Tools were excluded from that sale.

(7) On 1 October 2012, JDI entered into the Headlease with BHN referred to at [8] pursuant to which JDI leased UK Tools to BHN for no consideration in money or money's worth. BHN in turn entered into subleases with the Operating Companies referred to at [9].

(8) It became clear to the Baker Hughes Group that they were not going to obtain advance confirmation of the VAT treatment of a transfer of UK Tools from HMRC and the decision was taken to proceed with that transfer without such a confirmation. Therefore, on 22 November 2013, Oilfield Tools sold the UK Tools to JDI for a VAT exclusive purchase price of £15,477,187.04 (the equivalent of USD 25,023,516). The supply of the UK Tools was subject to VAT and Oilfield Tools duly accounted to HMRC for the VAT that was due.

The terms of the various lease arrangements

18. As noted above, JDI leased UK Tools to BHN for no monetary consideration. However, although no lease rental was charged, JDI and Oilfield Tools did enter into

[4] I was not shown the document effecting this transaction. The transaction was described as a "transfer", although since it appears to have effect in respect of the burden of the IP Licence as well as its benefit, if documented under English law, it would have to take effect as a novation. However, nothing material turns on this point.

a written agreement documenting the Headlease of the Tools. The Headlease had the following terms, so far as material:

(1) The Tools were provided on what was described as a "call off basis" under which each individual Tool was treated as leased separately and BHN could terminate the lease at any time by redelivering a Tool to JDI.

(2) BHN was not obliged to pay any monetary consideration for use of the UK Tools.

(3) BHN was permitted to use the Tools only for providing oilfield services to customers or for training purposes. The Headlease also permitted BHN to provide the tools to an affiliated company provided that the affiliated company agreed to be bound by the terms of the lease agreement. Any sublease of the Tools had to be substantially on the terms of a sublease agreement annexed to the Headlease.

(4) Clause 3 of the Headlease required BHN to take care when using and storing the Tools. In addition, BHN agreed that the Tools would be disassembled only by skilled operatives designated by JDI. The Headlease contained no provision requiring BHN (or indeed any other person) to maintain the Tools by purchasing Spare Parts.

(5) The Headlease provided that JDI retained the risk of loss or damage to the Tools. However, if BHN (or any sublessee of BHN) received compensation for any such loss or damage, BHN undertook to ensure that any such compensation was remitted to JDI.

(6) The Headlease was expressed to continue in force until such time as BHN or JDI agreed to enter into a new lease agreement or to cancel the Headlease.

(7) The Headlease was subject to the law of the Netherlands.

19. As noted above, BHN agreed to sublease the Tools to the Operating Companies. I was shown an example of such a sublease and it was common ground that all leases to Operating Companies were in materially identical terms. Material terms of each sublease were as follows:

(1) The Tools were leased on the same "call off basis" as applied pursuant to the Headlease. Therefore, an Operating Company could terminate the lease of any particular Tool by redelivering it to BHN.

(2) An Operating Company could only use the Tools for the purposes of providing them to the Operating Company's customers for use in oilfields. An Operating Company could also use the Tools for training purposes and could provide them to affiliated companies who agreed to be bound by the terms of the sublease agreement.

(3) Operating Companies paid BHN a rental for use of the Tools.

(4) Either party could terminate a sublease on 30 days' written notice. Otherwise, the agreement would continue until they both agreed to enter into a new sublease agreement or to terminate the sublease agreement.

(5) BHN retained the risk of loss or damage to the leased Tools. However, if the lessee of the Tools received compensation for damage to the Tools, the lessee was obliged to remit that compensation to BHN (after deduction of a 5% processing fee).

(6) The sublease agreement was subject to the law of the Netherlands.

Relevant Statutory Provisions

20. Article 2 of the 13th VAT Directive (Council Directive 86/560/EEC) as in force at the times relevant to this appeal provided for Member States to refund VAT to taxable persons not established in the territory of the EU. Those provisions have been incorporated into UK law by s39 of the Value Added Tax Act 1994 ("VATA 1994") and the Value Added Tax Regulations 1995 (the "VAT Regulations"). Since there is no suggestion in this appeal that the UK legislation fails to give effect to the provisions in the EU directive, I will refer only to the UK legislation.

21. Section 39 of VATA 1994 provides relevantly as follows:

> **39 Repayment of VAT to those in business overseas**
>
> (1) The Commissioners may, by means of a scheme embodied in regulations, provide for the repayment, to persons to whom this section applies, of VAT on supplies to them in the United Kingdom or on the importation of goods by them from places outside the member States which would be input tax of theirs if they were taxable persons in the United Kingdom.
>
> (2) This section—
>
> (a) applies to persons carrying on business in another member State, and
>
> (b) shall apply also to persons carrying on business in other countries, if, pursuant to any Community Directive, rules are adopted by the Council of the Communities about refunds of VAT to persons established elsewhere than in the member States,
>
> but does not apply to persons carrying on business in the United Kingdom.

22. Regulations have been made in Part XXI of the VAT Regulations. Regulation 186 of the VAT Regulations provides as follows:

> **186 Repayments of VAT**
>
> Subject to the other provisions of this Part a trader shall be entitled to be repaid VAT charged on goods imported by him into the United Kingdom in respect of which no other relief is available or on supplies made to him in the United Kingdom if that VAT would be input tax of his were he a taxable person in the United Kingdom.

23. Therefore, in order to be entitled to a repayment of VAT, JDI must establish that the VAT it incurred on the supplies of goods to it (the sale of Tools referred to at

[17(8)]) and the supply of services to it (the lease of the Tools referred to at [17(5)]) would have been input tax of JDI if JDI were a taxable person in the United Kingdom.

24. The provisions relating to recovery of input tax were, at times material to this appeal, contained in Article 17(3) of Council Directive 77/388/EEC (the "Sixth VAT Directive") which provided, so far as material as follows:

> **Article 17 Origin and scope of the right to deduct**
>
> 1. The right to deduct shall arise at the time when the deductible tax becomes chargeable.
>
> 2. In so far as the goods and services are used for the purposes of his taxable transactions, the taxable person shall be entitled to deduct from the tax which he is liable to pay:
>
> (a) value added tax due or paid within the territory of the country in respect of goods or services supplied or to be supplied to him by another taxable person…
>
> 3. Member States shall also grant every taxable person the right to the deduction or refund of the value added tax referred to in paragraph 2 in so far as the goods and services are used for the purposes of:
>
> (a) transactions relating to the economic activities referred to in Article 4(2), carried out in another country, which would be deductible if they had been performed within the territory of the country

25. Article 4(2) of the Sixth VAT Directive provided as follows:

> 2. The economic activities referred to in paragraph 1 shall comprise all activities of producers, traders and persons supplying services including mining and agricultural activities and activities of the professions. The exploitation of tangible or intangible property for the purpose of obtaining income therefrom on a continuing basis shall also be considered an economic activity.

The issues arising in this appeal and the parties' respective arguments

26. It was common ground that JDI was not prevented, by reason only of being incorporated in the Cayman Islands, from making a claim for repayment of VAT under the VAT Regulations. The parties were also agreed that JDI had complied with all relevant procedural requirements and therefore the only issue in dispute for the purposes of this appeal was whether the VAT that JDI incurred referred to at [17(5)] and [17(8)] above would be input VAT of JDI if JDI were a taxable person in the UK[5]. That reduced to the question of whether the supplies giving rise to that VAT were "used for" the purposes of transactions relating to economic activities and it was common ground that JDI had the burden of proof in this regard.

[5] There had previously been a dispute as to the extent to which the UK Tools were actually located in the UK. However, that dispute was resolved by the time of the hearing.

27. Mr Hill argued that JDI's activities were overall economic activities. It did not have any charitable or non-economic objects. Mr Hill did not seek to argue that there was a link between JDI's acquisition of the UK Tools and any specific supplies that JDI made. Rather, his argument was that there was a "direct and immediate link" between JDI's acquisition of the UK Tools and its overall economic activity (which included the provision of Spare Parts). Applying the reasoning of the CJEU in *'Sveda' UAB v Valstybine mokesčių inspekcija prie Lietuvos Respublikos finansų ministerijos* [2016] STC 447 ("*Sveda*") he argued that this direct and immediate link was not broken by the fact that the immediate use to which JDI put the Tools was a nil-rent lease to BHN.

28. Mr Jones's argument, in summary, was that, to obtain input tax credit, JDI had to establish that the supplies of goods and services that JDI received when it leased and acquired the UK Tools had to be "used for" the purposes of its taxable transactions. The Court of Justice of the European Union ("CJEU") has developed its jurisprudence on the concept of a "direct and immediate link" as an approach to the question of whether input transactions were "used for" taxable transactions and the concept has to be understood in that context. He denied that the supplies that JDI had received of UK Tools were "used for" the economic activity of selling Spare Parts since, viewing the matter objectively, it did not need to purchase or lease UK Tools in order to be able to sell Spare Parts. Rather, he argued that there was a direct and immediate link between JDI's acquisition of the UK Tools and its leasing of those Tools for no consideration (since JDI leased out the very same Tools that it acquired and, without incurring the price of acquiring those Tools, it would not be in a position to lease them out).

Discussion

The law on input tax credit

29. In this section, I will summarise my conclusion as to the legal criteria that must be satisfied in order for a taxable person to be entitled to input tax credit. In subsequent sections, I will apply those criteria to the facts of this appeal.

30. In *Sveda*, the CJEU formulated two tests that a taxable person must satisfy to be able to obtain credit for input tax incurred on supplies of goods or services. Firstly, the taxable person must be "acting as such" at the time of receipt of the supplies. Secondly, the taxable person must use the goods or services for the purposes of taxed transactions. Both tests are objective in the sense that they must be confirmed by objective evidence and do not depend on the subjective intentions of the taxpayer.

31. The first test (whether the taxable person is "acting as such") must be determined in the light of all relevant circumstances, including the nature of any asset being acquired. It is a question of fact for the national court to determine. In *Sveda*, the CJEU determined that the Lithuanian national court had determined this issue in favour of the taxpayer by finding that the expenses associated with the development of a Baltic mythology recreational path were a means of attracting visitors with a view

to providing them with taxable goods and services such as souvenirs, food and drinks and paid-for bathing, even though no charge was made for use of the recreational path.

32. The second test (whether goods or services are used for the purposes of taxed transactions) depends on whether there is a direct and immediate link between the input transactions and taxed output transactions. However, to establish such a direct and immediate link, it is not necessary to show a link with a particular output transaction. If a particular input transaction is part of a taxable person's general costs and, as such, a component of the price of goods and services the taxable person supplies, there is a direct and immediate link with the taxable person's economic activity as a whole (see paragraph 28 of the CJEU's judgment in *Sveda*). In order to establish that an input transaction is part of "general costs", it is not necessary to establish that those costs are incorporated into the price charged for an output supply (see the Court of Appeal's judgment in *Volkswagen Financial Services (UK) Limited v HMRC* [2015] EWCA Civ 832).

33. A "direct and immediate link" can be purely economic and need not depend on a particular legal or other relationship. So, for example, in *AES-3C Maritza East* (Case C-124/12) a company bought items for use by employees who were employed by a different company. Since there was an economic link between the cost of the items and the company's economic activity, it did not matter that the company did not, as a legal matter, employ the individuals who used the items. Moreover, in *Sveda* both the Advocate General (in paragraphs 45 and 46 of her opinion) and the CJEU in (paragraphs 22, 23 and 33 of its decision), approached the question of whether there was a "direct and immediate link" by considering whether there was an economic link between the costs associated with the construction of the recreational path with the taxpayer's overall activity of selling souvenirs and refreshments.

34. In *Associated Newspapers Limited v HMRC* [2017] EWCA Civ 54, the Court of Appeal considered a promotional scheme which involved a taxpayer incurring VAT on the purchase of vouchers which were supplied to the taxpayer's customers free of charge as part of a scheme to incentivise them to purchase newspapers from the taxpayer. Patten LJ made it clear at paragraph 51 of his judgment that the mere fact that newspapers could be sold without the taxpayer incurring the expense of the vouchers did not prevent there being a "direct and immediate link" between the supply of the vouchers and the taxpayer's overall economic activity of selling newspapers. In that case, the Court of Appeal endorsed the approach that the Upper Tribunal had taken:

> In our judgment, 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. That is not to rely on the subjective intention of ANL; it can be objectively discerned from the nature of the business promotion scheme itself. It is to that element of the economic activity of ANL to which the acquisition of the vouchers and any input tax attributable to that acquisition is

> directly and immediately linked. Viewing the circumstances from an economic perspective, no such link can be established with the provision of the vouchers by ANL to its customers for no consideration, and the immediate use of the vouchers acquired by ANL in providing those vouchers to its customers free of charge cannot affect the direct and immediate link with ANL's economic activity. The costs associated with the acquisition of the vouchers were cost components of the sales of the newspapers and of advertising, and thus cost components of transactions within the scope of ANL's taxable activities. The output supplies by ANL in that respect were taxable supplies, and input tax is accordingly deductible.

35. It is clear, therefore, that the mere fact that the immediate use to which a taxpayer puts goods and services acquired does not involve the taxpayer receiving any consideration from its customers, is not of itself an obstacle to input tax recovery. However, paragraphs 32 and 33 of the decision in *Sveda* acknowledge that there will be cases in which a link between input transactions and economic activities can be severed:

> 32. In that regard, 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 (judgment in *Aset Menidjmunt*, para 44 and the case law cited). 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.
>
> 33. First, in no way does it follow from the order for reference that the making available of the recreational path to the public is covered by any exemption under the VAT Directive. Second, given that the expenditure incurred by Sveda in creating that path can be linked, as is apparent from para 23 of this judgment, to the economic activity planned by the taxable person, that expenditure does not relate to activities that are outside the scope of VAT.

36. These paragraphs do not, however, offer much in the way of practical guidance as to when a link with economic activities is "severed". Indeed, paragraph 33 of the judgment simply confirms that there <u>was</u> a link between the creation of the path and the taxpayer's overall economic activity. It does not explain why there <u>was not</u> a link between the creation of that path and its free provision to customers.

37. Mr Jones in his submissions suggested that a useful approach to the issue raised at [36] would be to consider whether JDI's activity of leasing the Tools to BHN was separate from its activity of selling Spare Parts and he referred to the decision of the High Court in *University of Southampton v Revenue and Customs Commissioners* [2006] EWHC 528. In that case, a university had a business that included the supply of education, undertaking research for commercial sponsors and the exploitation of intellectual property. It also undertook publicly funded research ("PFR") which did not result in taxable supplies being made. A question arose as to whether input tax incurred on supplies used in PFR was in principle recoverable (as an overhead and subject to the taxpayer's partial exemption calculation) or whether it was not

recoverable at all (since the supplies were used for the purposes of PFR). The Value Added Tax Tribunal denied the university any input tax recovery having made a finding that the university's PFR was a completely separate activity from its other commercial activities. On appeal, the university criticised this finding of fact and Warren J accordingly conducted a detailed examination of the Tribunal's factual conclusion and reasoning for it. Mr Jones accepted quite rightly that the *University of Southampton* decision was not laying down a legal test but argued it could be regarded as a helpful approach to the factual exercise before this Tribunal. I have concluded, however, that I will not determine whether JDI was conducting two "separate" activities or not. Rather, I will apply the principles outlined above which will include (but are not limited to) a determination of whether there is a direct and immediate link between the supplies that JDI received and its economic activity as a whole (since Mr Hill did not seek to argue that there was a link with any specific taxable supplies).

Application of the legal principles to the facts

38. I will start with an examination of the second limb of the test articulated in Sveda since that will put into context the approach that I have taken to the first limb of that test.

39. It was common ground, as it had to be, that JDI's activity of leasing UK Tools to BHN for no monetary consideration was not an economic activity. However, JDI's activity of selling Spare Parts is an economic activity. Mr Hill was not seeking to argue that the UK Tools that JDI acquired were used for the purposes of selling any particular Spare Parts. Therefore, to succeed with this appeal, JDI must establish, among other matters, that there is a direct and immediate link between the acquisition of the UK Tools and the overall economic activity of selling Spare Parts.

40. Mr Hill emphasised in his submissions that JDI is a commercial company that pursues commercial objects. As a general statement, that is doubtless correct. However, it does not determine the question at issue in this appeal. In order to obtain input tax recovery, even a commercial company carrying on commercial objects must establish a direct and immediate link between the input transactions and its taxable transactions or its taxable economic activity.

41. In both the *Sveda* and *Associated Newspapers* cases, the facts largely spoke for themselves. That "Baltic mythology path" at issue in *Sveda* was analogous to business premises. The taxpayer allowed its customers to use the path without charge in the hope that those customers would buy refreshments or souvenirs in much the same way as a retailer would allow customers to enter its shop without charge in the hope that they would make a purchase while on the premises. It would be absurd to say that the rent that a shopkeeper pays on his shop has a "direct and immediate link" with the activity of providing free licences to customers to enter the shop and it would be just as absurd to determine that the taxpayer incurred expenditure on building the Baltic mythology path for the purpose of allowing the public to use it without charge. Similarly, in *Associated Newspapers*, it was clear from an objective examination of the transactions themselves that the taxpayer acquired the vouchers for the purposes

of a business promotion scheme designed to increase taxable (though zero-rated) supplies of newspapers.

42. However, in this appeal, the facts by no means speak for themselves. There is not an obvious link between JDI's acquisition of UK Tools and the sale of Spare Parts. As Mr Jones noted, businesses selling spare parts for private motor cars do not typically own the cars in question. Rather, private individuals own the motor cars themselves and vendors of spare parts are able to run viable businesses based on the proposition that individuals' ordinary use of motor cars will inevitably over time result in a need for spare parts. Moreover, in both *Sveda* and *Associated Newspapers*, both taxpayers were offering free inducements to their own respective customers. In this appeal, as noted at [10], BHN, which receives the benefit of the free hire of the UK Tools, is not to any material extent a purchaser of Spare Parts for UK Tools from JDI.

43. Of course, the Tools at issue in this appeal are highly specialised and the fact that a direct and immediate link is not obvious does not mean the link does not exist. Mr Hill explained the nature of the link between the acquisition of the UK Tools and JDI's overall activity of selling Spare Parts in two ways:

> (1) Firstly, he referred to Mr Smith's witness evidence. Mr Smith said in that evidence that "as a direct consequence of allowing [the Tools] to be used under a lease, [JDI] is able to arrange for the manufacture of tools (to which it holds the exclusive intellectual property…) and supply parts and consumables to operating entities in the Baker Hughes Group". Mr Smith also referred to benefits that JDI obtained from having "control" of the Tools saying that "By ensuring that the Assets are out in the industry being used [JDI] ensures that it has a market for its sales and consumables business."
>
> (2) Secondly, he submitted that Mr Smith's evidence demonstrated that the intra-group reorganisation referred to at [17] resulted in JDI taking on a "package deal". In order to acquire the Intellectual Property (that was essential for JDI to be able to arrange for the manufacture of Spare Parts), JDI also had to acquire the Tools.

44. Mr Smith's evidence was tested in cross-examination. He accepted that the market for Spare Parts would be the same whether JDI, or anyone else, owned the Tools although he did make the point that the purpose of the reorganisation was to ensure that JDI owned both the Tools and the Intellectual Property (so it was not realistic to postulate another entity in the Baker Hughes Group owning the Tools). However, despite accepting this point, Mr Smith appeared to be asserting that there was a link between JDI having "control" of the UK Tools (which was achieved by acquiring them and leasing them to BHN) and its ability to sell Spare Parts. I have not found these aspects of Mr Smith's evidence entirely straightforward to reconcile, but I have concluded that, viewed objectively, the position is as follows:

> (1) There was no objective link between JDI's acquisition of the Tools (including UK Tools) and its market for Spare Parts (given Mr Smith's acceptance of this point in cross-examination). The market for Spare Parts is

driven largely by the use of the Tools by third party customers of the Operating Companies referred to at [19(2)] and does not depend on the precise legal entity that owns or has an interest in the Tools.

(2) Mr Hill emphasised in his submissions that the Tools need to exist in order for JDI to be able to sell Spare Parts for them. That is true, but does not alter my conclusion at [(1)] above. The point is that it is the existence of the Tools, and their use, that drives the demand for Spare Parts. There is no objective link between the market for Spare Parts and JDI's acquisition of Tools (including UK Tools).

(3) However, once JDI had acquired the UK Tools, JDI's business of selling Spare Parts benefited from its decision to lease UK Tools to BHN. The reason for that is simple: if JDI, having acquired the UK Tools, simply left them unused in a warehouse, they would not be used in demanding environments. While they would still need some Spare Parts because of the routine servicing referred to at [12], fewer parts would break or become worn. By leasing to BHN, therefore, JDI put the UK Tools "into the market" with the corresponding prospect that they would be used and generate an increased requirement for Spare Parts.

(4) By acquiring the Tools (including UK Tools), JDI inevitably obtained a measure of "control" over them. While it was the lessee of UK Tools, it had the right to use them in accordance with the lease that Oilfield Tools had granted JDI (referred to at [17(5)]. When it became the outright owner of Tools it naturally obtained all the rights of an owner. The objective evidence that JDI used the "control" to increase the market for Spare Parts is, however, weak. The Headlease agreement with BHN does not require BHN to ensure that the Tools are used frequently (which would generate a corresponding increased demand for Spare Parts). Indeed, the "call off basis" specified in the Headlease would entitle BHN to terminate the lease of any particular Tool at any time without notice. Since BHN was paying no rent under the Headlease for UK Tools, it would not have a particular commercial incentive to generate maximum use from UK Tools (as it would not need to generate any particular level of income from the UK Tools in order to meet rental obligations to JDI). Neither the Headlease, nor the sublease arrangements that were mandated by the terms of the Headlease, imposed any contractual obligations relating to Spare Parts on BHN or on Operating Companies. In addition, the combined effect of the Headlease and sublease arrangements was that JDI retained the majority of the risk of loss or damage to the Tools.

45. Although Mr Smith made the assertion in his witness statement that ownership of the Tools enabled it to arrange for the manufacture of further Tools, he did not explain why this was the case. In paragraph 12 of his witness statement, he suggested that access to the Intellectual Property was crucial to JDI's ability to manufacture Spare Parts and I accept that is the case. However, it was not clear to me that, viewed objectively, there was any link between JDI's ownership of the Tools and its ability to manufacture further Tools.

46. I reject Mr Hill's first argument, summarised at [43(1)]. That is not because I consider that, in order to obtain repayment of VAT, JDI would have to establish that the acquisition of the Tools was essential to enable Spare Parts to be sold. Patten LJ made it clear at paragraph 51 of his judgment in *Associated Newspapers* that this is not the test as the taxpayer in that case could have sold newspapers perfectly well without offering free vouchers to its readers. Rather I have concluded that the evidence has not satisfied me that, viewed objectively, there was the requisite direct and immediate link between the acquisition of the UK Tools and the economic activity consisting of the sale of Spare Parts.

47. I have accepted JDI was offered a "package deal" consisting of both the Tools and the Intellectual Property. Corporate groups may often be managed as a single business and, while no doubt the directors of JDI would have had to consider their fiduciary duties when deciding whether to acquire both the Tools and the Intellectual Property, it would be fanciful to expect JDI, just one company in the Baker Hughes Group, to negotiate a deal under which it acquired the Intellectual Property without the Tools. That is particularly the case given that Mr Smith's unchallenged evidence was that the Baker Hughes Group as a whole expected operational efficiencies to result if all the Tools were owned by a single entity. I therefore accept that JDI may have considered that it had no alternative but to acquire both the Tools and the Intellectual Property together.

48. Mr Smith explained in his witness statement the benefits that the Baker Hughes Group hoped would come from the Tools being owned by a single entity. The evident aim was to make efficiency and cost savings and that makes sense viewed objectively as, if all Tools were held by a single company, the need for a number of companies to have their own systems for dealing with, storing and maintaining Tools would be reduced. However, Mr Smith did not suggest that JDI's business of selling Spare Parts would be enhanced by all Tools being held by a single entity and nor is it objectively obvious why it should be enhanced. In those circumstances, I do not consider it matters that JDI's subjective purposes for acquiring the Tools might have included a perception that, if it did not acquire the Tools, it could not acquire the Intellectual Property and so could not sell Spare Parts. The jurisprudence of the CJEU, including *Sveda*, makes it clear that any "direct and immediate link" must be established by means of objective evidence. For the reasons I have given, I do not consider that the objective evidence demonstrates the existence of such a link. I therefore reject Mr Hill's second argument summarised at [43(2)].

49. I have therefore concluded that there is no "direct and immediate link" between the acquisition of the UK Tools and JDI's overall economic activity of supplying Spare Parts. JDI has failed to satisfy its burden of proving that the second test set out in *Sveda* is satisfied and that conclusion is enough to dispose of the appeal[6]. I will, however, make some brief conclusions on the first test in *Sveda*.

[6] In particular, since JDI has the burden, I do not consider that HMRC needed to establish positively that there was a direct and immediate link between the acquisition of the UK Tools and the activity of leasing those tools for no consideration.

50. Applying the first test in *Sveda*, and having regard to the factors mentioned by the CJEU, I have noted that the assets involved in the input transaction (the UK Tools) are plainly assets designed for commercial exploitation. In addition, JDI carries on a commercial venture. Without more, those factors might suggest that JDI was acting as a taxable person when it acquired the UK Tools. However, while the Tools are designed for commercial exploitation, JDI decided immediately after acquiring them not to exploit them in the most natural way (by leasing or hiring them for consideration to interested parties). Instead, it used the UK Tools in an apparently uncommercial way by leasing them to BHN without charging BHN any lease rental. No explanation has been given as to why JDI decided to use the UK Tools in that way. Mr Jones speculated that this may have been for a direct tax reason, but this was speculation only and Mr Smith in his witness evidence admitted frankly that he did not know why the Tools were leased for no consideration. As I have noted in my consideration of the second test in *Sveda*, there is no objective link between the acquisition of the UK Tools and JDI's taxable economic activity of selling Spare Parts. Against the that factual background, I have concluded that, even though JDI is a commercial company and the Tools are suitable for commercial exploitation, JDI was not acting as a taxable person when it acquired the UK Tools.

51. My overall conclusion, therefore, is that neither test in *Sveda* is satisfied.

Conclusion and application for permission to appeal

52. During the hearing, the parties indicated that they wanted me to make a decision as to whether or not JDI is in principle entitled to repayment of all of the VAT that it incurred as described at [17(5)] and [17(8)]. Neither party suggested at the hearing that part of the VAT might be repayable. However, so that they could agree matters of quantum between themselves if necessary, they asked for a decision in principle only.

53. My decision is that JDI is not entitled to repayment of the VAT in question.

54. 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.

JONATHAN RICHARDS
TRIBUNAL JUDGE

RELEASE DATE: 20 APRIL 2017