[2017] UKFTT 080 (TC)

TC05598

Appeal number: TC/2015/06354

VALUE ADDED TAX – decision to cancel registration on grounds that no business activity – assessment to recover input tax – refusal to repay input tax – construction of new recording studio – construction and equipping taking longer than anticipated – loss of initial customers – failure to secure new customers once studio completed – attributable to downturn in industry – cessation of activity without any supplies being made - whether studio intended for business activity or as a hobby

FIRST-TIER TRIBUNAL
TAX CHAMBER

GRAVEL ROAD RECORDS LTD **Appellant**

- and -

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

TRIBUNAL: JUDGE MALCOLM GAMMIE CBE QC
IAN PERRY

Sitting in public in Oxford on 5 October 2016

Mr B Townsend (director) for the Appellant

Ms Jane Ashworth, Solicitor's Office and Legal Services, HM Revenue and Customs, for the Respondents

DECISION

Introduction

1. Gravel Road Records Limited ("the Appellant") appeals against the Respondent Commissioners' decision of 12 June 2014 (confirmed on review on 17 September 2015) (a) to deregister the Appellant for VAT with effect from 29 May 2009, (b) to reduce a VAT repayment claim to 'nil' for the period 03/12 and (c) to issue a VAT assessment relating to the previous VAT returns on which VAT had been reclaimed. The decision to reduce the repayment claim to 'nil' had initially been taken on 5 September 2012 and the assessment was issued on 18 September 2012. These actions were consequent upon the Respondents' conclusion that no business activities had taken place during the period of VAT registration and that the Appellant therefore had no entitlement to claim repayment of the input tax it had suffered.

2. We had before us a bundle of documents relating to the matters in dispute. In addition, Mr Townsend gave evidence on behalf of the Appellant and answered the questions put by Ms Ashworth for the Respondents and by the Tribunal. Based on the documents before us we set out the facts in the following section, including within it Mr Townsend's evidence. We comment further on his evidence as necessary in reaching our decision.

The Facts and Mr Townsend's evidence

3. The original Gravel Road Records Ltd was registered in Scotland on 14 July 2004 under number 270675. Mr Townsend was initially the sole director and shareholder. His occupation was stated to be a composer/musician. The company traded under that name until the decision was taken to expand operations from an independent record label to that of a production and sound recording facility. For filing purposes the decision was taken to re-register in England. Accordingly, in 2009 the company changed its name to Crag Records Ltd and under a Business Asset Transfer Agreement ("the Agreement") it transferred its business to a new company – the Appellant – incorporated in England on 28 May 2009.

4. The Appellant applied to be registered for VAT from 1 April 2009 but was in fact registered on the date of its incorporation (being the earliest date possible). It did so on the basis that it intended to make taxable supplies and expected those supplies to exceed the registration limit on 1 January 2010. It estimated the value of taxable supplies that it would make in the next 12 months as £140,000.

5. The copy of the Agreement produced at the hearing was undated and unsigned but the Respondents did not contend that it had never been entered into. We therefore find that this copy correctly reflects the terms on which the business was transferred. Under Clause 2.1 Crag Records Ltd agreed to transfer its music recording and music publishing business and all its assets (including intellectual property and goodwill) to the Appellant. The main assets were evidently intellectual property and other

intangibles, but apparently not giving rise to any supplies for the Appellant in the periods with which we are concerned. The Appellant assumed all liabilities. Under clause 7.1 the parties were to use their reasonable endeavours to procure that the business transfer should be treated as a transfer of a business as a going concern for the purposes of section 49 of the Value Added Tax Act 1994 and Article 5 of the VAT (Special Provisions) Order 1995. Crag Records Ltd was later struck off the register.

6. The Appellant had two directors, Mr Townsend and Mr Robinson (also the company secretary and Mr Townsend's solicitor). The shareholders comprised Icealarm Limited, which ultimately took a 60 per cent interest, Mr Townsend as to 35 per cent and Mr Robinson as to 5 per cent. Icealarm was an unrelated external investor. No evidence was given on behalf of Icealarm and no documents were in evidence relating to its decision to invest in the Appellant. Mr Townsend said, however, that it had invested for commercial gain and would not have invested in an entity that had no intention of trading profitably in the accepted sense. He said the same was true for Mr Robinson. Neither Icealarm nor Mr Robinson had any musical aspirations, pretentions or the ability to play or perform in any way and were just investing based on Mr Townsend's knowledge and experience based on 50 years in the music/recording business. He received a salary and this cost and the cost of developing the studio were largely financed by equity contributions from Icealarm.

7. The Appellant was not in a position to offer production and sound recording services immediately because it first had to construct the studio. To that end it took a lease of industrial premises in Wantage and engaged builders to undertake the necessary conversion work. The space that was to be created included the recording studio with an office at the front, a 'meet and greet' area and a kitchen and toilets. Mr Townsend produced photographs of the studio facility during construction and at completion.

8. The papers before us include invoices in respect of rent, rates and electricity. There are invoices in respect of preparatory works in June 2009 of removing internal walls and laying concrete blocks, building work and electrical installation services and the supply of related materials. The invoices for building work are dated June and July 2009 (Atha Property Maintenance) and November 2009 (Abel Building Ltd). The invoices for electrical installation services are dated September and October 2009. There is an invoice of December 2009 in relation to the supply and fitting of acoustic laminated glass. An invoice of July 2009 relates to the provision of professional fees for undertaking an acoustic design review for the development of new studio recording facilities.

9. Other invoices include an invoice of 12 May 2011 relating to an advertisement in the "Red Alert" Armed Forces and Public Awareness Magazine and invoices of October 2010 and November 2010 relating to sponsorship of a boy's football team. It is not clear to us how either of these items might be relevant to the promotion of a sound recording studio. There were equipment lease agreements dated 29 March 2011 and related invoices of April and May 2011 for arranging a bridging facility for those agreements. Other invoices in the Appellant's and Mr Townsend's names for a

variety of dates (including some dates as early as April 2009) cover office furniture telephone and internet charges, anti-virus software, stationery (for the sum of £12.80 in April 2009), UPS deliveries, calor gas and propane, garage repairs, car hire invoices (including a London congestion charge traffic violation charge related to a hired car) and bank and finance charges.

10. In anticipation of the completion of the studio conversion work two potential clients were identified. CMR Nashville/Django Productions confirmed in December 2009 a continuing interest in recording projects at the Appellant's studio in 2010 provided the studio was tested and operational by 8 January 2010. Forward Engineering agreed on 14 October 2010 to use the recording studio from 8 November 2010 to 19 December 2010 for a total sum of £36,800. Mr Townsend's evidence was that problems began to emerge because the conversion work was taking much longer than planned. He explained that there were differing views as to the best approach in designing a recording studio. He outlined some of the design considerations in terms of insulation, placement of baffles, electrical arrangements and the creation of an acoustic design suitable for US clients.

11. He said that the first builder was inexperienced and had not properly understood aspects of the work required, in particular the insulation aspects. It became necessary to engage a second builder to complete the work. Given the passage of time Mr Townsend could not always recall precisely the timings involved but the construction work apparently stretched into 2010 before it was completed. He thought it that construction might have been complete by March or April 2010. The studio then had to be equipped. He outlined the type of equipment that was needed, some of which was evidently only available on a second hand basis. He thought that it was not until late in 2010 that the studio was fully equipped. The dating of the equipment leases may suggest it was even later.

12. In any event, by the time the recording studio was ready CMR Nashville/Django Productions had decided to use another recording studio. The same outcome was the case with Forward Engineering. Mr Townsend said that had the construction of the studio been completed within the projected timeframe and without the technical delays that had been encountered, then the level of projected business from these two clients would have made economic sense and would have allowed the Appellant to gain an industry-faced reputation that could have generated an increased and unsolicited client base later on. He estimated that a studio might generate fees of around £500 to £700 per day. However, that was not to be.

13. Once it became apparent that the Appellant would lose its two identified clients Mr Townsend said that he made considerable efforts to secure other prospective clients within the industry (including making use of gratis advertising offered by the two main clients) but to no avail. The Appellant was unable to generate any income because of the inordinate length of time taken to construct the studio facility. During that extended period the recording and music business had suffered a severe economic downturn and contraction. Mr Townsend described the industry as going through a bleak period. Many potential clients 'went to the wall'. It therefore proved too late in

the day for the Appellant to benefit from its studio facility given the state of the industry by that time.

14. Eventually Icealarm refused to continue funding the venture. As a result the Appellant ceased to trade in 2012 and forfeited its lease. The equipment leases were also terminated. Mr Townsend said that the landlord subsequently rented out the studio to two other recording businesses, both of which failed.

The Law

15. Value added tax is charged under the Value Added Tax Act 1994 ("VATA 1994") on the supply of goods and services made in the United Kingdom where it is a taxable supply made by a taxable person in the course or furtherance of any business carried on by him (ss.1 and 4 VATA 1994). A person is a taxable person for the purposes of VAT while he is, or is required to be, registered under the VATA 1994.

16. Under paragraph 9 of Schedule 3 to the VATA 1994, a person who is not liable to be registered and is not already so registered satisfies the Respondents that he is carrying on a business and intends to make taxable supplies in the course or furtherance of that business may be registered with effect from the day on which the request is made or from such earlier date as they may agree.

17. A taxable person is entitled to credit the input tax suffered on supplies made to that person so far as those supplies are attributable to taxable supplies made or to be made by the taxable person in the course or furtherance of his business (s.26 VATA 1994). In Case C-110/94 *Intercommunale voor Zeewaterontzilting (in liquidation) v Belgian State* [1996] STC 569, the taxpayer (INZO) incurred input VAT on a study as to the profitability of a desalination plant. The VAT was repaid but INZO never embarked on the planned activity and was put into liquidation. The Court of Justice nevertheless concluded that Belgium could not recover the input VAT, interest or penalties. It held that preparatory steps, even to establish the potential profitability of a particular activity, may be regarded as an economic activity conferring the status of a taxable person and giving rise to the entitlement to deduct input tax. Furthermore, except in cases of fraud or abuse, the status of taxable person would not be withdrawn retroactively just because the study had led to the decision not to move to the operational phase of the activity, so that the economic activity envisaged had not given rise to any taxable supplies.

18. In Case C-400/98 *Finanzamt Goslar v Breitsohl* [2001] STC 355, Mrs Breitsohl applied to a car manufacturer for a dealership and acquired land for use in the same and repair of motor vehicles. She commissioned a builder to construct a motor vehicle repair workshop on the land and work commenced. It soon became apparent, however, that the overall cost of building works would exceed the planned budget and her bank refused to finance additional work. She was therefore forced to make a tax exempt sale of the land. The Court of Justice nevertheless concluded that the right to deduct input VAT paid on transactions carried out with a view to the realisation of a planned economic activity remained even where the Revenue authority was aware,

from the time of the first tax assessment, that the economic activity envisaged, which was to give rise to taxable transactions, will not take place.

19. The operation of a sound recording studio for use by third parties for payment is plainly an economic activity that will give rise to taxable transactions. A sound recording studio designed and set up solely for the personal gratification and use of the individual in question, without any intention of making taxable supplies, would not be. In this respect the Respondents relied in particular on the decisions in *Customs and Excise Commissioners v Morrison's Academy Boarding Houses Association* [1978] STC 1 and *Customs and Excise Commissioners v Lord Fisher* [1981] STC 238 as providing the relevant tests to determine whether the Appellant's intended activities amounted to a business.

20. In *Morrison's Academy*, Lord Emslie in the Court of Session summarised the position arrived at by the Tribunal as follows ([1978] STC at 3):

> "The problem for the tribunal, accordingly, was one of interpretation of s 2(2)(*b*) of the 1972 Act in the context in which it appears in the Act and they resolved that problem by holding that the word 'business' for the purposes of that subsection connotes the carrying on by the taxable person of activities of a commercial nature having as their object the pursuit of profit or gain. In so interpreting s 2(2) the tribunal followed all earlier decisions of the tribunal elsewhere in Britain in cases in which the construction of the subsection was in issue. On their finding that the association does not seek to make profits the reason for the decision reached by the tribunal was that they did not consider that there was any commercial element in the association's activities."

21. In reversing the Tribunal's decision, Lord Emslie said this (at page 6):

> "In my opinion it will never be possible or desirable to define exhaustively 'business' within the meaning of s 2(2)(*b*). What one must do is to discover what are the activities of the taxable person in course of which taxable supplies are made. If these activities are, as in this case, predominantly concerned with the making of taxable supplies to consumers for a consideration it seems to me to require no straining of the language of s. 2(2)(b) of the 1972 Act to enable on to conclude that the taxable person is in the 'business' of making taxable supplies, and that taxable supplies which he makes are supplies made in the course of carrying on that business, especially if, as in this case, the supplies are of a kind which, subject to differences of detail, are made commercially by those who seek to profit by them."

22. Lord Cameron also said (at pages 8-9):

> "The word 'business' in its dictionary meaning can include 'occupation' or 'function' and in my opinion the word 'business' as used in s 45(1) and therefore in s 2(2) is sufficiently comprehensive to include within its meaning 'occupation' or 'function'. An occupation does not necessarily have as one of its objects the pursuit or promotion of profit or gain and a function can be

discharged without yielding a profit; nor can it be said that the word 'business' is necessarily tied to such occupations or callings as are wholly commercial and pursued for the purpose of profit or gain. Indeed it is commonplace that for perfectly sound commercial reasons certain commercial undertakings can be carried on with the deliberate purpose of making neither a profit nor a gain or even in certain circumstances a loss, yet the absence of an objective of profit or gain should not and would not deprive the undertaking of the appellation of business."

23. As a result, the activities of the Housing Association which were deliberately and continuously carried on by it in a business-like way constituted a business notwithstanding that their motive was to assist Morrison's Academy by providing accommodation for pupils.

24. In *Lord Fisher's* case, the taxpayer's main hobby was shooting but he sought substantial contributions to the costs by those whom he invited to join the shoot on his estate. Gibson J concluded that 'business' did not include any activity which was no more than an activity for pleasure or social enjoyment and the mere sharing of costs of a sporting or other activity engaged in for pleasure or social enjoyment by those participating in it did not by itself turn the activity into a 'business'.

HMRC's submissions

25. Ms Ashworth took us through the correspondence leading up to the decision on review. Based on the decisions in *Morrison's Academy* and *Lord Fisher's* case and on a detailed consideration of the criteria they adopted, as set out in the Respondents' review letter, Ms Ashworth for the Respondents posed the following questions:

(1) ***Is the activity a serious undertaking earnestly pursued?*** Ms Ashworth submitted that the only evidence offered by the Appellant comprised one letter and one e-mail from two prospective customers claiming to have an interest in using the studio, the first dated November 2010 and the second January 2010. She said that this was insufficient to indicate any "earnest pursuit" of a recording studio business.

(2) ***Is the activity an occupation or function, which is actively pursued with reasonable or recognisable continuity?*** Ms Ashworth submitted that there had been no frequency to the Appellant's business activities. No supplies had been made and, as in (1), only two items had been provided to illustrate any attempt to get any business. There was minimal evidence of any advertising and none of the contracted electrical and building work illustrated a definite intention to pursue a business activity with the aim of making taxable supplies.

(3) ***Does the activity have a certain measure of substance in terms of the quarterly or annual value of taxable supplies made (bearing in mind that exempt supplies can also be business)?*** Ms Ashworth submitted that no supplies had ever been made and no business plan had been produced to indicate that the suggested turnover of £140,000 per annum entered on the VAT 1 had any real basis.

(4) ***Is the activity conducted in a regular manner and on sound and recognised business principles?*** Ms Ashworth submitted that there was no evidence to suggest that the activity was supported by a sound or commercial business plan. There was nothing that could be described as 'regular' in the activity or which was representative of 'sound and recognised business principles". There were invoices for telephone, building work and van hire but these did not provide any necessary support for the idea that the Appellant was engaged in a business activity.

(5) ***Is the activity predominantly concerned with the making of taxable supplies for a consideration?*** Ms Ashworth submitted that although the activities described on VAT 1 would have given rise to taxable supplies if made for a consideration, no taxable supplies had in fact ever been made. The delay in construction was the reason given for the loss of two prospective customers but there was no evidence to suggest what action the Appellant had taken to resolve these issues with a view to making taxable supplies in the future.

(6) ***Are the taxable supplies that are being made of a kind which, subject to differences of detail, are commonly made by those who seek to profit from them?*** No taxable supplies had been made and none of the evidence pointed to the existence of a business concerned with profit or income.

26. Ms Ashworth submitted that based on those principles and having regard to the evidence the correct conclusion was that the Appellant was not in business for VAT purposes and its appeal should therefore be dismissed.

The Appellant's submissions

27. Mr Townsend said that this was not a 'hobby' activity. 'Hobby' studios did not require the investment undertaken by the Appellant. He said that recording facilities in the 'hobby' sense were generally accommodated in a room or a garage within a residential property and equipped with 'in-home' studio consoles, monitors and outboards. Such 'hobby' facilities cannot usually produce recorded product fit for general release in audio or visual format. Their set up costs were a fraction of the cost of the acoustic design, construction and specialist equipping of a professional commercial recording studio in a leased industrial space such as that created by the Appellant. This could be seen from the photographs that had been produced of the facility, which illustrated his point that this was an investment that would only be undertaken by a commercial venture. The fact that the Appellant's recording studio was constructed in commercial premises offered a further indication of the intention to trade as a commercial business.

28. The majority shareholder (initially with a 40 per cent interest but subsequently increased to 60 per cent) was only interested in investing in a business that would generate a commercial return on its investment. The same was true in Mr Robinson's case. In contrast to Mr Townsend, the other shareholders had no personal interest in the music or recording business other than through the commercial return that the Appellant hoped to generate through its business.

29. As he had explained in his evidence, the construction delays meant that the Appellant was unable to provide the intended facilities to its initial customers. Furthermore, during the extended construction period the recording and music industry market had suffered a severe economic downturn. As a result, by the time the construction issues had been resolved the Appellant's potential client base had virtually disappeared. It had nevertheless been the Appellant's intention throughout, however, to conduct a commercial recording studio business.

Our Decision

30. Our decision can be shortly stated. The invoices produced by the Appellant are not entirely satisfactory in what they show but in essence they tend to support rather than contradict the key elements of Mr Townsend's evidence. We therefore accept his evidence. We think that his evidence was persuasive that the scale of investment in the construction and equipping of the recording studio in leased industrial premises points to an intention to pursue a commercial business activity. The construction and equipping of this recording studio does not appear to us to be a 'hobby' activity. It was financed almost entirely by a third party, Icealarm Limited, and there was nothing to contradict Mr Townsend's evidence that Icealarm was investing in a recording studio that was intended and designed (and had at the outset the potential) to repay its investment and to make a commercial return for it on that investment.

31. The documents (other than perhaps the telephone bills) offer no particular evidence of any significant efforts on Mr Townsend's part to promote the Appellant's business or to secure further clients for it once the delays in constructing and equipping the studio had resulted in the loss of the two initial clients. On the other hand, we have no reason to doubt Mr Townsend's evidence on the downturn and 'bleak period' suffered by the industry, which overtook the Appellant as well as other industry participants.

32. We conclude that the Appellant at all times intended to carry on a commercial business activity that was intending to make taxable supplies and was entitled to request that it be registered for VAT. We therefore conclude that the Respondents were wrong to cancel the Appellant's registration retrospectively from the date of registration. We accordingly allow its appeal on that issue.

33. On that basis the assessment designed to recover input tax previously repaid to the Appellant should also fail and the decision to refuse repayment of input tax claimed for the period 03/12 should be reviewed. In this respect the correspondence and the Respondents' Statement of Case note that the Appellant had not produced invoices to justify all of the input tax claimed and, as we have noted, not all the invoices produced at the hearing appear entirely satisfactory to us. Ms Ashworth said nothing about this aspect of the matter at the hearing, resting the Respondents' case entirely on the issue of whether the Appellant was correctly registered in the first place. Given that the Appellant has ceased any activity and may be insolvent or at least dormant with no remaining assets, it may be that the Respondents will be content to discharge the assessment and not enquire further into its VAT affairs. In the absence of any submissions by the parties on this aspect of matter, however, we leave

the resolution of the assessment and repayment of input tax claimed for the period 03/12 to their agreement in the light of our decision on the first issue, with liberty to apply to the Tribunal for a final determination of those two matters should they be unable to agree.

34. This document contains full findings of fact and reasons for the decision on the registration issue. 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.

MALCOLM GAMMIE CBE QC
TRIBUNAL JUDGE

RELEASE DATE: 10 JANUARY 2017