CA-2024-000806

IN THE COURT OF APPEAL
ON APPEAL FROM THE UPPER TRIBUNAL
(TAX AND CHANCERY CHAMBER)
Judge Rupert Jones and Judge Vinesh Mandalia

BETWEEN:

HIPPODROME CASINO LTD ("HCL")

Appellant

- and -

THE COMMISSIONERS FOR HIS MAJESTY'S REVENUE AND CUSTOMS ("HMRC")

Respondents

HCL's REPLACEMENT APPEAL SKELETON ARGUMENT
12 JULY 2024

References: (1) To the Core Bundle are in the form of [Core/Tab/Page]
(2) To the Supplementary Bundle are in the form of [Supp/Tab/Page]
(3) To the judgment of the First-tier Tribunal [2022] UKFTT 110 [Core/11/156-182] are in the form [FTT/Paragraph]
(4) To the judgment of the Upper Tribunal [2024] UKUT 27 [Core/7/86-130] are in the form [UT/Paragraph]

INTRODUCTION

1. This case raises the following issues:
   (a) When does a decision of the First-tier Tribunal ("**FTT**") contain inadequate reasoning so as to entitle the Upper Tribunal ("**UT**") to interfere?
   (b) Is the jurisdiction of the Tribunal in relation to an appeal relating to the standard method override radically different to that relating to the parallel special method override, both of which deal with the situation where the default method applicable to a given business for apportioning input tax on overhead expenditure between taxable and exempt supplies does not reflect the economic use by the business of its overhead expenditure?
   (c) Is the standard turnover-based method of attribution of overhead expenditure only to be departed from in rare or extreme cases (if at all)?
   (d) How does Article 5(1) of the Value Added Tax (Input Tax) Order 1992 (SI 1992/3222) ("**the Input Tax Order**") which blocks the recovery of input tax incurred for the purpose of business entertainment operate in relation to a business which makes both taxable and exempt supplies?

2. HCL was granted permission to appeal by the Court of Appeal (Lady Justice Asplin) on all the grounds set out below [Core/5/82]. This skeleton will address HCL's grounds of appeal. Should HMRC seek to submit that the decision of the UT should be upheld for reasons different from or additional to those of the UT, HCL will (with the Court's permission) address those reasons in a supplementary skeleton.

BACKGROUND AND SCHEME OF LEGISLATION

3. HCL operates the Hippodrome premises in Leicester Square, from which it makes both taxable supplies of hospitality and entertainment and exempt gaming supplies [FTT/1]. The appeals before the FTT related to HCL's overhead expenditure, which falls into two broad categories:
   (a) Capital expenditure on the refurbishment of the Hippodrome (principally between 2008-2012, with some expenditure in 2013); and
   (b) Ongoing expenditure (such as the rent on the Hippodrome, security costs, building maintenance and cleaning, as well as central marketing costs and general costs of running the business).

4. Under Articles 168 and 173 of Directive 2006/112/EC (the "**PVD**") a taxable person who incurs expenditure which it "uses" to make both taxable and exempt supplies (such as HCL's overhead expenditure) is only entitled to deduct such proportion of the VAT as is attributable to its taxable supplies. Article 174(1) of the PVD makes provision for the standard method of attribution, a rather rough-and-ready comparison of the taxpayer's taxable turnover with its total turnover ("**the standard method**"). Under Article 173(2)(c), it is open to Member States to require (or authorise) a taxable person to depart from the standard method and instead "*make the deduction on the basis of the use made of*" the goods or services in question. The caselaw of the Court of Justice of the European Union ("**CJEU**") has identified that Member States may do so on condition that such a method "*guarantees a more precise determination of the deductible proportion of the input VAT*" (Case C-153/17 *HMRC v Volkswagen Financial Services (UK) Ltd* (EU:C:2018:845) [2018] STC 2217 ("***VWFS***") at [51]). However, the method used need not necessarily provide the most precise proxy possible for identifying use. Rather, it must provide a more fair, reasonable and precise proxy than the standard method (*VWFS* at [53]).

5. As a matter of UK law, regulation 101 of the VAT Regulations 1995 (SI 1995/2518) ("**VAT Regulations**") provides for the standard method (made pursuant to section 26(3) VAT Act 1994). As envisaged by Article 173(2)(c) PVD, UK law also identifies circumstances where some other method of attribution should be applied. One such provision is regulation 107B of the VAT Regulations (the Standard Method Override (or "**SMO**")):

   (1) … this regulation applies where a taxable person has made an attribution … according to the method specified in regulation 101 and that attribution differs substantially from one which represents the extent to which the goods or services are used by him or are to be used by him, or a successor of his, in making taxable supplies.

   (2) Where this regulation applies the taxable person shall—

   (a) calculate the difference, and

   (b) … account for the amount so calculated …"

   A difference is "substantial", for present purposes, if it exceeds £50,000 (regulation 107C(a)).

6. The concept of "*use*" to which the legislation refers is that of "*economic use*" (*St Helen's School Northwood v RCC* [2006] EWHC 3306 [2007] STC 633 ("***St Helen's***") at [75]-[76]). Identifying the economic use of input VAT is "*highly fact-sensitive*" (*London Clubs Management* [2011] EWCA Civ 1323 [2012] STC 388 ("***LCM (CA)***") at [42]).

7. In the present case HCL considered the questions posed by regulation 107B and concluded that the SMO applied for each year within the scope of these appeals. In place of the standard method it relied instead on a method of attribution based on the use of floorspace within the Hippodrome premises (described by the FTT at [FTT/98]). HMRC rejected HCL's floorspace-based override calculation, and HCL appealed to the FTT against that decision. The FTT allowed HCL's appeal.

8. A further issue in this appeal relates to the use of the Hippodrome by HCL in order to provide "business entertainment" (in the form of complimentary items of food and drink given away to certain valued customers). Article 5(1) of the Input Tax Order blocks the recovery of input tax on expenditure incurred for this purpose. It is common ground that HCL's override calculation incorporates an appropriate restriction to reflect the use of the Hippodrome to provide business entertainment ([FTT/130]). However, in circumstances where the SMO does not apply (as the UT concluded) the further issue that arises relates to the interaction of the input tax block with the standard method; in particular the order in which the input tax block and the standard method should be applied. This issue is addressed in detail under Ground Four below.

THE DECISION OF THE UPPER TRIBUNAL

9. In summary, so far as material to the present appeal, the UT (Judge Rupert Jones and Judge Vinesh Mandalia) decided as follows.
   (a) At [UT/56-81], the UT held that the FTT's decision "*failed to address and give reasons for rejecting HMRC's contention that the areas allocated to the bars, restaurant and theatre were also used in part for the purposes of HCL's gaming business, such that there was dual use of those areas, or why if there was such dual use, the SMO guarantees a more precise result than the result which would arise from the application of the turnover-based standard method*" ([UT/76]).
   (b) As such, the UT set aside the FTT's decision and went on to remake it ([UT/81, 98-101]).

(c) In remaking the decision, the UT explained at [UT/113-126] that it saw the issue in an SMO appeal as being "*whether the SMO contended for guarantees a more precise determination of the deductible proportion of the input VAT than that arising from the application of the turnover-based method*" ([UT/122]) such that the "*focus of the appeal must therefore be on the proposed method with the taxpayer bearing the burden of proving that the proposed method guarantees a more precise determination than the standard method*" ([UT/126]).

(d) The UT concluded, in the light of what it found to be significant dual use of all areas of the Hippodrome premises, that the floorspace based SMO did not "*guarantee a more precise determination of the economic use and deductible proportion of the input VAT than that arising from the application of the standard turnover method*" ([UT/196]).

(e) In arriving at this conclusion in [UT/196], the UT further found that although "*a third of customers do not gamble and that is a physical proxy for the economic use … it is not a good proxy for economic use when gambling customers are spending considerably more*" at [UT/195].

(f) At [UT/198-210], the UT held that the effect of Article 5(1) of the Input Tax Order is that "*VAT is first subject to a restriction for use for the purposes of business entertainment, with the residual amount then apportioned under the standard method. The statutory apportionment of input tax under Regulation 101(2) is as between input tax used for taxable supplies, and input tax used for exempt supplies. However, input tax used for gratuitous business entertainment is neither.*" ([UT/207]).

10. In reaching those conclusions, the UT erred in the four ways set out below.

GROUND ONE

11. The UT erred in its conclusion that the FTT failed to address a central issue in the appeals before it and to give reasons for its Decision.

12. As noted already, the issue with which the FTT was faced was "*highly fact sensitive"*.

13. The UT was referred to extensive authority on the approach to be adopted in an appeal against the decision of a specialist fact-finding tribunal such as the FTT in a case of this nature. In particular:

(a) An appellate tribunal or court should be slow to interfere in a case like the present which involves (i) a multi-factorial assessment or value judgement, and (ii) the application of a concept ("*use*" or "*economic use*") which is a far from precise legal standard to a combination of feature of varying importance. (cf. in particular: *Procter & Gamble* [2009] EWCA Civ 407 [2009] STC 1990 ("***Procter & Gamble***") at [9]-[10] (per Jacob LJ) (citing Lord Hoffmann in *Designers Guild Ltd v Russell Williams (Textiles) Ltd* [2000] 1 WLR 2416 at 2423-4); *Instagram v Meta 404* [2023] EWHC 436 [2023] ETMR 20 ("***Instagram***") at [23]-[24]);

(b) The trial is not a dress rehearsal. It is the first and last night of the show. In making its decisions, the FTT will have regard to the whole sea of evidence presented to it, whereas an appellate court or tribunal will only be island-hopping. (cf. in particular: *FAGE v Chobani* [2014] EWCA Civ 5 [2014] ETMR 26 ("***FAGE***") at [114]; and *Instagram* at [23] (citing Lewison LJ's judgment in *Volpi v Volpi* [2022] EWCA Civ 464 [2022] 4 WLR 48 ("***Volpi***") at [2](iii)));

(c) Particular deference is to be given to expert tribunals such as the FTT since Parliament has entrusted them, with all their specialist experience, to be the primary decision maker. The correct approach to an appeal from an expert tribunal, is on the basis that it, charged with understanding and applying the law in its specialist field, has probably got it right (cf. Baroness Hale in *AH (Sudan) v Secretary of State for the Home Department* [2007] UKHL 49 [2008] 1 AC 678 ("***Sudan***") at [30], cited in *Procter & Gamble* at [11] (per Jacob LJ), [48] (per Toulson LJ) and *Instagram* at [26]);

(d) Reasons for judgment will always be capable of having been better expressed. In order to ascertain the reasoning of the FTT, the Decision must be gathered by a fair reading of its entirety, and it is not to be picked over or construed as if it were a statute or a contract. This guidance applies with particular force to the judgments of expert tribunals which include lay members. (cf. in particular: *LCM (CA)* at [74]; and *Instagram* at [23] (citing *Volpi* at [2](vi));

(e) In making a multifactorial assessment, it is not incumbent on the FTT not only to identify each and every aspect of similarity and dissimilarity but to go on and spell out item by item how each was weighed as if it were using a real scientist's balance. In the end it is a matter of overall impression. All that is required is that the judgment must enable the appellate court to understand why the FTT reached its decision and for the parties to know why they won or lost. There is no duty in giving its reasons to deal with every argument presented by counsel, nor to deal at any length with matters that

are not disputed. Its function is to reach conclusions and give reasons to support its view, not to spell out every matter as if summing up to a jury. (cf. in particular: *FAGE* at [114]-[115]; and *Procter & Gamble* at [19] (per Jacob LJ), [61-2] (per Toulson LJ)); and

(f) The issue is not whether the appellate body agrees with the conclusions of the fact-finding tribunal – rather, as a matter of law, was the tribunal entitled to reach its conclusions. An appellate body should not rush to find a misdirection of law simply because they might have reached a different conclusion on the facts or expressed themselves differently (cf. in particular: *Sudan* at [30]; *Procter & Gamble* at [74] (per Mummery LJ); and *Instagram* at [23] (citing *Volpi* at [2](i)-(ii), (iv)-(v))).

14. Having summarised much of the above guidance, the UT nevertheless went on at [UT/61] to state that "*Having said all that, we are satisfied that this ground of appeal is not a complaint regarding perverse or unreasonable findings of fact, evaluative judgments or* adequacy *of reasons given. This ground concentrates upon the FtT's* failure *to address a central issue in the appeal and* lack *of reasons*." (UT's emphasis on "*adequacy*", "*failure*" and "*lack*").

15. In so far as the UT here found the that the guidance outlined above is not relevant where the charge against the FTT is a failure to provide reasons rather than a failure to provide adequate reasons, the UT erred in law. The UT failed to recognise that there is only a single error of law in this regard – a failure to provide adequate reasons. That error can be committed by a failure to provide any reasons (see e.g. *Awards Drinks v HMRC* [2020] UKUT 201 [2020] STC 2336 ("***Awards Drinks***") at [85]) or sufficient reasons. In either case, it is only by applying the approach prescribed in the guidance outlined above that the error can be identified. The UT therefore erred in drawing this false distinction.

16. Further and in any event, on a fair reading of the FTT's Decision as a whole in the light of the guidance outlined above it is clear that, in the course of its analysis of the suitability of HCL's override calculation, the FTT grappled in terms with the issue of dual use. In particular, as can be seen from the following analysis of the FTT's Decision, the FTT found there to be dual use as a fact, but then went on to consider whether the dual use that it had identified was so extensive as to render HCL's floor-space based override calculation an

unreliable proxy. It found that it was not and set out its reasons for having arrived at that conclusion.

17. Accordingly, the decision of the UT that the FTT failed to address and give reasons for rejecting HMRC's arguments which relied on such dual use is both unfair and unwarranted. As a result, the UT once again erred in law.

18. At [FTT/6-27], the FTT set out (correctly) the relevant legal principles in play in the appeals before it, which it clearly understood.

19. At [FTT/29-31] the FTT observed that, in addition to trial bundles running to over 2000 pages, oral evidence had been given by Mr Thomas (Chief Executive and Chairman of HCL) and Mr King (Managing Director of HCL), and that it had had "*the benefit*" of a site visit of the Hippodrome with a guided tour conducted by Mr Thomas on the first afternoon of the hearing. At [FTT/31], the FTT found that Mr Thomas and Mr King were both credible and truthful witnesses who sought to assist the Tribunal at all times.

20. The FTT's principal findings of fact are at [FTT/32-97] and clearly recognise a degree of dual use (see in particular [FTT/64, 66, 68, 77, 79]). Indeed, this appears to be accepted by the UT at [UT/26, 65]. Moreover, it is unsurprising that the FTT made such findings as the existence of dual use was not even in issue between the parties (as can be seen from the submissions on behalf of HCL recorded at [FTT Day 4 Transcript Page 55 Line 16 to Page 56 Line 5] [Supp/7/169] [FTT Day 5 Transcript Page 96 Line 24 to Page 97 Line 3] [Supp/8/212-3]).

21. At [FTT/108-110] the FTT flawlessly set out HMRC's case – including their arguments on "dual use".

22. The FTT's analysis then begins at [FTT/113].

23. At [FTT/114], relying on the Judgment of Warren J in *St Helen's School* at [60], the FTT noted the importance of the observable terms and features of HCL's business, and the context in which the expenditure in issue had been incurred.

24. Applying this guidance, the FTT concluded at [FTT/115] (referring back to its findings at [FTT/39, 40]), that the Hippodrome should be "*contrasted'* with other casinos and, at [FTT/116] and [FTT/117], that the Hippodrome was not just in competition with other casinos, but also many bars, restaurants and theatres. This clearly feeds into the FTT's analysis of the economic use by HCL of its overhead expenditure – what drives the expenditure is not merely a desire to attract custom from other casinos, but to attract custom from other bars and restaurants.

25. The FTT's specific analysis of dual use issue is at [FTT/118-123] – in particular whether the scale and importance of dual use is such as to render HCL's override calculation an unreliable proxy. In this context, an important question that the FTT had to address was the significance of, for example, the restaurant and theatre as assets for gaming. It addressed this question centrally at [FTT/118-119] when, for example, it described the "*limited crossover between restaurant and gaming*".

26. In a similar vein, at [FTT/120] the FTT's conclusion from Mr King's evidence was that that if the overriding economic use of the bars or restaurant was that of supporting or enhancing the gaming on offer they would look wholly different. That is a finding that to the extent that the space, ambience and offering in the bars and restaurant is far <u>more</u> extensive than that which would be required as a strategic asset for gaming, the predominant economic use of those assets must be for some other purpose.

27. At [FTT/121-123], the FTT then compared HCL's override calculation with the standard method. It tested the appropriateness of the standard method by considering two other cases involving the "*dual use*" of a building, in which it had been found that the standard method was a more reliable proxy than a proposed alternative. In doing so the FTT focused on the reasons that had been given for concluding that the standard method was the more reliable proxy for the economic use of the expenditure in issue in those cases:
    (a) *St Helen's* was a case about the amount of input tax a private school could recover on the construction costs of a sports complex. Although the supply of education is exempt, the school granted a taxable "*out-of-hours*" licence to a wholly-owned subsidiary, which in turn operated a sports club. The school applied to use a partial exemption special method ("**PESM**") based on the "*'actual use'*" made of the complex by itself and the subsidiary (cf. [49]). The standard method was preferred to the

proposed time-based apportionment on the grounds that the same package of services would have been provided to the parents of the pupils whether or not the licence was granted, even though some economic use was made of the sports complex for taxable purposes.

(b) *Aspinall's Club Ltd* [2002] Lexis Citation 805 ("***Aspinall's Clubs***") was a case about a high-end casino operating as a private members' club. The taxpayer applied to use a floorspace based PESM rather than the standard method. The standard method was preferred over the PESM on the grounds that the scale and nature of the food and drink on offer was dictated by the need to "*promote the highly profitable gaming business*" ([49]).

28. In each of these cases, the taxable activity was not seen as justifying the expenditure in question with the result that the standard method remained the most reliable proxy for the economic use of the expenditure in issue. By contrast, in the present case, as the FTT identified, the need to compete with other bars, restaurants and theatres was what drove HCL to incur the overhead expenditure in issue before the FTT.

29. For example, when contrasting the case before it with *Aspinall's Clubs* at [FTT/123] the FTT stated that "*the expenditure incurred by HCL was not merely to provide an attractive atmosphere to gamers but to promote and gain additional income from the theatre, bars and restaurant which are of an altogether different nature from the hospitality supplied in Aspinall's Clubs*". In a similar vein at [FTT/125] the FTT stated that, "*given their extent and nature, the supplies of entertainment and hospitality from discrete and defined areas of the Hippodrome by HCL cannot be regarded as merely an adjunct to, or an amenity for, gaming*".

30. In each of these paragraphs the FTT was dealing with the very thrust of the arguments which HMRC had made and the evidence on which HMRC had relied in making those arguments– cf. [FTT/110], [FTT/62, 66]. Rejecting those arguments the FTT concluded that, whatever their use to promote or enhance supplies of exempt gaming, it was the use of the bars, restaurant and theatre to make taxable supplies of food, drinks, and entertainment that dictated their size, style and location.

31. Moreover, in the context of the alleged error of law which it had found to exist it is notable that the UT accepted that the FTT's analysis at [FTT/123] was indeed predicated upon dual use: "*... by implication of "not merely", the FtT was implicitly accepting that some of the purpose of the expenditure was to provide an attractive atmosphere to gamers*." ([UT/71]). The UT provides no answer as to how this is consistent with its conclusion that the FTT failed to address the existence of dual use.

32. Read fairly and as a whole, it is clear that the FTT in its Decision not only engaged with both the evidence before it and the arguments that had been presented to it, it set out with sufficient clarity the reasons for its conclusions to enable the parties to understand "*why they have won or lost*" (see *Proctor & Gamble* at [19] per Jacob LJ).

33. Accordingly, HCL respectfully submits that its appeal should be allowed on the following ground:

Ground 1: The UT erred in rejecting the guidance set out in cases such as *Procter & Gamble* [2009] EWCA Civ 407 [2009] STC 1990 (which highlighted the particular caution that should be exercised by an appellate court or tribunal before interfering with an overall evaluative judgement made by a specialist fact-finding tribunal). In particular, it set up an erroneous contrast between allegations of inadequacy of reasoning and those of lack of reasoning (at [UT/61]) and (further) erred in its conclusion that the FTT had failed both to engage with HMRC's arguments and to give sufficient reasons for its conclusion.

GROUND TWO

34. Having considered in error that it could interfere with the FTT's decision, the UT then turned to what it considered should be the focus of the appeal before it: namely the proposed method. The UT considered whether HCL's SMO was a more reliable/accurate proxy for use than the standard method and concluded it was not. In so far as that was a value judgement open to the UT (contrary to Ground One above), HCL does not look to challenge the UT's conclusions in this Court.

35. However, in identifying the focus of the appeal as the proposed method, the UT further erred in law. The UT should instead have started with an analysis of the suitability of the

standard method. This follows from the clear wording of regulation 107B of the VAT Regulations: in circumstances "*where a taxable person has made an attribution [under the standard method] and that attribution differs substantially from one which represents the extent to which the goods or services are used by him … in making taxable supplies*" the taxable person shall "*calculate the difference, and … account for the amount so calculated*". In answering that question there is no need to consider whether any other (or any other particular) method does represent the extent to which the expenditure in issue is used in making taxable supplies. Focussing exclusively on the taxpayer's override calculation fails to engage with the very mischief at which the legislation is aimed.

36. The UT nevertheless found support for its approach (at [UT/119]) in the decision of the UT of *Temple Finance* [2017] UKUT 315 [2017] STC 1781 ("***Temple Finance***"). It was wrong to do so.

37. Temple Finance sold goods on hire purchase. As such, it made both taxable supplies of the goods themselves as well as exempt supplies of finance. It recovered input tax on its overhead expenditure by applying the standard method. HMRC argued that Temple Finance's overhead expenditure related (almost exclusively) to its exempt supplies of finance, with the result that the application of the standard method (in which the value of the taxable goods was included in the turnover based calculation) allowed Temple Finance to recover too much input tax. Accordingly, HMRC argued that the SMO applied. The override calculation relied on by HMRC was straightforward; the standard method was adapted by excluding the value of the goods from Temple Finance's turnover. The FTT rejected the need for an SMO calculation, and HMRC appealed to the UT.

38. The UT in *Temple Finance*, in passages relied upon by the UT in this case, stated that "*Only two methods were before the FtT, [Temple Finance's] and HMRC's. The FtT was not required to make its own enquiry as to whether there might be another method that was preferable*", and that "*… the starting point is the standard method … [and] … that method is the appropriate method unless a [PESM] applies or the proportion of recoverable input tax 'differs substantially' from that which would be recoverable under a use-based method, so that the SMO applies*".

39. However, the issue with which the UT was faced in *Temple Finance* was very different (and far more straightforward) than that which faced the UT in this case. Having rejected the alleged flaw in the standard method relied on by HMRC in *Temple Finance* then, as the UT stated, it was not for the Tribunal to adopt an inquisitorial role and identify other problems with the standard method where the parties had not done so. This was why the UT in *Temple Finance* also stated (at [61]) that rejecting HMRC's case "*effectively left the default standard method contended for by [Temple Finance] as the applicable one*".

40. The UT's comments in *Temple Finance* are clearly appropriate in the circumstances of that case. However, it does not follow from the UT's Decision in that case that the SMO calculation relied on by a party is the only way for that party to demonstrate the existence of a problem with the standard method – it is rather the party's proposed solution to a problem. *Temple Finance* simply does not deal with the approach to be adopted by the Tribunal where one or other party has identified flaws with the standard method (engaging regulation 107B) which still require an answer even if that party's proposed answer is itself not satisfactory.

41. With the exception of the present case, this question has not arisen in the context of the SMO but it has arisen in the context of legislation addressing a parallel problem and which is in all material respects identical: the special method override. The UT in error (a) rejected the reliance placed by HCL on the special method override cases (addressed briefly below) and (b) has created an artificial and unwarranted distinction between appeals relating to the SMO and appeals relating to the special method override.

42. Once a PESM has been approved or directed under regulation 102(1) of the VAT Regulations, it continues until its termination is approved or directed under regulation 102(3). For a taxpayer with a PESM in place therefore, it has become the default in the same way as the standard method is the default for a taxpayer without a PESM.

43. A Special Method Override Notice ("**SMON**") is issued (under regulations 102A or 102C of the VAT Regulations) where the PESM "*does not fairly and reasonably represent the extent to which goods or services are used by him or are to be used by him in making taxable supplies*." The effect of a SMON is not that the PESM is disapplied and the standard method applied in its place (if that is the result desired, regulation 102(3) is the relevant

provision). Rather, the effect of a SMON is the same as that of satisfying the condition for the SMO to apply in regulation 107B(1) of the VAT Regulations: the taxpayer must calculate the difference between the current attribution and an attribution which reflects the principle of use and account for the difference (regulation 102B of the VAT Regulations). In other words, the SMO and special method override apply in identical circumstances with identical consequences.

44. In *Vision Express (UK) Ltd v HMRC* [2010] STC 742 ("***Vision Express***") at [49], McCombe J made clear that in addressing the need for a special method override calculation it was unnecessary "*to examine the methodology adopted by the commissioners in raising their assessment in order to find whether the 'cure is worse than the disease' … The sole issue on the appeal against the notice is whether reg 102A is satisfied.*" And that "*It is, as a matter of statutory construction of the regulations, unnecessary for these purposes to decide whether the commissioners, in calculating their later assessment, have come up with an alternative which does satisfy the overall statutory objective of a fair and reasonable attribution.*"

45. *Vision Express* also identifies that in circumstances where neither the default method (be it the standard method in a SMO appeal or the PESM in a SMON appeal) nor the proposed replacement reflect the economic use of the inputs in question, the Tribunal may either provide the answer or provide guidance to the parties to allow them to seek to agree this subject to a further hearing if necessary – [53]-[55]. The same approach was adopted by the FTT in another SMON case – *St John's College Oxford* [2010] UKFTT 113 ("***St John's***") (see in particular [83-85] [147-151]). For completeness, this also reflects the approach to be adopted in any VAT appeal prescribed by the UT in *Revenue and Customs Commissioners v General Motors UK Ltd* [2016] STC 985 ("***GMUK***") at [66]-[70], namely that a Tribunal's "*primary task is to find the correct amount of tax, so far as possible on the material properly available to it, the burden resting on the taxpayer*".

46. In arriving at its flawed conclusion that the focus of the appeal should be on HCL's SMO calculation, the UT also placed reliance at [UT/120] on the approach in the very different case of an appeal against the refusal by HMRC to allow the use of a PESM. In appeals of that nature the question is whether the PESM that has been proposed should be approved so as to replace the standard method as the default. As Warren J held in *St Helen's* at [27],

if the Tribunal rejects the proposed PESM, it cannot come up with its own PESM as an alternative. However, an analogy cannot be drawn between such a case and a case where the (standard or special method) override legislation is in issue. This is because:

(a) First, the focus of the scheme of the legislation is different. A PESM appeal can succeed even if the standard method is fair and reasonable so long as the proposed PESM is more fair and reasonable – cf *St Helen's* at [80] "*the questions for me are whether the standard method and the School's proposed special method each produce a fair and reasonable attribution and if so whether the School's method is more fair and reasonable than the standard method*.". However, the application of the SMO is precluded if the standard method itself is fair and reasonable – the gateway condition in regulation 107B(1) of the VAT Regulations will not be satisfied. In the very same way, no SMON can be issued where the existing PESM is fair and reasonable. If HMRC or the taxpayer think either the standard method or another PESM is merely <u>better</u>, the appropriate course is to terminate the PESM and replace it, not to issue a SMON.

(b) Second, the application of a PESM involves choice – a taxpayer is under no requirement to request a PESM nor are HMRC required to direct a PESM on its own initiative. By contrast, the language of the SMO legislation is mandatory. It is not surprising therefore that the nature of the Tribunal's jurisdiction is different.

47. For completeness, it is noted that in addition to the suitability of the PESM relied on by the taxpayer in *St Helen's*, the need for an SMO was also in issue. When he turned to the need for an SMO at [82-83], the approach adopted by Warren J mirrors that relied on by HCL in the present case – he first evaluated whether the standard method produced a result which differed substantially from one which represents the extent of economic use.

48. As such, HCL respectfully submits that its appeal should be allowed on the following ground:

Ground 2: Having set the FTT's decision aside, the UT erred in its approach to jurisdiction.

GROUND THREE

49. Had the UT adopted the correct approach (cf. Ground Two above) and first asked itself whether the standard method was a reliable proxy, the UT should have concluded that it was not. In particular, the evidence, based on HCL's statutory returns to its regulator (the Gambling Commission), that one third of customers visiting the Hippodrome did not do any gambling (accepted at [UT/191]) should have demonstrated that the standard method (which would attribute between 12% and 22% of HCL's inputs to taxable supplies (this can be seen either from the SMO calculations sent to HMRC on 10 July 2020 [Supp/1/2-15] which were before the FTT and UT or by comparing the second and fourth columns in the table at [FTT/99])) differed substantially from an attribution which represented the extent to which the inputs are used in making taxable supplies.

50. At [UT/195] the UT (in error) discounted the relevance of this evidence. It held that, "*We have found that a third of customers do not gamble and that is a physical proxy for the economic use but it is not a good proxy for economic use when gambling customers are spending considerably more*".

51. The UT's reason for referring to the proportion of non-gaming clientele at [UT/195] is unclear, as in this section of its Decision the UT is explaining why "*Even if the burden had been on HMRC to satisfy us that the standard turnover method guarantees a more precise determination of the deductible proportion of the input VAT than the floorspace SMO proposed by HCL, we would have been so satisfied*". However, insofar as the UT was suggesting at [UT/195] that the evidence relating to non-gaming clientele did not undermine the reliability of the standard method it was in any event wrong to do so.

52. As noted, the UT's logic for rejecting "*customer numbers*" as a "*good proxy for economic use*" is on the basis that "*gambling customers are spending considerably more*" than their non-gambling counterparts. In other words, the logic of the UT is that there is an inevitable correlation between economic use and turnover. The flaw in this logic is that, were it correct, the standard method (which attributes overhead or residual input tax to taxable supplies by comparing a business's taxable turnover to its total turnover – thereby assuming that the economic use of VAT-bearing overheads to make £1 of taxable income is identical to that to make £1 of exempt income) would in <u>all</u> circumstances more fairly reflect

economic use than any other method, and departure from that method (by way of override or otherwise) would never be justified. This is plainly wrong.

53. The basis upon which the UT discounts the evidence relating to the proportion of non-gaming clientele at [UT/195] also bears some resemblance to its statement in [UT/123] that "*the standard method […] by definition will provide for a fair and reasonable deduction based on the use or intended use of purchases*". Again, the UT fails to recognise that the legislation specifically envisages circumstances where the standard method will not produce either a fair and reasonable proxy or the most fair and reasonable proxy, and there mandates the use of another proxy.

54. The evidence that one third of those customers visiting the Hippodrome did so with no interest in gambling and did not make use of any of the gaming facilities on offer, should have led the UT to conclude that HCL was entitled to recover at the very least one third of the input tax incurred by it on its overhead costs. The Tribunal should further have concluded that the true figure was somewhat higher than that given that taxable food, drink, and entertainment would also have been supplied to those customers who additionally gambled.

55. As noted at [45-46(b)] above in relation to Ground Two, in circumstances where the standard method has been found to be an unreliable proxy for the use by a taxpayer of its VAT-bearing overhead costs, but the parties have been unable to identify a reliable override calculation as an alternative, the function of the Tribunal is to provide guidance. Had the UT invited submissions on the issue HCL would have suggested the following (alternative) override calculation to the Tribunal for its consideration:

$$\frac{1}{3} + \frac{\text{Two thirds of the taxable turnover}}{\text{Total exempt turnover + two thirds of the taxable turnover}}$$

56. This override calculation starts by identifying that HCL uses one third of its overhead costs (which are mostly property related – [FTT/102-3]) in order to cater to the one third of its customers who *solely* receive taxable supplies (i.e. food and/or drink and/or entertainment). A modified turnover-based calculation is then applied to the remaining overhead expenditure. The calculation assumes that the average customer spend on food, drink, and entertainment is the same whether or not the customer additionally gambles. Accordingly,

the one-third taxable turnover attributable to the one third of customers who do not gamble is excluded from this modified turnover calculation.

57. As such, HCL respectfully submits that its appeal should be allowed on the following ground:

Ground 3: Insofar as it did so, the UT erred in rejecting the proportion of non-gaming clientele as demonstrating that the attribution of HCL's overhead costs to taxable and exempt supplies in accordance with the standard method differed substantially from an attribution that reflected the true economic use of that expenditure.

GROUND FOUR

58. Article 5(1) of the Input Tax Order blocks the recovery of input tax on expenditure incurred to provide business entertainment. It provides (so far as is relevant) that,

> *"(1) Tax charged on any goods or services supplied to a taxable person, […] is to be excluded from any credit under section 25 of the Act, where the goods or services in question are used or to be used by the taxable person for the purposes of business entertainment […]*
>
> *(3) For the purposes of this article, "business entertainment" means entertainment including hospitality of any kind provided by a taxable person in connection with a business carried on by him […]"*

59. As the UT stated at [UT/199], having rejected HCL's override calculation, there was "*a further narrow secondary dispute, which [was] about how the use of the Hippodrome Casino premises for the purposes of business entertainment should be dealt with under the [capital goods scheme]*". However, the issue between the parties is not one related to a particular feature of the capital goods scheme ("**CGS**"). The relevant point of difference is one which applies to any partially exempt taxpayer who provides business entertainment. That is because (under regulation 116 of the VAT Regulations) the ongoing use of items within the CGS (which is monitored against the use of the item at the time of the expenditure) is determined in the same way as the use of recurrent expenditure in making taxable and exempt supplies i.e. in accordance with the provisions of sections 24 to 26 of the VAT Act 1994 ("**VATA**") and the regulations thereunder; in the present case, on the

basis of the UT's conclusions in relation to Grounds One to Three above, in accordance with the standard method.

60. Accordingly, the true issue between the parties relates to the interaction between the prohibition on the recovery of input tax on expenditure incurred in order to provide business entertainment and the standard method.

61. The issue between the parties is whether the VAT on any given item of expenditure is first subject to a restriction for the use of that expenditure in order to provide business entertainment, with the remainder then apportioned under the standard method (as HMRC contended) or whether (as HCL contended) the input tax should first be apportioned in accordance with the standard method and only further restricted in so far as the use of the expenditure in question to provide business entertainment relates to the promotion of taxable as opposed to exempt supplies.

62. The UT concluded that "*input VAT is first subject to a restriction for use for the purposes of business entertainment, with the residual amount then apportioned under the standard method*" because the "*statutory apportionment of input tax under Regulation 101(2) is as between input tax used for taxable supplies, and input tax used for exempt supplies. However, input tax used for gratuitous business entertainment is neither*" ([UT/207]).

63. This is wrong for the following reasons. First, the mere fact that business entertainment is provided gratuitously does not lead to the conclusion that the input tax on the associated expenditure is neither used for taxable supplies nor exempt supplies – it may be used for either or both – see *HMRC v Associated Newspapers* [2017] STC 843 [2017] EWCA Civ 54. Second, expenditure on business entertainment is, as its name suggests, incurred with a clear business purpose in mind i.e. the making of supplies. It is a cost component of those supplies and the input tax on that expenditure is in principle recoverable as such. If the input tax on such expenditure were otherwise irrecoverable (as the UT appears to suggest), there would be no need for Article 5 of the Input Tax Order and Parliament would have acted in vain.

64. Moreover, the conclusion reached by the UT that "*input VAT is first subject to a restriction for use for the purposes of business entertainment, with the residual amount then*

apportioned under the standard method" ([UT/207]) is inconsistent with the clear wording of the legislation. Input tax allowable under section 26 VATA (i.e. that determined under the provisions of Part XIV of the VAT Regulations (which includes regulation 101)) feeds into section 25(2) VATA to provide a credit, to be set against the taxpayer's output tax. However, section 25(2) is "*subject to the provisions of this section*", and thus in particular to section 25(7) VATA (the current vires for the Input Tax Order). It follows that the amount of allowable input tax (i.e. that attributed to taxable supplies) is further restricted insofar as the goods and services to which that input tax relates have been used or will be used to provide business entertainment.

65. Finally, at [UT/208-210] the UT agreed with and relied on a hypothetical example which had been provided by HMRC, involving capital expenditure on a building "*used in a particular year for the purposes of making (a) taxable supplies …; (b) exempt supplies …, and (c) gratuitously-provided business entertainment …*". However, in treating the use of the building to provide business entertainment as something distinct from its use in order to make taxable and exempt supplies then, for the reasons discussed already, the premiss on which the example is based is flawed.

66. In any event, to the extent that a taxpayer increases the amount of business entertainment it provides in order to boost its exempt turnover, this will lead to a lower amount of input tax on any associated overhead expenditure being recovered in accordance with the application of the standard method. The objective of Article 5 of the Input Tax Order has already been satisfied. Conversely, where the taxpayer increases the amount of business entertainment it provides in order to boost its taxable turnover, the application of the standard method will lead to the recovery of a higher amount of input tax on any associated overhead expenditure. However, Article 5 of the Input Tax Order would in these circumstances apply.

67. Finally, the UT was wrong to suggest that HCL's approach *"in effect renders the Input Tax Order nugatory in any partial exemption situation*" ([UT/210]). As can be seen from above, this is not the case. HCL's approach merely reflects that where the taxpayer (1) is partially exempt and (2) exclusively or predominantly provides business entertainment for the purposes of its exempt business, the Input Tax Order has little or no effect because the VAT is attributed to exempt supplies and irrecoverable in any event.

68. Accordingly, HCL respectfully submits that its appeal should be allowed on the following ground:

Ground 4: The UT erred in its approach to Article 5 of the Value Added Tax (Input Tax) Order 1992 (SI 1992/3222) (which blocks the recovery of input tax on expenditure incurred in order to provide business entertainment) and its interaction with the standard method.

CONCLUSION

69. The Court of Appeal is therefore respectfully invited to allow HCL's appeal on the following four grounds:

(a) Ground 1: The UT erred in rejecting the guidance set out in cases such as *Procter & Gamble* [2009] EWCA Civ 407 [2009] STC 1990 (which highlighted the particular caution that should be exercised by an appellate court or tribunal before interfering with an overall evaluative judgement made by a specialist fact-finding tribunal). In particular, it set up an erroneous contrast between allegations of inadequacy of reasoning and those of lack of reasoning (at [UT/61]) and (further) erred in its conclusion that the FTT had failed both to engage with HMRC's arguments and to give sufficient reasons for its conclusion.

(b) Ground 2: Having set the FTT's decision aside, the UT erred in its approach to jurisdiction.

(c) Ground 3: Insofar as it did so, the UT erred in rejecting the proportion of non-gaming clientele as demonstrating that the attribution of HCL's overhead costs to taxable and exempt supplies in accordance with the standard method differed substantially from an attribution that reflected the true economic use of that expenditure.

(d) Ground 4: The UT erred in its approach to Article 5 of the Value Added Tax (Input Tax) Order 1992 (SI 1992/3222) (which blocks the recovery of input tax on expenditure incurred in order to provide business entertainment) and its interaction with the standard method.

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