

# Input tax recovery of theatre production costs: *HMRC v Royal Opera House Covent Garden Foundation* [2020] UKUT 132 (TCC)

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## **Background**

Supplies of theatre and museum tickets fall within the 'cultural exemption' under Schedule 9 of the VAT Act 1994. However, the business model of many cultural venues does not rely solely on income from ticket sales. As well as funds from public grants and endowments, many venues also make taxable supplies of food and drink at on-site bars and restaurants, or sell other merchandise too. On the input side, venues will have paid VAT on the costs of staging productions or putting on exhibitions. The present appeal concerned whether the Royal Opera House's production costs fell to be attributed solely to its exempt sales of tickets and taxable sales of programmes, or alternatively to a wider range of taxable supplies, principally its bar and restaurant offerings.

The opera house ("ROH") relied on recent European caselaw to argue that in economic terms there was a direct and immediate link between its production costs and catering supplies. ROH succeeded before the First-Tier Tribunal on that basis (see [2019] UKFTT 329 (TC)), but the Upper Tribunal (Morgan J and Judge Timothy Herrington) have now overturned that decision.

## ***Mayflower***

Article 168 of the Principal VAT Directive provides for the right to deduct input tax where the inputs are '*used for the purposes of the taxed transactions of a taxable person*'. According to the European caselaw, what is required is a 'direct and immediate link' between the input and the output; the former must be a 'cost component' of the latter.

In the theatrical context, HMRC used to treat production costs as directly and immediately linked only to ticket sales, so did not allow any input tax recovery (tickets being an exempt supply). This changed, however, after the Court of Appeal's decision in *Mayflower Theatre Trust Ltd* [2007] STC 880, which held that production costs were in part attributable to programme sales too, given that the productions were the 'subject-matter' of the programmes. At an earlier stage of the litigation, the theatre had sought to argue that there was a direct and immediate link to its catering supplies too, though the point was not pursued on appeal. Carnwath LJ nevertheless indicated that in his view there was '*no sufficient link between such sales and the production services. Such sales are the same in character whether they are in an ordinary shop, a theatre kiosk, or a railway station ... any link with the activities of the particular location is "indirect and not immediate".*'

### European developments and the Chester Zoo case

The key issue in the present case was the extent to which the European caselaw on input tax recovery has moved on since *Mayflower* in accordance with the broader trend towards economic realism. In *Sveda* [2016] STC 44, the taxpayer had constructed a 'recreational (discovery) path' to which there was free public access. However, the domestic court had found as a matter of fact that the construction was also a means of attracting visitors with a view to providing them with a range of taxable supplies of goods and services, including souvenirs, food and drinks. There the CJEU held that the immediate use of the path free of charge did not affect the existence of the direct and immediate link between input transactions and output transactions, or with the taxable person's economic activities as a whole.

*Iberdrola Inmobiliaria Real Estate Investments* ECLI:EU:C:2017:683 was similar. A property developer was required to construct a municipal pump station free of charge in order to complete a building project; had it not done so, the developer would not have been able to make taxable supplies of holiday apartment leases once the project was complete. Consequently, the CJEU held, the developer was entitled to treat the costs of the reconstruction as a component of its supply of leases. The more nuanced approach represented by *Sveda* was acknowledged domestically by the Court of Appeal in *Associated Newspapers* [2017] STC 843, CA, relating to whether the input costs of vouchers distributed free to readers by a newspaper group could be attributed to the taxable supply of newspapers. Per Patten LJ at [47]:

*'It seems to me that the CJEU has clearly moved away in these recent decisions from any disregard of the ultimate economic purpose of the relevant expenditure in considering whether it should be treated as linked to the taxpayer's wider economic activities. This is not a question of subjective intent but requires an*

*objective analysis in terms of the taxpayer's identifiable economic activities of why the input supplies were acquired.'*

Though it predates *Sveda*, a previous FTT decision in *North of England Zoological Society v HMRC* [2015] UKFTT 287 (TC) ("*Chester Zoo*") had in many ways foreshadowed these developments. The Zoo incurred a range of costs in maintaining its menagerie, such as feed and enclosures. The most obvious onward supply was the exempt sale of entrance tickets; however, the Zoo also wished to deduct the VAT incurred on the animal-related costs from catering and retail supplies to visitors. Finding for the taxpayer, the tribunal held that there was a direct and immediate link here: rejecting the narrow approach taken by HMRC, the tribunal instead took a broader, more commercial approach:

*' 130. ...The [Zoo's] business model, in commercial terms, exploits the animals in order to achieve various income streams, the most significant of which are admissions, catering and retail. In that sense the animal related costs are borne by all those supplies.'*

Customers were attracted by the animals to purchase tickets, but also to spend on catering and merchandise. Importantly, the Zoo's taxable supplies operated at a surplus, and therefore made a significant contribution to the Zoo's expenditure, including the costs of maintaining the animals. The tribunal also placed weight on visitors to the zoo having an 'integrated experience'; observing the animals and enjoying the catering and retail offerings were not separate and distinct activities.

Overall, the Tribunal accepted that there was a 'virtuous circle' at work here:

*'...looked at in the round there is a strong economic link between the catering and retail offerings and the animals. Catering outlets and shops are carefully positioned and themed by reference to the animals. The Zoo is operated in a way designed to increase dwell time. This is done by improving and renewing animal exhibits and the other facilities offered by the Zoo, including catering and retail facilities. This is what [the Zoo's witness] described as a "virtuous circle". The better the collection of animals and habitats the greater the income from all income streams. In turn, that provides funding to improve the animal collections and habitats.'*

## **The FTT decision**

Following *Chester Zoo*, ROH argued that there was a similar 'virtuous circle' at the heart of its business model. While the 'main event' was of course the performance of opera and ballet, the opera house contended that the high quality of its productions allowed it to generate more income from commercial

sources which could in turn be ploughed back into the artistic output. From an economic point of view, it would not have made commercial sense for ROH to incur Production Costs at the levels it did had it relied solely on ticket sales, or else it would have run a deficit. Rather the productions were the 'hook' which brought in the audience, who would then spend on catering and retail during the course of their visit.

HMRC, however, rejected this analysis. Relying on the earlier *Roald Dahl Museum* case ([2014] UKFTT 308 (TC)), the Commissioners said that simply because profits from the taxable supply ultimately subsidised a loss-making exempt supply did not allow the input costs of the latter to be attributed to the former. They also contended that there was a break in the chain here, such that catering and retail were linked back to the production costs through the exempt supply of tickets, and therefore that the input tax was irrecoverable accordingly.

The Tribunal, however, largely found in favour of ROH. After a compendious review of the authorities, the judge accepted that the 'direct and immediate link' test was satisfied here. Though he acknowledged that there were some factual differences between this case and *Chester Zoo* as regards theming and 'dwell time', these factors were not decisive. Nor was it determinative that the production costs were not shown as direct costs of catering in ROH's accounts. Furthermore, the chain-breaking argument did not apply here; as with theatre programmes in *Mayflower*, catering supplies were separate from ticket sales, not links in the same chain.

Most importantly, the Tribunal accepted that Carnwath LJ's obiter dicta in *Mayflower* could no longer be relied upon in the light of *Sveda* and *Associated Newspapers*; rather the 'direct and immediate link' should now be construed as '*necessary economic link between the initial expenditure and the economic activities which follow*'. As such, on the basis of the '*different approach*' now required, the judge was satisfied that the production costs were directly linked to ROH's catering supplies:

*'84. As with the animals in Chester Zoo, in this case, as I have already mentioned, it is the opera or ballet that is central to everything the ROH does. It is these performances that bring the restaurants and bars of the Opera House their clientele. Such a connection between the productions and catering supplies is, in my judgment, more than a "but for" link. Taking an economically realistic view the performances at the Opera House, and therefore the Production Costs, are essential for the ROH to make its catering supplies. It therefore follows that the purpose of the Production Costs, objectively ascertained, is not solely for the productions of opera and ballet at the Opera House but also to enable the ROH to maintain its catering income.'*

ROH also sought to argue that there was a direct and immediate link to certain of its other taxable supplies. In respect of ice cream sales during performance intervals, the judge agreed that the same reasoning applied, but the claims in respect income from non-performance specific commercial venue hire, production work for other companies, and sales in the Covent Garden shop (other than recordings of ROH productions) were not allowed. The judge held instead there were merely 'but for' links between these and the production costs, and the cost component test was not satisfied.

### Appeal to the Upper Tribunal

On appeal, HMRC argued that the judge had erred in law by applying a simple 'but for' test to establish a direct and immediate link to Catering Supplies and, alternatively, that the chain-breaking rule did apply, with the link between Catering Supplies and Productions Costs operating only through the exempt supply of tickets.

After conducting their own comprehensive review of the previous authorities (as well as two further decisions that post-dated the Tribunal's decision: *Frank A Smart* [2019] UKSC 39 and *University of Cambridge* [2019] STC 1523), the UT upheld the FTT on the second point, but found in HMRC's favour on the first. Looking in particular at *Sveda* and *Associated Newspapers*, it held that while the law might have moved on in respect of direct immediate and link to a taxpayer's overheads, the position had not changed as regards attribution to a specific taxable supply – for which the orthodox *BLP* cost component test remained applicable.

*'97. In our view, the FTT erred in its approach by relying on ANL and Sveda and by holding at [83] that those cases were authority for the proposition that all that was necessary to establish a "direct and immediate link" in this case, a specific attribution case, was to consider whether there was a "necessary economic link" between the Production Costs "and the economic activities which follow".*

*98. In our view, the FTT's reasoning at [84] takes it no further than establishing a "but for" link between the Production Costs and the Catering Supplies. The FTT is clearly correct in its conclusion in the second sentence of [84] that the opera and ballet performances bring the restaurants and bars of the Opera House their clientele. That clearly establishes a "but for" link. However, in the fourth sentence of [84] the FTT seem to do no more than elevate that link into a "direct and immediate" link on the basis that the Production Costs are "essential" for the ROH to make its catering supplies. In the context in which the word "essential" is used, in our view it does no more than emphasise the commercial link between the productions of opera and ballet and the bars and restaurants and demonstrate that the Catering Supplies could not take place without those productions.'*

As such, there was only an indirect link, and the Production Costs were only cost components of the supply of tickets (and programmes).

*'108. ... The Production Costs are not used in order to make supplies of champagne at the bars of the ROH. There is an indirect link to the supplies of champagne in that without the performances the champagne would not be served but that is an indirect link. In no sense could it be said that the Production Costs are part of the costs of supplying the champagne and thus a direct and immediate link is precluded. Whilst accepting that the making of the exempt supplies in this case is promotional of the Catering Supplies and assists in giving the visitor to the ROH "a fully integrated visitor experience", that is not sufficient in itself to enable conclusion to be reached that the Production Costs are a cost component of the Catering Supplies.'*

By way of more general guidance, the tribunal then observed:

*'109. This case shows that the requirement of a direct and immediate link between the two supplies is an important qualification which must be satisfied if the input tax is to be deducted. It was always clear that a but for test of causation was not sufficient in itself to satisfy the direct and immediate requirement. It is not enough to express the but for test in economic terms and then contend that the link must be considered to be direct and immediate. A requirement that the link be direct and immediate will produce the result in some cases that an indirect link or a non-immediate link will not meet the requirement. The present is such a case. We do not consider that the conclusion in this case is in any way a departure from economic reality.'*

## **Comment**

This decision will be a disappointment not just to ROH, but the theatre industry more widely, particularly given the other problems which the sector is currently facing. However, even had the FTT decision been upheld, HMRC might well have sought to confine the case to the unique circumstances of the 'fully integrated' operatic-cum-dining experience of a Covent Garden performance, and consequently have refused to allow theatres to attribute production costs to supplies of refreshments in their bars more generally.

Indeed, this was somewhat the approach the UT took towards the *Chester Zoo* case, which the FTT had considered persuasive in the circumstances. Rather than explaining precisely why the logic of that decision did not apply to ROH, the UT declined to engage with the substance, and were instead content simply to treat it as a case decided on its own facts:

*'98. The case does not contain any statement of general principle which we should apply in preference to the principles we derive from the authorities*

*we have considered earlier. Accordingly, we are not unduly influenced by this decision, even though there are some similarities between the facts of that case and the present case.'*

It might also be felt that the UT was somewhat harsh on the FTT, overturning its decision on the grounds that it had wrongly applied a 'but for' test, notwithstanding that the judge had been clear that he was not doing so – indeed, it was precisely on that basis that he had found against ROH in respect of the other taxable supplies in respect of which it had also sought to attribute its Production Costs. Instead, the real difference between the UT and FTT would appear to be not whether 'but for' was sufficient for direct and immediate link (which it plainly is not), but rather whether an identified economic link, for example by way of the attraction of customers to consume taxable supplies, such that an input is commercially essential for a taxable output, was sufficient; also whether or not it was relevant to look in detail at the facts of the operation of the business and, for example, whether the customer experience was "fully integrated"

The UT's view that the latter was not sufficient appears to derive from its reading of the recent caselaw to the effect that the 'economic approach' is limited to attribution cases involving overheads, rather than those involving attribution to particular taxable supplies. However, it is submitted the authorities may not necessarily require such a limitation, and certainly in *Sveda* the Advocate General's view appears to have been that an 'objective economic link' was sufficient in specific attribution cases.

While *Associated Newspapers* was plainly an overheads case, it is not clear that Patten LJ's comments there must be construed so as to apply solely to that context either: see, in particular, his comment at [50] that *'it makes no difference in my view in economic terms whether one treats this as a choice between non-taxable supplies and the taxable supplies of newspapers and advertising or between non-taxable supplies and ANL's general overheads.'*

In the same case at [55] Patten LJ also observed that the law had moved on since BLP and Carnwath LJ's application of the cost component test in *Mayflower*. The UT again considered that this referred only to overheads cases. However, this would seem surprising given that *Mayflower* was of course a specific attribution case, so if the UT's interpretation is correct here it is not clear what aspect of that case Patten LJ would have been seeking to cast doubt on – especially given that his comment in the preceding paragraph that *'the purpose of the performance [in Mayflower] was in part to enable the Trust to make taxable supplies of refreshments'* follows on from the discussion of the 'new' objective economic purpose test in the European authorities.

Overall, then, UT decision seems somewhat retrograde, moving away from the

trend towards economic/commercial realism in other recent appellate decisions and reviving the narrow 'cost-component' test from *BLP* in respect of specific attributions. While the latter is straightforward enough to apply in a paradigm case where an input is physically incorporated in the output supplied, it is less helpful for businesses such as ROH who seek to rely on less visible forms of connection, albeit where the link is equally compelling commercially.

The judgment is available [here](#).

***The comments made in this case note are wholly personal and do not reflect the views of any other members of Monckton Chambers, its tenants or clients.***